HBF submission to inquiry into leasehold reform

ABOUT THE HOME BUILDERS FEDERATION

The Home Builders Federation is the representative body for home builders in England and Wales. HBF's membership of more than 300 companies contributes around 80% of the private new homes completed in England and Wales, and encompasses private developers and Registered Providers. The majority of home builder members of the HBF are small and medium sized companies.

INTRODUCTION

HBF welcomes the opportunity to contribute to the Select Committee's inquiry into the Government's leasehold reform agenda. This provides a useful and timely opportunity to consider the breadth and depth of the current proposals and take stock of the progress made to date in addressing instances where the leasehold system has been discredited.

Our response focuses on several important areas which have emerged as significant areas of interest for policymakers and media as part of the current leasehold reform agenda:

- Interests of existing leaseholders
- Distinguishing between issues for house and flat owners
- 'Onerous' lease terms
- Potential impact of 'zero ground rents' on ownership and management of buildings
- Problems with the current commonhold regime as an alternative to leasehold for flats

INTERESTS OF EXISTING LEASEHOLDERS

At the outset, it is crucial, when discussing leasehold reform to place recent concerns in context. With some high profile exceptions, the leasehold tenure of home ownership works very well for the vast majority of the four to five million leaseholder households who currently own their homes in this way. On apartment schemes leasehold has for generations been the only genuinely appropriate and universal tenure. The system of ownership itself has rarely presented any major issues for leaseholders or the housing market in general over many years. At the heart of this system are ground rents and other lease terms which, if and when they are fair and reasonable, and do not impinge on a property's value or an owner's ability to secure mortgage finance against that home.

Home Builders Federation
HBF House, 27 Broadwall, London SE1 9PL
Tel: 0207 960 1600
Email: info@hbf.co.uk Website: www.hbf.co.uk
Twitter: @HomeBuildersFed

Most leases originated for new build flats and houses have included fair and reasonable ground rents. This fact is reinforced by the fact that these properties have been purchased with mortgages and with professional oversight by purchasers' solicitors often multiple times and with no impact on value or the homeowners' ability to mortgage or remortgage the property. With the current reform agenda in mind, care should be taken not to adversely affect the mortgageability – and thus the value – of the existing leasehold properties which have, until now had no such issues.

Care should be taken in the way campaigners, politicians and media address the issue of leasehold reform. Exaggeration of the prevalence of leasehold houses and 'onerous' lease terms risks undermining a tenure that many millions of people have considerable security tied up in. Rhetoric implying the existence of two-tier property ownership may score points but is inaccurate and has consequences for millions of households.

DISTINGUISHING BETWEEN LEASEHOLD HOUSE AND LEASEHOLD FLAT ISSUES

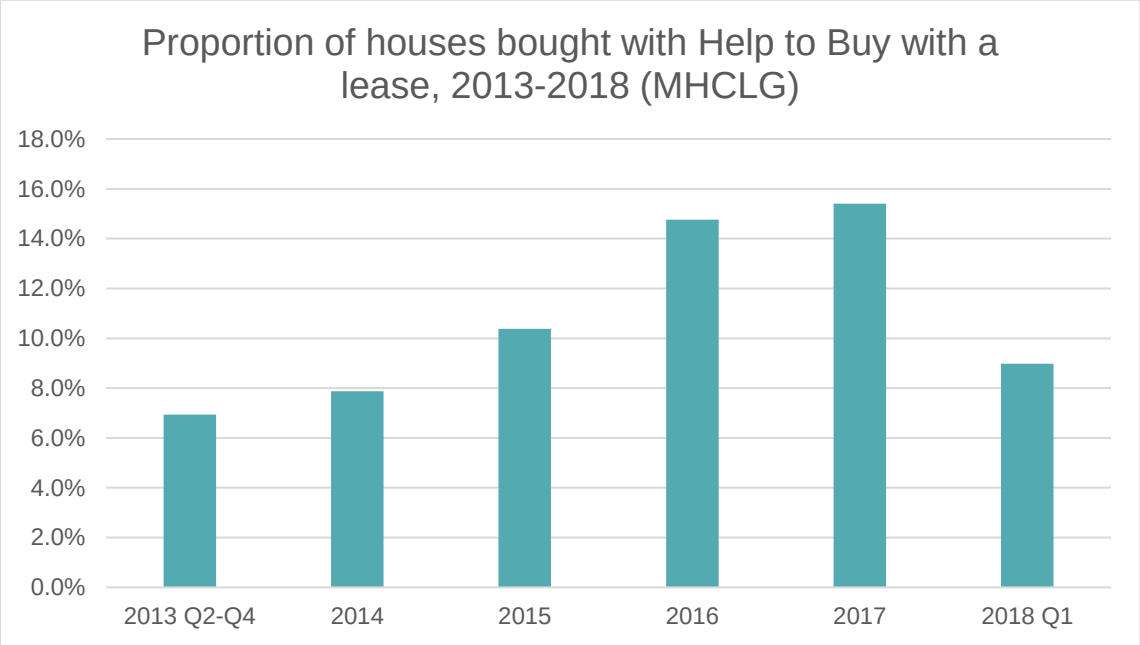
It is important to distinguish between the Government's policy objectives and statements on leasehold houses and flats. While the house building industry has acknowledged and reversed the growth in production of new leasehold houses, leasehold is widely recognised as the most appropriate tenure for multiple dwelling buildings and developments, particularly where there are many shared facilities and spaces.

