Consultation response

DCLG consultation

Tackling unfair practices in the leasehold market

September 2017

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This document contains information and policies that were correct at the time of publication.

Shelter

Shelter helps millions of people every year struggling with bad housing or homelessness through our advice, support and legal services. And we campaign to make sure that, one day, no one will have to turn to us for help.

We're here so no one has to fight bad housing or homelessness on their own.

Introduction

Shelter welcomes the opportunity to respond to this consultation. We believe that abuse of the leasehold system, as outlined in the consultation document, has its roots in our broken housebuilding system. There is nothing inherently wrong with leasehold: it is a well-established form of tenure[1], that can give homeowners a very high degree of security in their ownership. Leasehold can particularly suit apartment blocks with shared areas that need to be maintained. It can also be a useful tool for tackling issues around affordability of homes and the funding of local services. Leasehold underpins restricted resale models to maintain affordability, such as those used by Community Land Trusts and by Pocket Living. It can also help to ensure the long term stewardship of new places and enshrine leaseholders' obligations to public benefits, such as the obligation to contribute to communal upkeep costs, preserve design features, or abide by the principles of the project.

The critical issue in question is not the leasehold system per se, but its abuse in recent years. This abuse is most acutely demonstrated through the use of onerous ground rent terms in order to generate additional development value for the housebuilder, and an ever-increasing income stream for the eventual freeholder. As Shelter set out on our blog in February 2017, this has left leaseholders trapped, facing ever growing charges to live in their own homes, and unable to sell them. We believe that fundamentally, rather than being a question of greed on the part of housebuilders, this practice has its origins in our dysfunctional land market.

Competition between developers is focused in the land market. Developers compete to buy land using a method known as residual land valuation. The value of land is calculated as the total value of the homes that could be built on it – what they could be sold or let for – minus the costs of building those homes, putting in the roads and utilities to support them, and a return for the developer. This is why we characterise it as the speculative housebuilding model: housebuilders must guess how much they will be able to sell homes for, several years in advance, and then commit themselves to a land spend which reflects those estimates. If they get it right, and the total costs of development are projected to be less than the total value of what is going to be built, the developer will make a profit, and the scheme is said to be 'viable'.

Increasingly, we have seen this residual valuation process distorted to maximise land values, and win the competition for land to build on. By making ever more generous assumptions about the eventual price homes could be sold at, cutting corners on the quality of new homes, and negotiating away obligations to provide affordable housing or infrastructure, housebuilders can offer more to landowners than their competitors. However, there is an argument to be made that builders are reaching the limits of their ability to do this – even in our over-heated property market there are limits to how much homes can be sold for, and to how much you can cut corners on quality and developer contributions. So developers are looking for innovative ways to get an edge in the land market – and future income from ground rents (in effect, diluting ownership), is one way to achieve this.

Shelter strongly believes that abuse of the leasehold system through the imposition of onerous ground rent conditions needs to be stopped. However, this will only tackle the symptoms of the problem, not its underlying cause. We need clear and decisive intervention in order to rebalance the land market, and ensure that more of the value generated by development goes towards providing the infrastructure and amenities needed to support it – rather than to ever increasing rewards for landowners.

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[1] Almost 10% of homeowners are leaseholders; DCLG, English Housing Survey statistical table FT2231 (S322): whether accommodation is owned freehold or leasehold

Summary

Sale of new build leasehold homes:

- Shelter does not think that the sale of leaseholds should be restricted across the board, as there are numerous valid uses of leasehold, including for new build houses. Efforts should focus instead on ending the unjustifiable abuse of ground rents.
- if the government *is* determined to limit the sale of new build leasehold houses, then sufficient but tightly-drawn exemptions must be made for community-led models such as Community Land Trusts.
- Shelter believes that paragraph 173 of the National Planning Policy Framework (NPPF) should be amended to state that developers and landowners should be entitled simply to 'a return'. This could include an explicit statement that any impact on the viability of schemes caused by changes to the use of leasehold will not be counted in any assessment of reasonable return.
- sales of new build leasehold homes should be supported by the Help to Buy Equity Loan where freeholds are transferred to or retained by an organisation which will recycle all income derived from ground rents into community facilities and local services in a fair and transparent manner. If community-led housing schemes include a proportion of homes for sale on a leasehold basis, such sales should also be eligible to be supported by the Help to Buy Equity Loan, to prevent these schemes being unfairly discriminated against.

