

## **City of London Law Society Land Law Committee’s response to the Government’s consultation on “Modern leasehold: restricting ground rent for existing leases”**

### **Introduction**

This is the response of the City of London Law Society Land Law Committee to the Government’s Consultation on “Modern leasehold: restricting ground rent for existing leases”.

The City of London Law Society represents approximately 17,000 City lawyers through individual and corporate membership including some of the largest international law firms in the world. These law firms advise a variety of clients from multinational companies and financial institutions to Government departments, often in relation to complex, multi-jurisdictional legal issues.

The City of London Law Society responds to a variety of consultations on issues of importance to its members through its 21 specialist committees. This response to the Consultation has been prepared by the Land Law Committee, described as the Committee in this response.

If there are any questions in relation to this response, please contact Kevin Hart of the City of London Law Society at 4 College Hill, London, EC4R 2RB, email address [kevin.hart@cills.org](mailto:kevin.hart@cills.org) and telephone number 020 7329 2173.

### **Response**

The Committee is pleased to respond to this important Government consultation on existing ground rents and the various options for intervention that the Government has put forward in relation to the capping of existing ground rents for residential long leasehold properties in England and Wales.

The Government has noted that subject to this consultation, they will look to introduce a cap on existing ground rents through the Leasehold and Freehold Reform Bill. The consultation puts forward five options:

- Capping ground rents at a peppercorn (option 1);
- Setting a maximum financial value for ground rent (option 2);
- Capping ground rents at a percentage of the property value (option 3);
- Limiting the ground rent to the original value when the lease was agreed (option 4);
- Freezing the ground rent at current levels (option 5).

The Committee refers to these option numbers below.

The Committee absolutely acknowledges the problems that the most egregious types of ground rent cause for leaseholders and many of those problems are acknowledged and highlighted in the Consultation and accompanying impact assessment. The impact assessment provides an example of ground rents doubling more frequently than every 20 years, although the most egregious types of ground rent increase would be doubling considerably more often than every 20 years.

While the Government may seek to tackle the most egregious types of ground rent increase, great care needs to be taken when considering introducing retrospective legislation to override freely entered into contractual bargains, where such an intervention may have a significant adverse impact on investments that benefit the public generally.

The Committee understands that the Gross Value Added (GVA) of the real estate sector in the UK in 2022 was over £260 billion, and it is responsible for 12.5% of all economic output generated across the UK,

surpassing that of any other sector. The potential impact of the proposed changes in the consultation on such a significant investment market will no doubt be taken into account when undertaking a more detailed impact analysis following this consultation.

Since the Committee generally represents the freeholder/landlord/investor community, the Committee's comments focus on its view of the impact of the proposals on that community. The Committee's comments cover Question 3 onwards of the Consultation, although it will be appreciated that, as a legal representative body, the Committee is not in a position to comment on valuation issues.

The Committee's key point is that it is very concerned about the impact of these proposals, especially the proposal to cap ground rents at a peppercorn (option 1). The Committee comments on each of the options below.

### **Role of ground rents**

As the questionnaire in the Consultation acknowledges, ground rents fulfil a number of purposes for the freeholder/landlord/investor community. They may service a loan, or fund further property development or the performance of management functions not otherwise met by the service charge. While they may sometimes be used to generate profits, the other purposes mentioned are important for the property industry and, without such funding, there may be an impact on investment in residential property and the provision of high-quality management functions.

Some, if not many, institutional investors including pension funds, life assurance companies, property companies and REITs, sovereign wealth funds, fund and investment managers and developers contend that to restrict ground rents to a peppercorn would remove the financial incentive to buy residential properties and they would depart that market. If such proposals encourage investors to leave the market, this may cause unintended adverse consequences for the very tenants who the proposals are intended to protect.

Reinforcing this point, ground rent is an important source of income for investors and the proposals in the Consultation will create a great deal of uncertainty among the investment community. This will impact on pension funds for which residential ground rents are a significant source of income. Pension funds and insurance companies that are reliant on residential ground rent income to meet index-linked liabilities to their members would need to find alternative investments to meet those liabilities. The impact assessment that accompanies the Consultation [Consultation impact assessment - modern leasehold: restricting ground rent for existing leases - GOV.UK \(www.gov.uk\)](#) does not begin to explain how that will be achieved.

Importantly also, mortgage lenders who have ground rent as whole or part of the security for the loan will be concerned about the impact of the proposals on their security.

The Committee is also aware of large-scale regeneration projects where a local authority receives the benefit of ground rents and the Government's proposed actions may well have the perverse effect of local authorities suffering a shortfall and then having to increase council taxes to recoup the loss from the very residents whose ground rents have stopped.

So in summary the very people who may gain from the capping of ground rents may lose out because of a consequential adverse impact on their finances whether in the form of the pension that they receive or council tax increases. And from a human rights perspective, to remove this value without any compensation is draconian and inequitable.

## **Impact of the Options**

### **Option 1**

The Committee is most concerned about the impact of Option 1. The Government in the impact assessment estimates that the effect of Option 1 in restricting ground rent to a peppercorn in existing leases would come at a cost to freeholders/landlords with an expected loss of income of £5.1bn (present value) over the 10-year appraisal period in England and Wales. The Government also estimates that the change in asset value, by calculating the loss of ground rent income over the remainder of lease terms, is estimated at £27.3bn (PV).

