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Publications —— Summer 2019

Quarterly Housing Update

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Foreword

It was a pleasure to see so many of our clients and contacts at June's CIH conference in Manchester.

I am pleased that we have excellent contributions in this edition that draw on two of the key themes emerging from Manchester. The "coming of age" of modern methods of construction, and the growing importance of strategic land developments in meeting housing delivery targets.

Boris Johnson has appointed a new ministerial team at the Ministry of Housing, Communities and Local Government. If early press reports are to be believed, the policy shift witnessed under Theresa May's administration towards a (renewed) commitment to a social rent may well be reversed to a new programme focused once again around home ownership. If that is true, we may see a nervousness from housing associations and local authorities alike to committing to large scale social rented developments, risking slowing much of the momentum we have witnessed in the past year.

That said, the presence of Sir Edward Lister at the heart of government does give some grounds for optimism and has the capacity to give some continuity to the housebuilding agenda.

The risk, as always, is that of stagnation in the market as developers, funders and local authorities alike look for a degree of certainty in the new administration's policy and stagnation is absolutely the last thing our sector needs as it seeks to deliver already challenging delivery targets.

And what of the still awaited government response to the Social Housing Green Paper? Where does that sit in the new minister's in tray?

It is arguable that housing is now politicised in a way that has not been known for generations and while that is welcome in so far as it means "something" will happen, it seems to me that it is continuity in policy above all else that leads to delivery.

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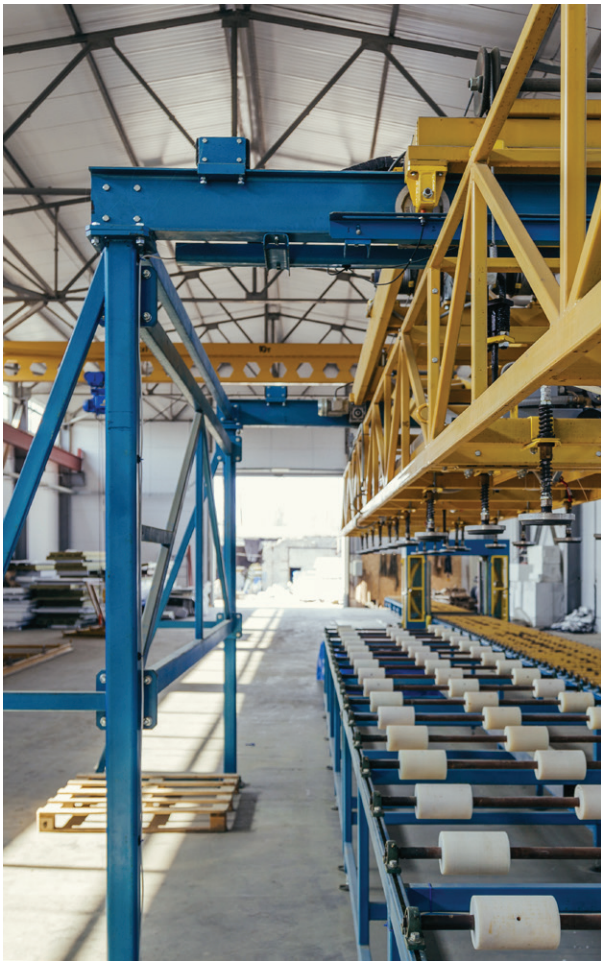
Asset management of MMC Homes

It is easy to understand how the use of modern methods of construction (MMC) directly improves the preconstruction and build phase of a development for housing providers and developers. The potential for speed and design delivery as well as consistent quality standards through precision engineering means the upfront benefits of MMC are widely promoted.

However, as MMC becomes mainstreamed into delivery how can the sector provide assurance that those initial benefits will feed through into the long term asset management of the homes being built?

Do MMC homes provide different challenges to asset management teams for housing providers and local authorities?



MMC

First of all what do we mean by MMC? In order to understand the impact of an MMC home for a long term asset holder, such as a housing provider, it is useful to refer to the defined MMC categories now published by the Ministry of Housing, Communities and Local Government which places MMC into seven categories. Category 1 being fully pre-manufactured volumetric products which can be craned in as complete homes onto site, through to category 7 which covers improvements in productivity offsite thus reducing the amount of labour required on a site on a traditionally constructed project. Within that spectrum of seven categories are pre-manufactured component parts of homes such as panelised systems as well as kitchen and bathroom pods.