Issue of onerous ground rents and potential impact of any changes on the existing development pipeline:

- housebuilders should not be compensated at the expense of local communities, or indeed the taxpayer more broadly, simply because the government has been forced to address housebuilders' own abusive practices. Housebuilders have profited from the abuse of leasehold, and they should bear the costs of adjusting to a world in which such abuse is prevented by law.
- Shelter agrees with Nationwide Building Society that the maximum appropriate starting ground rent on new build leasehold properties is 0.1 percent of the property's value.
- it would be reasonable to restrict increases in ground rent terms to an inflation linked measure such as the Consumer Price Index, as this would give leaseholders a fair degree of certainty while ensuring that, over time, ground rents do not lose their value.
- as the problem of onerous ground rents has been largely created by housebuilders, it would be reasonable for the government to require them to bear the costs of adjustment and of supporting existing leaseholders.
- where developers are willing to voluntarily take on the costs of adjustment and of supporting existing leaseholders they should be allowed to, provided the resolutions arrived at for leaseholders are identical to those achieved through legislation.

Exempting leaseholders potentially subject to 'Ground 8' possession orders:

- the government **should** amend the Housing Act 1988 (as amended by the Housing Act 1996) to ensure a leaseholder paying annual ground rent over £1,000 in London or

over £250 in the rest of England is not classed as an assured tenant, and therefore cannot be issued with a Ground 8 mandatory possession order for ground rent arrears.
- the government should also take the opportunity to look at the impact of Ground 8 mandatory possession orders for leaseholders in shared ownership.

Service charges for maintaining communal areas and facilities on freehold and mixed tenure estates:

- the government **should** promote solutions to provide freeholders equivalent rights to leaseholders to challenge the reasonableness of service charges for the maintenance of communal areas and facilities on a private estate. Anyone liable to pay service charges should have equal right to challenge them. In addition, by making service charges clearer and more transparent, the need to challenge them should be reduced.

Response to specific consultation questions

Question 1: Are you responding as:

On behalf of an organisation.

Question 3: If you are responding on behalf of an organisation, is the interest of your organisation as:

Other: Shelter, the national housing and homelessness charity.

Question 4: Please enter the first part of the postcode in England in which your activities (or your members' activities) are principally located (or specify areas in the box provided):

Nationwide – Head Office based in EC1V and Hub offices in 11 towns and cities across England.

Limiting the sale of new leasehold houses

Question 5: What steps should the government take to limit the sale of new build leasehold houses?

Shelter does not think that the sale of leaseholds should be restricted across the board, as there are specific valid uses of leasehold, including for new build houses. As detailed below, efforts should focus instead on ending the unjustifiable abuse of ground rents.

However, if the government is determined to limit the sale of new build leasehold houses, then sufficient exemptions must be made for community-led models such as Community Land Trusts. One approach might be to legislate that any income collected by a freeholder should be restricted for reinvestment into community services and amenities. The principle of an 'asset lock' can be a helpful way to ensure that this is the case – whether this is a legal requirement for the structure in question or whether it is voluntarily adopted. Ideally, there should be a role for community ownership or management of freeholds through a Community Land Trust structure or similar. There are circumstances in which community-led housing schemes need to issue dividend-paying shares as a means of raising finance for the overall scheme: it is critical that any steps taken to limit the sale of new build leasehold houses does not prohibit this course of action.

Question 6: What reasons are there that houses should be sold as leasehold other than under the exceptions set out in paragraph 3.2?

Community-led and custom build housing

Community Land Trusts, and similar models like cohousing or community custom build, make good use of leasehold structures, and are not implicated in abuses of the system. Indeed, they represent models to improve the housing market. They should continue to be allowed to sell homes – including houses - on a leasehold basis, with the freehold retained by the Community Land Trust or similar body.