As mentioned earlier, there are many businesses for whom ground rent is a critical source of income and depriving such businesses of the ground rent income may well lead to some of those businesses becoming insolvent. Other businesses may choose not to continue investing in the UK if such a proposal is implemented.

If the landlord cannot charge the ground rent, it may instead seek to use service charge for the purposes that it would have used the ground rent. Some landlords also make contributions to a building outside of costs recovered from the tenants under the service charge, but they may be less inclined to do so if there is no income from ground rents.

Coupled with the effect of the Building Safety Act 2022 provisions on recoverability of costs through the service charge, the ground rent cap at a peppercorn may be another factor which results in more landlords becoming insolvent, which will lead to management problems for tenants.

Pension funds and insurance companies that are reliant on residential ground rent income to meet index-linked liabilities to their members would need to find alternative investments to meet those liabilities. No evidence is provided in the impact assessment in this respect to alleviate concerns about the impact of the proposal.

### **Option 2**

The Committee notes that the impact assessment estimates a total cashflow transfer from the loss of ground rent from freeholders/landlords to leaseholders in England and Wales of £2.3bn (present value) over the 10-year appraisal period, with the change in asset value being estimated at £14.6bn. The assessment notes that Option 2 is less likely to impact investor behaviour than Option 1, but the Committee remains concerned about how pension funds and insurance companies, reliant on residential ground rent income to meet index-linked liabilities to their members, will achieve this if ground rents are capped as proposed in Option 2.

### **Option 3**

The impact assessment shows a similar adverse impact for freeholders/landlords as Option 2 and the Committee reiterates its concerns about how pension funds and insurance companies will meet the index-linked liabilities to their members.

### **Option 4**

The impact assessment suggests this has a lower total cashflow transfer from the loss of ground rent from freeholders/landlords to leaseholders in England and Wales of £0.6bn (present value) in the 10-year appraisal period., with the change in asset value being estimated at £7bn. While these are lower figures than Options 1-3, capping the ground rent at the original figure may mean using an amount that is many years old and wholly inadequate to enable pension funds and insurance companies to meet the index-linked liabilities to their members.

## **Option 5**

The impact assessment highlights that this option of freezing the ground rent at current levels has the smallest financial impact with total cashflow transfer from the loss of ground rent from freeholders/landlords to leaseholders in England and Wales of £0.4bn (present value) over the 11-year appraisal period used, with the change in asset value estimated at £4.2bn (PV).

The Committee opposes the implementation of any of the Options on the basis of their varying degrees of adverse financial impact on pension funds, investors and insurance companies as well as the inequitable impact of retrospective legislation without compensation mentioned below, but the Committee notes that Option 5 has the smallest impact, based on the evidence provided in the impact assessment.

### **Problem of retrospective legislation**

The Committee is concerned about the dangerous precedent being set of legislation retrospectively altering existing agreements to take away value from a party to the agreement. The concern is that if any of the proposals in the Consultation are enacted with retrospective impact, this precedent could be applied in other circumstances. The Committee was surprised that the sanctity of existing contracts was not being respected.

The stable and certain nature of the UK legal system is a crucial attraction to overseas investors in the UK. This is considerably undermined by retrospective legislation. The proposals are compounded by the fact that no compensation is offered to the party deprived of its ground rent income.

While there may be some justification for retrospective legislation overriding the most egregious ground rents, there is no distinction in the Consultation proposals between such a situation and what is generally regarded as fair ground rent increases usually inflation linked of the type used by pension funds and other investors. The proposals appear to envisage a blanket amendment changing every lease, whether containing fair or unfair terms.

### **Method of implementation**

The method of implementation of whichever proposal is chosen is another crucial issue. The impact assessment indicates that legislation would seek to override existing leases with new terms to apply to future ground rent payments, meaning that freeholders would not be able to take leaseholders to the Tribunal to recoup any such ground rents. The Committee reiterates its concern about the dangers of using retrospective legislation to nullify a freely-negotiated contractual bargain.

### **Compensation**

The Consultation makes it clear that it will provide no compensation to landlords for reducing the ground rents, on the basis that the changes would be equivalent to a rent cap, not the removal of or reduction in a proprietary right that would or might be protected under the Human Rights Act 1998.

The Committee is concerned that in respect of ground rents that rise in line with inflation (where such an inflationary rise is crucial in the context of pension funds and for other investors), first such a rise should not be capped, but if it determined that this should be the case, suitable and fair compensation should be paid to the fund, investor or other organisation that has been deprived of what many in the property industry consider are fair increases.

The Committee found the impact assessment very helpful, but it is a consultation-stage impact assessment and it is important for more precise impact assessments to be provided once the policy proposals are more fully developed.

### **Conclusion**

Regardless of which option the Government deems the most appropriate following its Consultation, the result may well have a significant adverse financial impact on the value of portfolios held by professional and institutional landlords and investors who rely on ground rent as an income stream. The Government needs to take care to ensure that the changes do not have the unintended consequence of penalising (directly or indirectly) the tenants whom they are intended to protect.