Benefits of MMC for the long term asset management of housing

Taking the example of a category 1 fully volumetric product which leaves the factory 100% complete, the housing provider should be able to receive assurance from the manufacturer that each element of the product can be identified and the source of materials confirmed along with requisite guarantees. This means that the all-important golden thread of information can be preserved, as recommended by Dame Judith Hackitt, and which is now a central theme of the consultation on Building a Safer Future. A housing provider, working closely with the manufacturer, can establish where the individual component parts have been sourced and can influence what elements are installed in their homes. This also makes it much easier for a housing provider to store data about their homes digitally and to comply with the Building Information Modelling Standards (BIM) which could be mandated as part of the Government's latest consultation.

Therefore the importance of the ability of MMC to provide housing providers with accurate data on the construction of their housing stock should not be underestimated.

In order to fully maximise the benefits it is essential that the development and asset management teams work closely together in specifying the makeup of the home and educate their in-house or outsourced maintenance teams on how to maintain and repair those products, where they may differentiate from elements in traditionally constructed homes.

Challenges

Funders are asking for more data on the life cycle of MMC homes on the basis that they need to be confident that the products will not depreciate in value. For new MMC products a regular checking process can be implemented to provide security for both funders and housing providers that the durability of an MMC home is comparable to a traditionally built home.

It is important that the selection process for MMC manufactures includes evaluation on the longer life cycle costs and sustainability of their products and reduced asset management costs in order to potentially offset any higher construction and installation costs compared to a traditionally built scheme.

Tender documents need to be designed with the evaluation of longer life cycle costs in mind. The most recent Public Contracts Regulations 2015 make it clear that life cycle cost (eg non-price elements) of a product/works/service may be taken into account at the point of procurement. Given this, clients seeking to evaluate the cost/benefit of a MMC solution versus a traditional build solution need to select a quality/price evaluation formula that anticipates and incorporates all of the non-price elements (e.g. ongoing costs), as well as the quality and price elements of a bid.

The traditional focus on lowest price scores the highest marks in price evaluation under a public procurement process does not allow for life cycle costing to be taken into account. However, there are price evaluation formula that can be used to focus on quality-driven, value-based prices not lowest price. For example, by adopting an absolute price evaluation model (e.g. a price/quality ratio), a client is able to evaluate the quality and cost elements of a bid on its own merits and ascertain how much quality it is obtaining for the price of the bid, rather than seeking to compare two different methods of construction against each other on a lowest cost basis.

Latent defects insurers are also addressing the importance of designing out defects to maintain quality and can provide sign off at the milestone completion stages of each home either in the factory and on site to provide comfort to funders.

Recommendations

For a housing provider or local authority embarking on an MMC scheme for the first time it is recommended that the asset management teams work closely with the development team to understand the component parts of the MMC product and that the asset management team are involved in inspections in the factory environment to ensure that appropriate warranties and guarantees are requested from the manufacturer and any suppliers and subcontractors.

BIM should be used as a tool to create a long term data record for the asset management teams to use to maintain the MMC homes at the outset so that the life cycle costs of the MMC products are evaluated in competition with similar products. This can provide comfort to the housing providers and funders that they are selecting quality products on a long term sustainable basis.

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Building a Safer Future: proposed reforms to the building industry

In June 2019 the Government published its Building a Safer Future consultation, outlining its proposals for legislative reform of the building safety regulatory system. As expected, most of the recommendations in the Hackitt Review have been accepted. If adopted, the new regime will radically alter the way in which building safety is maintained in the future. Here's a quick guide to what is set to be a major shake-up of the building industry.

Scope of the reforms

The new regime will cover all multi-occupied residential buildings of more than 18 metres (6 storeys) with enhanced obligations for buildings over 30 metres (referred to as "in-scope buildings"). The proposals cover new build and major refurbishments, with a gradual roll-out of obligations to existing buildings in occupation. The Government is consulting on whether the reforms should be extended to other non-residential buildings where people sleep (e.g. sheltered housing, prisons and hospitals).

Dutyholders

The proposals create new dutyholder roles, with legal obligations to ensure in-scope buildings are designed and built to be safe for their residents. Dutyholders may be individual persons or legal entities. Legal entities may be required to nominate an "accountable person" at board level, who will be identified as having responsibility for building safety. Criminal liability will attach to any non-compliance with dutyholder obligations. The Government is also considering placing all dutyholders under a statutory duty to promote building safety and the safety of people in and around in-scope buildings, both during the design and construction and occupation stages of a building's life cycle.