Community-led housing models typically use leasehold for two primary purposes:

1. to enable the house to remain affordable in perpetuity, using restricted resale conditions on the lease

2. to allow income from ground rents to be reinvested in the community, whether through the maintenance of community facilities, the delivery of local services, or new development.

Both of these are positive responses to the severe housing problems we face, and should be encouraged not obstructed by any change in policy.

Garden towns and villages

One of the key principles of the garden city movement is that of land value capture for the benefit of the community. One way in which this can be delivered over the longer term is through retention of freeholds by local trusts, with income from ground rents restricted for investment in the local area.

New Home Zones

In Shelter's New Civic Housebuilding report, we advocate the introduction of a new planning tool, New Home Zones. These would be an exceptional planning tool for large scale development, used to deliver high quality new places in addition to the existing speculative housebuilding system. New Home Zones would be masterplanned according to strict, evidence-based policy requirements, and delivered by a new generation of development corporations.

Development corporations delivering New Home Zones could well need to use the leasehold system as a means of parcelling out development sites to SMEs and other developers without losing control over them. Retaining the freehold enables the development corporation (or similar body) to ensure adherence to the requirements set out by the masterplan. Acquiring a lease allows the purchasing developer to be able to raise finance. It is important in this case not to create opportunities for flipping, hoarding, or other forms of land trading that can work against the public interest and the efficient delivery of the scheme: leasehold is a critical way of preventing this.

Question 7: Are any of the exceptions listed in 3.2 not justified? Please explain.

No.

Question 8: Would limiting the sale of new build leasehold houses affect the supply of new build homes? Please explain.

Under current market practice, limiting the sale of new build leasehold houses is likely to have an impact on the existing pipeline of homes. This should not deter the government from addressing leasehold abuse – but it does highlight a further dysfunction in the dominant model of housebuilding that needs to be addressed.

Where developers and housebuilders have purchased land on the assumption that they would derive a return from the sale of both leaseholds and freeholds, any limitation on the sale of new build leasehold houses will affect their development appraisals. Developers are likely to complain that the financial viability of their schemes has been undermined, threatening their profit margins and increasing the chances of schemes stalling.

As reported in media coverage of the consultation's publication[2], housebuilders would be more willing to give up the sale of leasehold houses if this is on an equal basis to other housebuilders. However, it is not clear whether this willingness is in relation to the future pipeline or extends to cover existing schemes – and in either case, some housebuilders will inevitably be more exposed than others.

In an ideal world, in which leasehold houses were sold at a price reflecting their leasehold status, increasing sales prices to reflect the change in intention to sell on a freehold basis would be entirely reasonable. However, as set out in the consultation document itself, 'it is not clear that the "leasehold discount" is always passed on to the consumer.'[3] This therefore limits builders' capacity to increase sales prices to cover the loss from not having a freehold asset to sell on separately, as sale prices have already been inflated despite the leasehold status.

Housebuilders are likely to seek to reduce costs to compensate. This would likely include reducing build-out rates in order to keep sales prices up, or reducing build costs in order to maintain their margin. Housebuilders may also seek to renegotiate their affordable housing and infrastructure commitments, by submitting renewed viability assessments reflecting the new market conditions. This process of renegotiation not only delays the delivery of new homes, it also reduces the benefit communities get from schemes and further weakens local support for development.

This raises the question of whether it is fair to enable housebuilders to renegotiate their development commitments on the basis of changes to the leasehold system. On one hand, financial returns from the sale of freeholds have been factored into housebuilders' overall business models, as well as development appraisals for the individual schemes in the pipeline. If central government changes the rules of the game partway through, making development no longer economically viable, the argument can be made that housebuilders should be able to make reasonable adjustments. On the other hand, it is clear that in many cases unscrupulous abuse of leasehold has negatively impacted many thousands of people. Housebuilders should not be compensated at the expense of local communities, purely because the government has been forced to address housebuilders' own abusive practices. Housebuilders have profited from the abuse of leasehold, and they should bear the costs of adjusting to a world in which such abuse is prevented by law. In comparison, in 2015, the government announced changes to the 10 year rent settlement for housing associations – thereby undermining many housing associations' business and development plans. No compensation was suggested in that instance, and nor should there be in this context.