Leasehold houses

The vast majority of new build houses are, and always have been sold on a freehold basis. At times it is necessary to sell houses with leases, including where the developer itself does not own the freehold title to the land.

It is important to remember that while both the number and proportion of leasehold houses increased between 2013 and 2017, the absolute numbers are inflated by (a) a major increase in housing supply, up 74% in the period between 2013 and 2017 alone, and (b) a change in what the industry was producing, with MHCLG statistics showing an increase in the production of houses from 75% of new dwellings in 2013/14 to 81% by 2017/18.

Even allowing for rapid growth in housing supply and a change in product mix, the proportion of houses sold on a leasehold basis have declined significantly over the past year. Using MHCLG's data on Help to Buy as a useful proxy for new build sales representing, as it does, a large proportion (circa 40%) of new build sales, we can see for the data available for 2018 to date, 9% of households purchasing a house with Help to Buy own the property with a lease. When the scheme began in 2013, this rate was at around 7%, reflecting what is thought to have been the long-term 'natural' rate of new houses sold as leasehold properties.



Many new houses will be on sites where the developer itself does not own the freehold title to the land. It has long been common for certain landowners, when disposing of sites for development, to retain the freehold title. Landowners such as the Crown, local authorities and other public bodies have traditionally sold land in this manner. It is notable that in its consultation document, *Tackling Unfair Practices in the Leasehold Market,* Government proposed exceptions to the ban on leasehold houses for land held by the Crown, Church, National Trust, universities and local authorities.

Leasehold flats

For multi-dwelling buildings and developments, leasehold is currently the only feasible mainstream tenure, particularly for developments of any scale. Most leases originated for new build flats have included fair and reasonable ground rents, reinforced by the fact that over many years and decades, new build apartments have continued to be re-sold from household to household and with the oversight of countless solicitors. The leasehold structure, with an appropriate and proportionate ground rent providing economic value to a freeholder in return for long-term custodianship of the building and/or grounds, provides certainty and security for homeowners and mortgage lenders where householders are interdependent, sharing space, facilities and services.

The Government has proposed the introduction of a maximum ground rent, described either as 'zero ground rents' or 'peppercorn ground rents'. Whilst a precise definition of these terms is yet to come forward, the literal interpretation of zero ground rents would essentially result in a dismantling of the leasehold system with the often important role of the active third-party freeholder eliminated. The implications of this for the management and maintenance of apartment buildings is discussed in more detail below.

'ONEROUS' LEASE TERMS

Based on discussions with many HBF members, we consider that very few, if any, leases with ground rents doubling at intervals of 10 years or more frequently have been created in recent years.

Several companies that originated such leases, usually in the late 2000s, have made efforts over the two years to vary the relevant leases through negotiation with the current freeholders. Most notable in this regard is Taylor Wimpey set aside £130 million for this purpose. This process inevitably involves complex negotiation between multiple parties and can take considerable time. It is in the long-term interests of responsible investors, who understandably view ground rents as a low risk investment, to work constructively with other parties on this and this generally seems to have been the case. In the meantime, and in the absence of variations of some leases, it is important that mortgage lenders act responsibly in their treatment of properties which have always previously passed the test of reasonableness and value retention.

