MODERN LEASEHOLD: RESTRICTING GROUND RENT FOR EXISTING LEASES

A PROPROSAL FOR OPTION 4 (MODIFIED)

CONTEXT

We, Bowlwonder Limited, are a ground rent investment company with a number of subsidiaries. In total, the controlling directors hold a portfolio of ground rent investments worth around £13 million. The ground rent income is £330,000 per annum, of which 70% is linked to the Retail Price Index (RPI). The portfolio has been built up over 38 years and many of the leases have been extended. We were keen to acquire index-linked income and not to cultivate a "wasting asset" whereby the real value of static ground rents was eroded by inflation. When granting lease extensions, apart from in a handful of cases we accepted significantly lower premia in order for the new ground rent to be tied to the RPI.

The reason for our setting up the business was to provide slow, but steady, growth and we were encouraged in our enterprise by the stance of successive governments and the fact that many UK pension funds hold significant ground rent investments. Our companies are not "get-rich-quick" schemes; they have provided many hundreds of stable, permanent jobs and attractive benefits for employees over four decades. This is reflected in a staff retention rate of over 95% per annum.

We did not take up any of the assistance offered by the Government during the COVID Pandemic. We did not take SEISS payments and we did not furlough staff. We believe, passionately, that a properly-structured business should be able to operate with modest profit without government intervention. The flip-side of our argument is that, when a business is functioning profitably, legally and with integrity, the Government should not – in a true democracy supported by the rule of law - intervene.

INTRODUCTORY NOTES

We have not completed the questionnaire on the five proposed options in the consultation process. We believe that there is an alternative way of dealing with ground rents which both respects the human rights of the freeholder and upholds this country's strong, global reputation in contract law. Our proposal addresses the pernicious ground rents that have come to light in recent times and is effectively a modification of Option 4.

With regard to the consultation process, we were surprised not to find an option whereby all but pernicious rents would remain unchanged. We were also surprised, and somewhat dismayed, to find The Rt Hon Michael Gove MP asserting that, ground rent had only ever been a token sum. In point of fact, a ground rent of £1 per annum on a terraced house in the industrial heartland in the north of England in 1900 was the equivalent of the average weekly household income for those occupying the house. That Mr Gove should mislead both Parliament and the public is disappointing, because it is likely to polarise opinion rather than achieve consensus and genuine progress.

The fundamental principle underpinning our views is that, ground rent is a key part of the overall financial package, or bargain, a freeholder seeks when granting a lease. To suggest that ground rent is for “no service” (another unhelpful phrase bandied about in current debate) would imply that, the premium received for a lease is in some way additional profit for a developer, over and above the sale price of the property. It is not. Developers, when assessing the price to pay for development land, base their calculations on the cost of construction and professional fees, the projected sale price of the units and the value of the freehold interest they will be creating. Ground rent is an integral component of the calculus. If the ground rent goes down, the sale price of units must go up, otherwise the development will not be profitable. Quite why some of the proposed legislation would seek to increase property prices and confine “generation rent” to perhaps never owning a home is beyond our understanding.

To imply that ground rent is for "no service" would require there to be a re-visiting of the costs incurred by the developer (perhaps decades ago) along with a fixed profit percentage to calculate what the correct price for the property should have been. It is only then that one could determine if the ground rent is indeed for "no service". Presumably, if the developer made a loss, the ground rent would be acceptable and could remain. No provision in the contract law of England and Wales allows for this.

In our free market economy, a vendor seeks to achieve the best possible price when selling an asset, with the *proviso* that terms must be disclosed before a purchaser commits to buying. The lease discloses the premium and ground rent terms explicitly, there often being an entire Schedule devoted to the subject. The terms are reviewed in detail by both the purchaser and their solicitor and it is not uncommon for negotiations to take two or three months.

Ground rent is perhaps therefore best described as deferred consideration, or an annuity paid by the leaseholder to the freeholder throughout the lease term. When selling the flat, the freeholder seeks a premium plus an annuity from the purchaser. To remove that annuity without compensation is profoundly unjust. To draw an anology, one might consider the case of an employee who is a member of a non-contributory pension scheme. After 40 years of service, if the employer advanced the argument that the retiree would be providing “no service” going forward and withdrew the pension, there would rightly be outrage, followed closely no doubt by legal action.