Nonetheless, housebuilders will inevitably use whatever tools are available to them to preserve their profit margins. This is a wider problem than the issue under consultation here, as developers and landowners have grown adept at using viability assessments to reduce their obligations and boost their returns. But the move to address leasehold abuse presents an opportunity to do something about these wider abuses of the viability regime.

As Shelter have highlighted before, the introduction of the NPPF brought in a change in what developers and landowners can expect in terms of financial return from development: where previously reference was made to 'reasonable' returns, the NPPF states that developers and landowners can expect a 'competitive' return. In practice, this usually equates to around 20%

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[2] The Times, Scandal of leaseholds on new-build houses to end in crackdown by Sajid Javid, 25 July 2017

[3] DCLG, Tackling unfair practices in the leasehold market, July 2017, para 3.5

of the total value of a scheme - and it is this figure which is taken into account when a viability assessment is prepared.

Shelter believes that paragraph 173 of the NPPF should be amended to state that developers and landowners should be entitled simply to 'a return' – without qualifying this further. This could include an explicit statement that any impact on the viability of schemes caused by changes to the use of leasehold will not be counted in any assessment of reasonable return.

A wholesale limitation on the sale of new build leasehold houses would also impact the existing pipelines of homes being built by community land trusts and other community-led schemes. However, this would not be the case if the requirements set out in our response to questions five and six are put into place.

Question 9: Should the government move towards removing support for the sale of new build leasehold houses through Help to Buy Equity Loan, unless leasehold can be justified and where ground rents are reasonable (which could be a nominal or peppercorn ground rent), and if not, why not?

Yes – Shelter's criteria for where sale of new build leasehold houses can be justified are set out in our response to questions five and six. Sales of new build leasehold houses under any other criteria should not be supported by the Help to Buy Equity Loan.

Shelter would caution against the definition of 'reasonable' ground rents being those set at a peppercorn level where the sale of houses as leasehold is justified, as this would limit the amount of income which could be recycled into community facilities and local services.

Question 10: In what circumstances do you consider that leasehold houses supported by Help to Buy Equity Loan could be justified?

Where the freeholds are transferred to or retained by an organisation which will recycle all income derived from ground rents into community facilities and local services in a fair and transparent manner. If community-led housing schemes include a proportion of homes for sale on a leasehold basis, such sales should be eligible to be supported by the Help to Buy Equity Loan, to prevent these schemes being unfairly discriminated against.

Question 11: Is there anything further the government could do through Help to Buy Equity Loan to discourage the sale of leasehold houses? Please explain.

No.

Question 12: What measures, if any, should be considered to minimise the impact on the pipeline of existing developments?

As in our response to question eight, housebuilders should not be compensated at the expense of local communities, or indeed the taxpayer more broadly, simply because the government has been forced to address their abusive practices. Housebuilders have profited from the abuse of leasehold, and they should bear the costs of adjusting to a world in which such abuse is prevented by law.

Limiting the reservation and increase of ground rents on all new residential leases over 21 years

Question 13: What information can you provide on the prevalence of onerous ground rents? We are keen to receive information on the number and type of onerous ground

rents (i.e. doubling, or other methods) and whether new leases are still being sold with such terms.

Shelter does not hold information of this nature.

Question 14: What would a reasonable ground rent look like, in terms of i) the initial annual ground rent, ii) the maximum rate of increase in annual ground rent, and iii) how often the rate of increase could be applied to an annual ground rent? Please explain your reasons.

i) initial annual ground rent –

Shelter agrees with Nationwide Building Society that the maximum appropriate starting ground rent on new build leasehold properties is 0.1 percent of the property's value.

ii) maximum rate of increase in annual ground rent –

Much of the abuse of leasehold has centred on escalating ground rents. It would be reasonable to restrict increases in ground rent terms to an inflation linked measure such as the Consumer Price Index, as this would give leaseholders a fair degree of certainty while ensuring that, over time, ground rents do not lose their value.

Question 15: Should exemptions apply to Right to Buy, shared ownership or other leases? If so, please explain.

No.

