Written evidence submitted by Dr Mark Andrew and Dr James Culley (LFRB23)

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The evidence presented in this document is based on research undertaken in a personal capacity following earlier research addressing the Relativity conundrum in leasehold extensions.

The arguments behind our submission are drawn from a report looking at the unconsidered financial implications of reducing a premium in lease extensions, published by The UK Collaborative Centre for Housing Evidence (CaCHE).
https://housingevidence.ac.uk/publications/leasehold-reform-proposals-in-england-and-wales-the-unconsidered-financial-implications-of-reducing-the-premium-in-lease-extensions/.

We argue that reducing the premium to extend a lease or purchase the freehold introduces a distortion in the market which could worsen housing affordability and lead to unfair outcomes in the distribution of financial gains among different types of leaseholders. These outcomes contradict current government policies in promoting affordable housing and levelling up.

The government should focus on making the premium calculation more transparent, certain and easier, which would reduce the transaction costs (e.g. advisor fees) involved in leasehold enfranchisement, whilst ensuring that the premium is "fair" to both freeholders and leaseholders as this avoids causing a distortion in the market.

Executive Summary: Leasehold and Freehold Reform Bill - Call for Evidence

- Our submission centres on two of the main provisions in the Bill: making it cheaper and easier for leaseholders to extend their lease and buy the freehold and increasing the standard lease extension term to 990 years with ground rent reduced to a peppercorn.

- Similarly to the Law Commission Valuation Report (2020), "cheaper" is interpreted as a reduction in the premium rather than transactions costs (e.g. hiring solicitors etc).

- We argue that the government's focus on this aspect of the reform should be on making the premium calculation more transparent, certain and easier, whilst ensuring that it is "fair" to both freeholders and leaseholders. This avoids causing a distortion in the market.

- Our submission is based on research reported in Andrew and Culley (2023).

- Our contribution to the discussion concerns the aggregated implications for the market and distribution of windfall financial gains among different types of leaseholders.

- Any reform which reduces the premium will lead to an increase in the value of the leasehold interest in a property and a decrease in the value of the freehold interest.

- Our analysis pointed out that this would lead to an increase in leasehold prices and due to the capitalisation of a premium reduction, also in short leasehold prices (when leases have not been extended).

- The increase in leasehold prices will worsen homeownership affordability for low-income and first-time buyers.

- A high proportion of short leaseholders are investors (or landlords) who let out property in the private rented sector in low-income postcodes. The increase in leasehold prices may encourage them to sell up or refurbish the property and let it out at a higher rent, reducing rental supply and raising rents in this housing submarket.

- Investor leaseholders are likely to be significant beneficiaries in reforms which reduce the premium. A significant minority of high-income households also stand to benefit.

- The regional impacts on the market and distribution of financial gains following a premium reduction will be uneven due to differences in the relative size of the leasehold stock, lease lengths and types of leaseholder ownership.

- Although our analysis focused on making the premium cheaper by abolishing the marriage value component, the underlying arguments translate to any reform will leads to a reduction in the premium. The major differences will be in the size and scale of the aggregate impact on the market and differences in the distribution of the windfall gain among leaseholder types.

- The aggregate impact of any premium reduction is likely to contradict government policies in promoting housing affordability and levelling up within and across regions.

Introduction

1. Our submission focuses on two of the main provisions in the Bill, namely:

- make it cheaper and easier for leaseholders in houses and flats to extend their lease and buy the freehold.
- increase the standard lease extension term to 990 years, with ground rent reduced to a peppercorn (zero financial value), upon payment of a premium.

Similarly, to the Law Commission Valuation Report (2020), we interpret "cheaper" to imply a reduction of the premium rather than costs in executing a transaction such as costs associated with time, inconvenience and advisor fees.

2. Our additional contribution to the discussion concerns any premium reduction's aggregated implications for the market and distribution of windfall financial gains among different types of leaseholders, which was not considered in the Law Commission Valuation Report (2020).