The lack of any reliable information on the number of homes with leases deemed 'onerous' presents difficulties, both in generally determining the extent to which such leases are still in existence, and in the creation of a vacuum for misinformation to spread.

POTENTIAL IMPACT OF ZERO GROUND RENTS ON OWNERSHIP AND MANAGEMENT OF APARTMENT BUILDINGS

As individual apartment owners acquire leases – usually of 250 to 999 years – the freehold interest in the building is retained by the developer and most often sold to a third party investor who will collect ground rents from leaseholders within the building over the lifetime of the associated leases. Respected institutional investors such as pension funds are typically the ultimate purchasers of the freehold title.

Without a mechanism for deriving income from the proprietorship of a building and other communal space on a development on which homeowners possess very long leases, the ownership of the building or estate has nearly no value, and would most likely be viewed as a liability. The vast majority of house builders have neither the expertise nor the inclination to retain freehold titles and provide long-term stewardship, and doing so would run counter to the objectives of the typical business model.

The role of a responsible freeholder

The role that an active and engaged freeholder can play in the lifecycle of an apartment building is often overlooked, and in many respects this is to be expected as the freeholder, as custodian of the building or estate provides a very long-term view on the decisions affecting the building and grounds. In contrast, a management company's interest in an estate is temporary and in extreme circumstances its interests can sometimes best be served by ceasing its involvement in the management of a building where complex situations arise.

Whilst individual households will have their own perspectives with priorities understandably in some instances short-term, and management companies being appointed for time-limited periods, the freeholder's is the only interest in the system that always stretches beyond a handful of years. For instance, in certain situations, many current homeowners would prefer to delay extensive remedial works, when they foresee selling their property in the intervening period. Doing so would pass on the liability for the apartment's share of the cost of the necessary works to the next owner; an entirely rational approach to take, particularly for a transient owner who may be trying to finance a move up the housing ladder. Transience is also a feature of the management company's interest in the building. Even within the contractually agreed period, management companies can occasionally decide to step away from a building where issues have increased in complexity or where relationships between leaseholders or with leaseholders have become fractious. This approach is not possible for freeholders who retain the longest term interest in the building.

As the ultimate long-term owner of a building, the freeholder is well placed to make decisions based on the value of the estate (and thus the saleability and value of component apartments) over the entire lifespan of the homes, extending even further than the period of the leases. When determining the best course of action with regards to remedial works or general maintenance, it is likely, therefore, that by far the longest term view will be taken by the freeholder which serves to also protect the 25-30 year interest of a mortgage lender (where occupiers owns with a mortgage). Should emergency works be required to a building, for instance, where major health and safety concerns emerge, a freeholder may also be able to assist the management company and residents to resolve issues quickly. This could involve the long-term loan to the service charge account allowing residents to bear any additional costs over a more protracted period rather than through a large payment which unfairly places the burden on existing homeowners rather than those who may benefit from improvements over many years. This can be made possible by the scale of many freehold investors compared with individual management companies which are less likely to be able to make such commitments.

A freeholder, providing effective oversight of the management of its asset, can also be extremely important in ensuring the financial strength and preparedness of the management company and residents, minimising the potential for arrears on the service charge account to arise which result in expensive, 'lumpy' payments when works are required.

The system without freeholders

Some campaigners have promoted a model of ownership that involves apartment owners holding a share of the ownership of all communal facilities and infrastructure. This is effectively a form of Commonhold. While superficially attractive, this system of ownership can bring with it a more short-termist approach while increasingly the likelihood of disputes amongst homeowners.

It is not clear that a large proportion of apartment owners or prospective purchasers would necessarily wish to take an active role in the management and financial oversight of the communal facilities on their estate, or even be entirely responsible for the appointment, re-appointment and replacement of management companies. An alternative that still allows for freeholders to play the often important role that many currently do but at significantly less cost to homeowners could help to achieve this balance.