Question 16: Would restrictions on ground rent levels affect the supply of new build homes? Please explain.

Yes, as outlined in our response to question eight. Restricting ground rent levels would reduce the value of freeholds. Where housebuilders have included freeholds as an asset for sale in their development appraisals, reducing their value by limiting ground rent levels may impact on the housebuilder's margin. Shelter feels strongly that housebuilders should not be able to reduce any of their other commitments in order to compensate for the loss of income from the sale of freeholds occasioned by government action to end leasehold abuse.

Under the NPPF, housebuilders can negotiate down their obligations by means of viability assessments. This generally means a reduction in the levels of affordable housing or community facilities provided. If the government takes steps to restrict ground rent levels, it should also ensure that housebuilders are not able to maintain their previously anticipated returns by cutting costs elsewhere. We recommend that paragraph 173 of the NPPF be amended to replace 'competitive return' simply with 'a return', and to specify that any impact on the viability of schemes caused by changes to restrictions on ground rent will not be counted in any assessment of reasonable return.

Question 17: How could the government support existing leaseholders with onerous ground rents?

As the problem has been largely created by housebuilders, it would be reasonable for the government to require them to bear the costs of adjustment and of supporting existing leaseholders.

Question 18: In addition to legislation what voluntary routes might exist for tackling ground rents in new leases?

Where developers are willing to voluntarily take on the costs of adjustment and of supporting existing leaseholders they should be allowed to, provided the resolutions arrived at for leaseholds are identical to those achieved through legislation.

Exempting leaseholders potentially subject to 'Ground 8' possession orders

Question 19: Should the government amend the Housing Act 1988 (as amended by the Housing Act 1996) to ensure a leaseholder paying annual ground rent over £1,000 in London or over £250 in the rest of England is not classed as an assured tenant, and therefore cannot be issued with a Ground 8 mandatory possession order for ground rent arrears? If not, why not?

Yes.

The government should also take the opportunity to look at the impact of Ground 8 mandatory possession orders for leaseholders in shared ownership.

It is bad enough that the mandatory rent arrears ground applies to the ground rent on long leases, where that ground rent exceeds £1,000 p.a. in London or £250 p.a. elsewhere. But it is even worse when it applies to the market rental part of a shared ownership lease, which was the outcome of the decision in *Richardson v Midland Heart* (2007). That means that the shared ownership lessee who falls into as little as two months' rent arrears on the periodic tenancy part of their lease could not only be evicted, but lose their entire equity in the property. This is an alarming legal precedent, and the government should ensure that in making changes to exempt leaseholders from Ground 8 possession orders, it does the same for shared ownership leaseholders.

Service charges for maintaining communal areas and facilities on freehold and mixed tenure estates

Question 20: Should the government promote solutions to provide freeholders equivalent rights to leaseholders to challenge the reasonableness of service charges for the maintenance of communal areas and facilities on a private estate? If not, what management arrangements on private estates should not apply?

Yes.

Anyone liable to pay service charges should have equal right to challenge them. In addition, by making service charges clearer and more transparent, the need to challenge them should be reduced.

Future issues

Question 21: The Housing White Paper highlights that the government will consult on a range of measures to tackle abuse of leasehold. What further areas of leasehold reform should be prioritised and why?

Shared ownership:

- security of tenure in the case of rent arrears (as raised in our response to question 19)
- lack of regulation and transparency of service charges

- full responsibility for repairs and maintenance lying with the leaseholder, regardless of share of equity owned

Leaseholder obligations

Leasehold obligations (set out by means of a covenant within the lease) are currently designed so that they can only be enforced in a 'top down' way, i.e. by the freeholder against the leaseholder, even though these covenants are for the benefit of all leaseholders. This may result in a situation whereby one leaseholder is causing harassment or nuisance to another, such as excessive noise or the use of a residential flat for a business, but the freeholder may not be interested in taking any action, and so there is no effective way of ensuring that people comply with their obligations. Changes to the legislation which governs the leasehold system could permit a leaseholder who is being disturbed by a breach of covenant to take action to enforce that term directly where the freeholder has failed to do so.

For more information, please contact:

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