3. Although our earlier analysis (Andrew and Culley 2023) focused on proposals to make the premium cheaper by abolishing the marriage value component in short leasehold extensions and to increase the standard lease length to 990 years with a ground rent reduced to a peppercorn, the fundamentals underlying it also apply to any changes which reduce the premium. The only difference will be on the projected impacts on the market and distribution of financial gains among various leaseholder types.

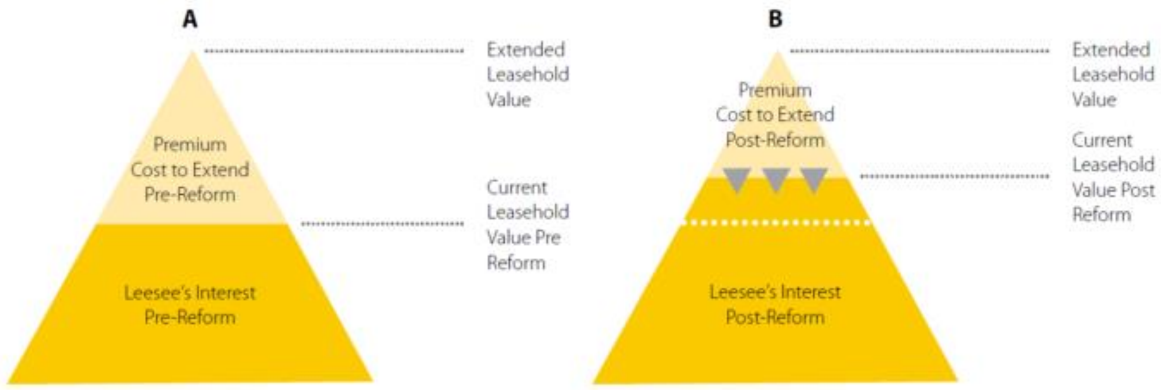
4. We identify several financial implications and knock-on effects, some of which potentially contradict current government policy on promoting housing affordability and levelling up. They include:

- short and longer-term deterioration in housing affordability, particularly for low-income households and prospective first-time buyers.
- implications for the private rented submarket catering for low-income households.
- the primary recipients being investor leaseholders as well as a significant minority of high-income occupier leaseholders.
- uneven regional impacts due to differences in the relative size of the leasehold stock

5. We advise that the government's focus should be on making the premium calculation more transparent, certain and easier, whilst ensuring that it is "fair" to both freeholders and leaseholders to avoid causing a distortion in the market.

How did we assess the financial implications for leaseholders?
6. Our foundation for assessing the financial implications was the realisation that a premium reduction does not affect the freehold value of a property (Freehold Vacant Possession Value[1]) but instead the distribution of its value between a freehold and leasehold legal interest. The reduction in premium payable will reduce the share of the value the freeholder holds in the property and increase the value the leaseholder has in the property. This is shown in the diagram below.

Figure: The change in the distribution of the value of the leasehold and freehold legal interests when the premium is reduced



In general, any reform which reduces the premium will lead to a windfall (financial) gain to leaseholders and a loss to freeholders.

Methodology
7. Our methodology is based on applying standard economic and financial models to micro-data to capture the price discounts attached to enfranchiseable apartments with varying lease lengths and an option pricing model to derive their unenfranchised value. Since the unenfranchisable value is affected by market fundamentals and not by any reform to the premium, it provides a basis for us to predict the projected impact a premium reduction in leasehold prices. More details of our methodology can be found in Andrew and Culley (2023) and Andrew et al. (2022).

8. Although our previous research focused on the proposals to abolish the marriage value and standardise the extended lease to 990 years the general principles in it apply to considering any reform which reduces the premium.

What are the implications for leaseholders?
9. A leasehold is a deteriorating asset since when it expires, the legal right to occupation in a dwelling reverts to the freeholder. Most existing leaseholds sell at a price discount to the freehold (FHVP) value (Giglio et al. (2015, 2021), Bracke et al. 2018, Andrew and Culley 2022)

[1] Freehold Vacant Possession Value refers to the value of a dwelling without any leasehold interests, i.e. purely freehold.

and often provide an affordable route to homeownership to financially constrained households.