Dutyholder obligations during the design and construction phase will broadly follow the CDM Regulations which have defined roles and responsibilities of "Client", "Principal Designer", "Principal Contractor", "Designer" and "Contractor". Dutyholders will be required to co-operate and share design information with a newly created Building Safety Regulator, and also ensure that the people they employ are competent. "Competence" is defined as "the ability of an individual to apply the necessary skills, knowledge and behaviours to make informed decisions and carry out their job effectively. Dutyholders must not accept appointments unless they have the relevant skills, knowledge, experience and behaviours to ensure that their work promotes compliance with the building regulations (i.e. is safe for residents to live in).

Gateways

Dutyholders will need to comply with three gateways for the design and construction of buildings and some major refurbishments, and demonstrate that they are managing building safety before construction is permitted to move to the next gateway.

Gateway 1 – applies to in-scope buildings of 30 metres and above, and major refurbishments requiring planning permission, and must be satisfied before planning permission is granted. Planning applicants will be required to submit a fire statement with their planning application, covering fire service vehicle access and access to water supplies. The Government is considering whether fire and rescue authorities should be statutory consultees to the planning process, and whether planning authorities should consider fire safety for buildings within the "vicinity" of in-scope buildings.

Gateway 2 – applies to all in-scope buildings over 18 metres and some major refurbishments at the "full plans building application" stage, and must be satisfied before construction commences. Dutyholders will need to demonstrate "the case for safety" by providing the Regulator with detailed plans in respect of fire safety, 3D digital models of the building and a fire and emergency file (all produced by the Principal Designer) and a Construction Control Plan (produced by the Principal Contractor). Dutyholders will also need to demonstrate to the Regulator sufficient skills, competence and effective management of building safety risk. Major changes that may compromise building safety will need to be notified to and approved by the Regulator before proceeding. Failure to satisfy the Regulator will result in a "hard stop" of the construction project.

Gateway 3 – applies to all in-scope buildings over 18 metres, and must be satisfied before occupation. Dutyholders will need to provide the client with building safety information to form "the case for safety" for occupation and safe management of the building. Principal Designers and Principal Contractors will be required to provide a declaration to the client that the building complies with the building regulations.

Duties in occupation

In-scope buildings (both new and existing) will need to be registered with the Regulator before they can be occupied. As part of this registration process, accountable persons must submit a safety case to the Regulator for approval before a Building Safety Certificate is issued. Safety cases for existing buildings are likely to require less information than for new buildings, in recognition that such information is likely to be hard to gather. All safety cases will need to be reviewed and registrations re-applied for at least every five years while the building is occupied.

Accountable persons will be legally responsible for ensuring that fire and structural safety risks in occupied in-scope buildings are reduced so far as is reasonably practicable.

Accountable persons should be the individual or corporate entity with control of the building and who receives rent or service charges from the residents, so may be the building owner or a management company. Specific duties will include registering buildings with the Regulator, complying with the requirements of Building Safety Certificates, carrying out and submitting safety cases demonstrating that they have reduced risk, and appointing a Building Safety Manager. Accountable persons will not be able to transfer their liability, and will incur criminal liability for non-compliance.

Building Safety Managers, named by the accountable person, will be responsible for carrying out day to day functions of ensuring the building is safely managed, engaging with residents and overseeing safety works, and supporting the accountable person to manage building safety risk.

Duties during a building's life cycle

A "golden thread" of building design and operation information must be created and regularly updated by dutyholders (in design and construction) and accountable persons (in occupation) for all in-scope buildings. The golden thread of information must be digitally stored, and the Government is considering mandating Building Information Modelling standards for creating and managing digital information. It is intended that the golden thread of information will be open and accessible to residents by default, subject only to limited exemptions.

Mandatory reporting and resident engagement

The proposals will require mandatory reporting of fire and structural safety issues to the Regulator within 72 hours, both during the design and construction and occupation stages. To support this process, the Government proposes express whistle-blower protections to allow formal complaints to be made without fear of retribution.

Accountable persons and Building Safety Managers must proactively provide residents with core building safety information in a clear and accessible format (rather than on request), and must also develop and implement a resident engagement strategy that empowers residents to ensure that their homes and buildings remain safe. All strategies must contain a management summary setting out how the accountable person will engage with residents, and an engagement plan setting out how the strategy will work in practice (including an internal process for residents to raise building safety concerns). Residents must be provided with a clear and quick route of escalation to the Regulator if their concerns are not dealt with effectively. The Government is also considering requiring residents to cooperate with accountable persons and Building Safety Managers, including giving reasonable access to residents' homes for inspections.