GROUND RENTS - THREE CATEGORIES

We believe that ground rents may broadly be divided into three categories.

Normal rents are modest and fall below 0.1% of the value of the property. They may have been granted many years ago. They often do not rise throughout the term, or if they do rise, they double or ‘staircase’ every 25 years or 33 years.

Onerous rents are such that they impinge on the value of a property. They are set out in the lease and disclosed to the prospective leaseholder, their solicitor and valuer before

the leaseholder buys the property. They affect what a purchaser is likely to pay for a property and often prompt a renegotiation of rent terms.

Pernicious rents appear normal because of their initial size but contain terms and/ or reviews that make buying out the stream of rental income very expensive for the leaseholder. Some of the figures are little short of shocking and this is not an area of the market in which we have been involved. There is a strong, and justified, suspicion that such leases are designed by "bad apples" in the sector to entrap the leaseholder.

Our definition of pernicious rent is one where the Net Present Value (NPV) of the rent was not considered and this can be confirmed when looking at the premium paid. The NPV of a ground rent of £300 per annum, doubling every 10 years of a 125-year term, equates to £57,000 when capitalised at 6%. As an aside, had there been a requirement in law to disclose the NPV of the ground rent next to the premium in the prescribed clauses of a lease, the problem of 10-year doubling ground rents would never have arisen and a great deal of unhappiness and worry could have been avoided.

OUR THOUGHTS ON REFORM FOR EACH CATEGORY

Normal rents should continue as written in the lease.

Onerous rents, above 0.1% of the value of the property, should stand unless rent reviews are greater than the Government's long-term inflation target of 2-3%. Mathematically, it follows that rents which double every 25 or 33 years would be considered acceptable. To suggest that the initial rent, whatever the figure, should be capped implies that the purchaser, their solicitor and their valuer did not read the lease. If the lease is second- or third-hand, the argument for capping rents is even more egregious, as it would imply that the freeholder must bear the costs of the lassitude of a series of property professionals, all of whom should carry Professional Indemnity insurance.

We would add a further observation based on our own portfolio. Many of our leaseholders sub-let their flats, to which we do not object. As time passes, the rents our leaseholders charge to their sub-tenants rises. It is not unreasonable for us to levy ground rents linked to the RPI or which double every 25 or 33 years; in colloquial terms, what is sauce for the goose is sauce for the gander.

A ground rent of £2,000 per annum on a flat worth £250,000 is onerous but ceases to be an issue if the premium paid for the property is £50,000 less than if the flat had a peppercorn rent. Those seeking to cap rents argue that the holder of such an onerous rent did not factor in the financial burden of the rent when purchasing the property. We believe that in the last seven years or so, attention has increasingly been paid to ground rent terms before purchase for the following reasons:

1. Media attention has, rightly, helped to raise the importance of considering ground rent terms because of the emergence of pernicious rents;

2. Mortgage affordability requires the borrower to include ground rent in their household budget. Mortgage underwriting has been far more demanding than prior since 2014; and

3. The mortgage handbook now used by a solicitor when acting for a mortgagee requires the solicitor to consider quite specifically whether a rent is onerous.

Pernicious rents should be addressed as part of any reform package. Invariably, the initial rent does not seem pernicious at first sight; it is later on, when the leaseholder has taken on the lease, that the frightening reality dawns of the cost of buying out the ground rent stream. A test is not required to determine whether rent terms are pernicious or not. All lease reviews should have an additional clause that requires the rent to rise, on the review dates prescribed in the lease, by the lesser of the planned increase or movement in the RPI. This avoids the complication of identifying such terms.

It follows that, a ground rent of £300 per annum, doubling every 10 years of the term, would rise every ten years by either doubling (as set out in the lease) or by the movement in the RPI. A pensioner receiving the State Pension would find that their ground rent, as a proportion of their income, would remain constant over time. During periods of high inflation, the rent would fall in real terms because the doubling clause would serve to limit the rent increase.

THE ROLE OF MORTGAGEES

Mortgagees set out their requirements as to what they regard as acceptable for ground rent and lease terms. Their refusal to lend causes anxiety to vendors because they are worried that their property may become unmortgageable. Many of the mortgagees' terms are based around the concern of having a ground rent exceed £250 or £1,000 in London, making the lease an Assured Shorthold Tenancy and therefore falling within the ambit of the Housing Act 1988. The Government is proposing to deal, quite rightly, with this anomaly, hopefully resulting in a widening of acceptable terms.