9. Broadly, there are two channels by which reforms to reduce the premium and standardising the lease length to 990 years could increase leasehold prices. The first is from the increased leasehold value following an extension. Cheaper premiums would encourage leaseholders to extend the lease. Furthermore, standardising all extended leases to 990 years implies that it will be approximately equal to the freehold (FHVP) value. Both aspects could significantly reduce the price discount to the freehold value.

10. The second channel highlights that existing leaseholders do not have to extend a lease to benefit from these reforms, as any premium reduction and uplift from having a longer extended lease will get capitalised into leasehold prices. Making it cheaper to extend the lease and standardising the extended lease to 990 years makes leaseholds more attractive to potential buyers as they benefit financially by extending the lease after its purchase. Subsequently, the prices of unextended leaseholds will also rise.

11. The potential gains from a premium reduction will not be evenly spread, however. Short leaseholds (80 years or less remaining in the lease) have significantly larger price discounts attached to them compared to long leases. If short leaseholds become much cheaper to extend, then they will rise significantly in value. Although long lease extensions do not to pay a marriage value, the above channels still apply. It's just that they are likely to experience a lower increase in value because the reduction in the cost of extending them will be lower as they are already closer to the freehold value.

What are the implications for the market?

12. We argue that any reform to reduce the premium is likely to worsen housing affordability for future buyers in the leasehold market, particularly in urban areas with a high proportion of enfranchiseable shorter leasehold stock. Andrew and Culley (2023) estimate a short and long-term impact nationally based on the abolishment of the marriage value alone will lead to a 1.0% and 3.2% rise in leasehold prices. The short-term impact assesses the effect of a capitalisation of the premium reduction into leasehold prices and the long-term impact examines the effect when all the short leaseholds extended.

Table: Impact of Abolishing the Marriage Value on National and Regional Markets (as of April 2023)

Region	Total Leasehold Stock[2]	Short Leasehold Stock	Short Leaseholds: Average Lease Length Remaining	Pre Reform Value (£bn)	Post Reform Value (£bn)	Change in Value (£bn)	Relative Change in Value (%)	Average Change per Leasehold	Leasehold Market Impact No Lease Extensions (%)	Leasehold Market Impact All Lessees Extended (%)
North East	174,442	39,855	52	£6.0	£6.6	£0.6	10.9	£16,262	3.1	7.4
North West	836,586	18,875	46	£3.4	£3.7	£0.3	9.6	£17,126	0.2	0.6
Yorkshire and Humberside	270,565	24,106	42	£3.8	£4.2	£0.4	9.7	£15,247	0.7	3.7

[2] Note that these figures exclude unenfranchisable leaseholds and leaseholds in the social rented sector.

East Midlands	113,644	12,033	41	£1.9	£2.1	£0.2	9.0	£14,105	0.9	4.8
West Midlands	330,697	99,980	43	£19.3	£21.6	£2.2	11.5	£22,297	4.9	18.6
East	279,956	32,239	55	£6.7	£7.3	£0.6	9.5	£19,554	1.0	2.5
London	991,025	95,334	51	£45.8	£50.0	£4.2	9.1	£43,942	0.8	2.6
South East	529,377	58,619	55	£13.2	£14.5	£1.3	9.5	£21,338	0.9	2.4
South West	274,226	23,426	48	£4.6	£5.0	£0.4	9.3	£18,023	0.6	2.5
Wales	133,315	34,787	43	£6.3	£7.0	£0.7	11.3	£20,278	3.7	12.2
Overall	3,933,833	439,254	48	£110.9	£121.8	£10.9	9.9	£24,896	1.0	3.2

13. The table highlights that the aggregate impact on leasehold prices is likely to vary regionally due to variations in the stock of leasehold dwellings, lease lengths and the general price of housing. The biggest decrease in housing affordability if all short leaseholds are extended is expected to occur in the Northeast, West Midlands, and Wales.

14. There may be implications for the private rented sector too. Approximately 40% of leasehold dwellings are rented out in the private rented sector, with a significant proportion rented out to low-income households. If the reforms induce leasehold landlords to either sell up to realise the windfall gain or to refurbish the property after an extension in a bid to achieve a higher rental value, it could decrease the supply of rented accommodation to this income group and put upward pressure on rents in this housing submarket.