New regulatory regime

A new national Building Safety Regulator will be established, responsible for overseeing the new regime, maintaining a register of in-scope buildings and inspecting buildings and safety information to ensure that dutyholders and accountable persons meet their obligations. The Regulator will ensure stronger enforcement and sanctions for non-compliance, including stopping construction projects that fail to achieve gateways, issuing improvement notices and fines, ordering the demolition of non-compliant building work, and revoking Building Safety Certificates for non-compliant buildings. The Regulator may also prosecute dutyholders and accountable persons for non-compliance of their respective duties. The Regulator will also be responsible for setting building standards, advising the Government on changes to the regime, and promoting competence in the building industry.

Sanctions and enforcement

It will be a criminal offence for dutyholders to carry out construction work without having acquired the necessary permissions from the Regulator. Criminal liability will also apply to Accountable Persons who fail to apply for building registration within required time limits, allow the occupation of buildings without a valid Building Safety Certificate or who breach any conditions imposed by the Regulator. The Government is considering extending claims under the Building Act 1984 to start from the time a serious defect is discovered, and to extend limitation periods for claims for up to ten years, and also allowing private civil actions against dutyholders and accountable persons for failures in building safety.

What's missing?

The consultation document does not make any express provisions to deal with Part 9 of the Hackitt Review, which recommended changes to procurement practices and contract terms. Given Dame Judith's comments about the importance of procurement in setting the tone of construction projects and ensuring that quality and fire safe outcomes are prioritised, this is a disappointing omission, and a missed opportunity to make radical and beneficial change to current UK procurement practice.

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All change for Fair Deal?

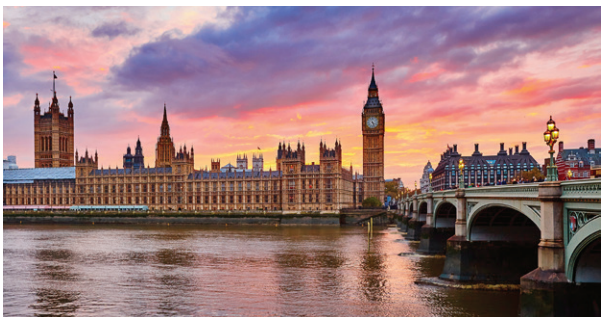
The Ministry of Housing, Communities and Local Government has finished its consultation published earlier in 2019 on changes which introduce Fair Deal where there is a compulsory transfer of staff from local government under a contract for services. Currently, Fair Deal only applies for outsourcings from central government.

What are the proposals?

The idea is that the existing regime, where employees of Best Value Authorities (which includes local authorities) are entitled to broadly comparable pension benefits would be replaced in its entirety. Under the new regime, employees of "Fair Deal Employers" would retain the right to membership of the Local Government Pension Scheme (LGPS) post transfer. The option to offer a broadly comparable scheme would no longer be possible.

Who are Fair Deal Employers?

All employers of staff who are members (or eligible to be members) of the LGPS are caught by the definition, except further or higher education corporations and admission bodies. This means most housing associations and charities will not be Fair Deal Employers, although they will have the option of requiring continued LGPS membership following an outsourcing. The transfer of staff to a subsidiary established by a local authority (for example an ALMO) would fall within the scope of the changes.



How can the new employer provide membership of the LGPS?

The new employer can offer LGPS by participating under an admission agreement (as is currently possible) or alternatively through a new concept whereby the Fair Deal Employer may agree to be the “deemed” employer for pension purposes and remain liable for pension funding and contributions. The default position is that the new employer must enter an admission agreement and take on the pensions risk. In either case, it is still possible for the parties to agree provisions on risk sharing (also known as "pass-through") through the outsourcing contract or the admission agreement.

What has been the industry response?

The industry is generally supportive, but there are significant concerns over the fine print. One key area of uncertainty is the concept of the Fair Deal Employer becoming the deemed employer. This concept is intended to make the outsourcing process less administrative and time consuming. However, it's not clear how it would work alongside TUPE from a legal perspective and dual employment status is likely to lead to confusion and potential disputes.

When will the changes happen?

In view of the industry's concerns, the government may need to go back to the drawing board once again. Bearing in mind this is its second attempt at introducing Fair Deal for local government (the last one being withdrawn last year), let's hope it is a case of third time lucky. Watch this space for further news once the government publishes its response.

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Challenges to unlocking strategic land sites

Strategic land firms and developers play a crucial role in the identification and assembly of sites and create housing opportunities which may not otherwise exist. But what exactly is strategic land and why is it so important?