We find it perplexing that a ground rent on a flat worth £250,000 of, say, £375 per annum linked to the RPI with a review every 10 years is considered by some lenders to be unacceptable. Clearly, the rent exceeds 0.1% of the value of the flat and the obligation to pay the rent needs to be considered in formulating an offer. It is on the high side, but it is not, to use the words of some campaigners, "crippling" or "extortionate" and it does not render a flat "valueless".

The reality is that, when compared with the same property with a peppercorn rent, the value of the flat with such a ground rent should be around £10,000 less. This may help some buyers who would see this as a source of funding. A rent of £375 per annum is a fraction over £1 per day. A typical first-time buyer with a £200,000 mortgage on a 25-year loan at 5.5% has monthly repayments of £40 per day. A mere 0.25% increase in the mortgage rate increases that payment by £1 per day. In other words, the figures do not accord with the inflated, pejorative rhetoric that is commonplace in some corners of the debate.

It might assist mortgagees if they were granted the right to buy out the stream of ground rent income only (not just where the term is more than 150 years as currently proposed for qualifying leaseholders). The cost of the buy-out would increase the mortgage debt, but would also increase the value and marketability of the property. As the reversion would be left untouched, this would be a desktop exercise and require the lender only to calculate the NPV of the rent. If we refer back to our example above of a flat worth £250,000 with a ground rent of £375 per annum, the lender might pare back their maximum advance by £5,000 to reflect the rent.

IMPLICATIONS OF CAPPING GROUND RENTS AT A PEPPERCORN

Capping ground rents at a peppercorn would have a catastrophic effect on our business and the many families who rely upon us for employment. We bought ground rent investments because they are contracts, governed by English law, and this has been the case for some 300 years.

We understand that interference with a freeholder's assets can be justified if it is in the public interest. The Leasehold Reform Act of 1967 granted owners of leasehold houses the right to extend their leases or enfranchise and compensation was paid to freeholders. The Leasehold Reform Housing and Urban Development Act of 1993 introduced similar reforms for the owners of flats. The premium payable for lease extensions under the latter has increased over the years as a percentage of property value. We attribute this to a collapse in long-term interest rates. Those leaseholders who feel aggrieved at paying the premium might also care to consider that the value of their properties has increased sharply and their mortgage payments have been very low.

We note that, in 1977, rent charges were abolished by introducing a sunset clause of some 60 years, along with compensation for an earlier buyout.

We question whether it is in the public interest to cap the payabilty of ground rent (not just in enfranchisement terms). This clearly interferes with the freeholder's right to income and the proposal that no compensation would be paid therefore amounts to confiscation.

This does concern those who invest in the UK, who are left wondering what further article of established contract law is to be retrospectively discarded. Whose assets are to be confiscated next? It is puzzling that we would risk our reputation as a bastion of stability and due process on the world stage by extinguishing a rent which on average amounts to 85 pennies a day without any compensation.

It is unfortunate that Mr Gove has chosen to undermine the work of his department and to ignore advice given by both the Law Commission and leading Counsel. The notion of capping existing ground rents at a peppercorn was put forward during the passage of the Leasehold Reform (Ground Rent) Act 2002 and failed at the first reading. The result of proceeding down this path will, inevitably, be a very strong legal challenge by the likes of Long Harbour, Aviva and the other big players, who have a duty to protect their shareholders and the pensions they administer, and years of uncertainty for leaseholders. All of this takes away from the matter of service charges and block

management, where we believe there are very real problems to be addressed and which involve much greater sums of money.

SUMMARY

By making the freeholder cover their own costs in a lease extension claim or enfranchisement, using prescribed rates to calculate the premium and having the freeholder take an overriding lease over non-participators in an enfranchisement claim, the Government will have made the exercise for leaseholders easier, quicker and cheaper. We support these three proposals in the Bill. We do not support the abolition of marriage value.

The emergence of 10-year doubling ground rents has created a lightning conductor to bring down to earth all the anger and negativity surrounding leasehold property management. If these pernicious ground rents are removed, we do not believe that further reform is required.

The proposal we put forward would ensure that the initial rent remains the same in real terms throughout the lease term or if the rent reviews set out in the lease produce a lower figure a fall in the real value of the rent.