15. The longer-term impact could be potentially much larger due to the pipeline of leases turning short, especially in London and the Southeast (Andrew and Culley 2023).

What about the distribution of windfall gains among leaseholders?
16. Although our analysis focused on short leaseholds, it does highlight that it is misleading to believe that most leaseholders are lower-income homeowners. We divide occupier leaseholders into low-, middle- and high-income households based on regional income deciles. We also identify another category of leaseholder which we refer to as investors, representing a group that rent out dwellings in the private rented sector.

17. A national comparison identified the main beneficiaries of a premium reduction from abolishing the marriage value. The numbers in brackets represent the amount of the short leasehold stock and its percentage. In England and Wales just under a third (142,264, 31.7%) of the short leasehold stock are rented out in the PRS, mainly to households in low- (114,482, 18.5%) and middle-income (44,407, 9.8%) postcodes, implying investors are likely to be the main recipients of windfall gains from this premium reduction. The next largest recipients will be occupier lessee's living in middle-income (128,693, 28.7%) postcodes, followed by those living in low-income (114,482, 25.5%) postcodes. Households living in high-income postcodes are a minority as renters (15,428, 3.4%) and a significant minority as homeowners (63,034, 14.1%).

18. Our intra-region analysis highlighted the differences in distributional gains across regions. Occupier leaseholder rates are noticeably higher in less affordable regions where investors dominate, such as London (24,073, 24.6%), Southeast (22,822, 37.7%) and East (9,966 29.9%), indicating that short leaseholds provide a route for lower-income households to own a home and a route for investors to achieve high rental yields. The regions with a significant

proportion of occupier leaseholders living in high-income postcodes are the Northeast (11,821, 29.4%), Wales (8,059, 23.0%), Northwest (3,339, 17.1%) and West Midlands (16,983, 16.9%). London has the second largest number of leaseholders living in high-income postcodes, but they own the smallest share of its regional stock (11,553, 11.8%).

19. Thus, reforms to reduce the premium could potentially contradict the government's policy of levelling up.

Conclusion

20. The government's statement "to make it cheaper and easier for leaseholders in houses and flats to extend their lease and buy the freehold" is ambiguous. The Law Commission Valuation Report (2020) interpreted that this meant considering proposals that would lead a reduction in the premium. Various hypothetical scenarios were considered in this report, but the analysis did not consider the aggregate implications for the market and distribution of windfall (financial) gains.

21. Leasehold reforms biased in favour of reducing the premium will generate windfall gains to leaseholders and losses to freeholders. The induced financial incentives from such a reform in the aggregate could have a significant impact on raising leasehold market prices and worsening homeownership affordability.

22. Furthermore, a large proportion of the leasehold stock is owned by investors rather than occupiers, who tend to rent it out to lower-income households in high housing cost regions. If the financial gains prompt investors to sell up, as many small scale buy-to-let investors have been doing so in the last few years, or to further invest by refurbishing their property to increase rental income, this could also worsen affordability in the low-rent housing submarket.

23. In the case of short leaseholds, the major beneficiaries are investors as well as a significant minority of high-income leaseholders.

24. The aggregated regional impacts will vary due to regional differences in the size of the leasehold stock, lease lengths and proportions owned by different types of leaseholders.

25. Although not considered in our analysis, reforms which reduce the premium imply that owners of the freehold legal interest lose out as the compensation from a reduced premium does not cover the existing value of their asset. Freehold legal interests are also owned by institutional investors, fund and investment managers who invest on behalf of individuals. The decrease in these asset values could also have a financial impact on household wealth.

26. The government's reforms should aim to achieve fairness in the housing market. Reducing the premium penalises freeholders and risks making housing even less affordable and reinforcing wealth inequalities. We would advise the government to ensure greater transparency and certainty in the premium calculation, as this would reduce the associated transactions costs of undertaking a lease extension or the purchase of the freehold. It would also avoid causing a distortion in the market.

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