Currently fewer than half of mortgage lenders lend on Commonhold apartments. There could be several reasons for this, and is currently the subject of a Law Commission inquiry, but one often cited cause of the lack of mortgage availability is the potentially unsatisfactory security in the event default by the borrower. This is discussed in more detail below.

Impact on sites of marginal viability

Income from ground rents on apartments has routinely been factored into appraisals supporting land acquisition. For many large schemes, this represents an important sum which feeds through into land value, affordable housing provision and infrastructure contributions.

Over time, it is not unreasonable to assume that land values will adjust, and affordable housing provision may be modified to ensure that a reasonable proportion of such sites remain economically viable for developers. However, a proportion of sites that have effectively no residual land value, or may even have a negative land value, will cease to be viable and will not come forward for development. Such sites will typically be on brownfield land in urban areas with additional development costs due to remediation of contaminated land or complexity of build. As stated above, without a suitable transition it is foreseeable that a large number of residential development sites could be affected. Assuming some transition period is determined, there would be far fewer sites affected but, inevitably, there are always likely to be sites of marginal viability coming forward. Where these have a land value that can reasonably be adjusted, they may still come forward provided there is still enough value to satisfy a willing land seller.

The impact of potential changes to ground rents on the future viability of development sites is, however, a particular concern for the developers of specialist retirement housing, which is usually sold as leasehold because of the extensive communal facilities and services provided. These developments are typically located on inner urban brownfield sites, with competing alternative use values and site remediation costs, where viability will inherently be more challenging. Receipts from the sale of capitalised ground rent income provides a significant contribution to the investment finance of these schemes, in particular contributing to the cost of providing their significant communal facilities while maintaining sales prices for apartments which are affordable to purchasers.

Specialist retirement developers have serious concern that setting ground rents to zero value would render a significant number of their schemes unviable and adversely affect their current business plans to increase supply to meet the shortfall in the provision of housing for older people, and are, therefore, seeking a suitable exemption to the proposed general policy.

COMMONHOLD AS AN ALTERNATIVE FOR FLATS: PROBLEMS

Without a major legislative overhaul, it is very unlikely that commonhold could provide a suitable alternative to the leasehold structure that works for many millions of households. Academic research indicates that of the 16 Commonhold schemes currently in England, a common feature is their relatively small scale with just three of these comprising 10 or more homes, and a median scheme size of 6.5

properties. Indeed, the largest Commonhold scheme in operation is a caravan park of 30 units.[1] Furthermore, a sizeable proportion of current commonhold schemes were constituted to support the ownership of multiple dwellings among family members suggesting that its application has been targeted mostly at subtly formalising an otherwise entirely informal, familial relationship, bearing no comparison to the reality for most multi-unit housing schemes.

Mortgage finance on commonhold titles

The availability of mortgage finance, or lack thereof, has long concerned developers as and when they have weighed up the possibility of creating commonhold structures for new residential schemes. A survey in 2014 found that fewer than 40% of mortgage lenders stated that they would lend on commonhold titles. There is little to point to any significant change in the appetite amongst lenders to advance loans on this type of housing since 2014.

New build mortgages tend to be specialised with a concentration of loans originated by a handful of lenders.[2] Amongst the most prominent in this field, the consensus was either that they would not lend on commonhold or that they would only do so on a qualified, or case-by-case basis. So while it may be possible to find a mortgage offer, the choice and variety would be minimal. The breadth of the mortgage market is also important as individual lenders often limit their own exposure to a location or site meaning that later purchasers could see options reduced even further. For commonhold, with intrinsically more risk associated for lenders, this threshold may be introduced for lenders at a lower level exacerbating its impact.

A common reason given for the lack of mortgage availability and choice, as set out in the Call for Evidence document, is the inadequate security offered to mortgage lenders by a commonhold title. In addition, any doubts about the ability of commonhold associations to properly manage and maintain apartment buildings, even if only relevant in a small number of circumstances, should be looked at.

Health and safety

A feature of interdependent home ownership schemes such as leasehold and commonhold is the responsibility that property owners and residents have towards each other. Freeholders in the leasehold system have the ability to ensure compliance with lease terms in a way that may not be possible under current commonhold arrangements. In the day-to-day running of an apartment building, the servicing and maintenance is of great importance to residents, but compliance with health and safety requirements are unmistakably of even greater importance. The presence of an engaged, proactive freeholder in the leasehold system introduces an additional check in the, to help ensure that buildings are safe for residents. The most obvious example of where this might be seen is in ensuring that regular fire risk

[1] Lu Xu (2014), 'Commonhold Developments in Practice', *Modern Studies in Property Law: Volume 8*

[2] Xu (2014)

assessments are conducted. And where remedial work is required to support health and safety objectives, a conscientious freeholder will be well placed to assist the management company and apartment owners.

The importance of the freeholder-leaseholder relationship, and enforcement, is important. It is not immediately evident that enforcement mechanisms within the commonhold framework would be as effective as those currently in operation for leasehold schemes where, for instance, a resident has replaced a front door with a less fire resistant one.

Commonhold for mixed-use schemes

The construction of mixed use developments, blending commercial or leisure facilities with residential schemes is a major source of housing supply, particularly on previously developed land in urban areas and such schemes provide many excellent examples of place-making. The practicality and effectiveness of commonhold for such developments is uncertain.

While there may be a technical legal solution to the issues relating to the process of managing the development (albeit likely a fairly convoluted 'layered' legal structure), concerns remain unanswered about the security that commercial tenants may derive from the overarching rules governing the commonhold structure. For instance, under current leasehold practices a commercial tenant will have the security of an inviolable lease agreement clearly establishing general service levels and the relative contributions to those services to be made by residential and commercial occupants alike. It is on this basis that the commercial tenant will obtain the necessary security to invest in a long-term occupancy. However, in a layered commonhold structure the ability to alter service levels and relative contributions would ultimately rest with the uppermost tier, meaning that commercial operators may be subject to changes to the nature of the services it receives as a product of the commonhold decision-making process. This could affect business-critical services such as security or cleansing and the lack of certainty would either make commercial space less valuable or saleable, or involve fundamentally redesigning future schemes to clearly delineate commercial/leisure amenities and residential spaces even where this is inconsistent with good design and place-making principles.

The role of management companies in commonhold schemes

While informal arrangements for building services abound for current commonhold schemes, it is obvious that if larger scale developments are to operate on a commonhold basis then management companies and/or specialist advisors and consultants to commonhold associations are likely to play a part in ensuring the obligations of directors and members are met. This would appear to be the common practice in Australia where strata managers are typically employed to manage commercial relationships on behalf of the property owners. Establishing a clear and efficient legal route for commonhold associations to engage professional assistance and advice in managing its assets would be beneficial if this tenure is to expand in this country.

In Scotland where the system of interdependent home ownership is not dissimilar to commonhold, it is estimated that between a third and a half of apartment owners 'self factor', but this can result in contractors

being reluctant to take on extensive work without payment upfront because of the danger they will have to seek payment individually from each and every owner. Advisory websites for property factors and homeowners in Scotland report that finding a property factor outside of Glasgow can be hard for property owners. Because of the extensive involvement that factors have in schemes, they can be reluctant, too, to take on complex developments or those that have experienced problems in the past collecting service charges from residents, managing accounts or maintaining a register of property.[3]

Flexibility, phasing and development finance

Current commonhold law allows for changes to commonhold statements at any point during its existence, because ownership of the communal spaces is passed to owners at the point at which they complete on the home, and when the majority of the homes are sold it may become practically difficult for house builders to adapt future parts of the sites. For instance, after the completion of just a handful of units on a large site, it would theoretically be possible for property owners to seek to alter the terms of the commonhold statement which is critical in establishing the principles, obligations and remit of the commonhold association and its directors and members. At the point at which more than half of the units are occupied, control of the remaining site and associated development rights could be compromised or, at least, made less secure.

On very large, multi-phase residential developments, it is likely that detailed planning consent will not yet be granted for later phases which would make the creation of a commonhold statement and the transfer of common parts and shared facilities to owners a very tricky balancing act to undertake for developers. Should plans for later phases be required to change, either in layout, house type mix or tenure mix, it is not immediately clear how this would be achieved in compliance with what may be a highly specific commonhold community statement.

[3] www.underoneroof.scot