Strategic land

Strategic land is the creation of development opportunities which do not yet have planning permission, in innovative and creative ways to bring forward land that may:

- have been underused (such as large car parks in prime retail areas); or
- be in need of regeneration (where under invested areas are revitalised by huge injections of capital investment in infrastructure and amenities to attract residents); or
- is not used for any housing purposes at all (such as 'greenfield' sites).

The successful development of strategic land sites usually requires a systematic and methodical approach to be adopted by developers that sees them shoulder financial exposure, without any return from their investment for a number of years. This includes planning and consultation costs but, in recent years, also includes undertaking preparatory and infrastructure works.

In order to deliver the volume of housing numbers the UK needs to serve the increasing population, via strategic land sites, there are a number of challenges which developers, whether large scale/national developer or small to medium size, need to address.

Planning

The foremost challenge to developers remains the process of obtaining planning permission for development.

Many local authorities are keen to assist in the process, particularly where a site has been identified for development. They will invite developers to consult with them months before an application is submitted – usually by way of pre-application meetings and consultations. However, some sites are not yet 'allocated' in the relevant local plans and often these plans are not up to date. Strategic land developers therefore need to undertake extensive works in bringing forward and 'promoting' these sites through the release processes.

This can increase the cost, but will work to reduce the risk of a site being actually rejected for planning once an application is submitted.

Furthermore, whilst a site may have been identified for development, a developer has to consider other factors such as planning policies, viability thresholds, local resident and other objections and this can impact the prospects of a planning application being successful.

The planning process can take years, particularly if the site in question has not yet been allocated, so it is often only the larger housebuilders and strategic practices who can shoulder the expense.

Notwithstanding this, steps are and have been taken to streamline this process for example in recent years the judicial review period has been reduced from three months to six weeks. The revised National Planning Policy Framework PPF encourages front loading viability to local plans to remove this complex and costly issue from the planning application process. For the smaller developer, their focus will be on smaller sites, usually in built up or already allocated areas. Even if the site is otherwise likely to be successful, sufficient objections from existing residents can halt a development scheme.

It remains a fine balance for all local authorities to manage both the expectations of its residents, but also the increasing demand to deliver homes.

Cost

The largest cost remains the acquisition of a site itself and the subsequent expense incurred in preparing it for residential development.

Site values are always driven by demand. Where a site is a "quick win" (i.e. for which planning can be obtained quickly making it particularly attractive to smaller developers), the demand will impact the price.

Acquiring such sites means developers do not have to build the infrastructure to support the housing – fewer/no roads to be built for access, fewer development needs such as the creation of schools and smaller financial contributions required.

Contributions to such infrastructure can place a huge pressure on profit margins and timescales. 'Social' and softer infrastructure needs to be considered as well. This means a site that would otherwise be ideal for development may not be considered by a smaller developer and the profit margins would not be attractive for a larger one. Unless the price of the site reflects these factors, it can have the impact of effectively sterilising development on a site. However land owners will remain reluctant to sell at lower prices or will seek future returns through overage mechanisms.

Developers also frequently have to deal with historic legal restrictive covenants registered against the titles to the site which may be obsolete, historic or inconclusively drafted. Remedying such matters can lead to substantial payments having to be made by developers who have to bear the cost of indemnity insurance premiums or compensatory payments to the benefiting land owners.

In recent years we have seen the Government demonstrate how committed it is to assist with the burden of costs, particularly for smaller and medium scale development. For instance the Government has recently awarded £450 million to support local authorities in preparing sites for development via the Local Authority Accelerated Construction Programme.

In addition the Mayor's office submitted applications to forward fund up to £4.1 billion towards the construction of infrastructure to support smaller schemes where a lack of sufficient infrastructure is a hurdle to sites being brought forward for development.

This is crucial to support our housing and development sector particularly through difficult times and we expect we will see further innovations of this nature over the coming years.

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A new VAT reverse charge on construction services

The way that VAT operates in the construction industry is changing with the introduction of a VAT reverse charge. Normally, the supplier is responsible for paying any VAT due to HMRC but under the VAT reverse charge, the customer is responsible for paying the VAT to HMRC.

The new rules apply to supplies from 1 October 2019, including to supplies made under contracts entered into before that date. This is an anti-fraud measure so that the supplier cannot charge the customer VAT and then fail to account for the VAT to HMRC. We do not expect the new rules to apply to most payments made by housing providers for construction services. In most cases, the normal VAT rules will continue to apply.

When does the VAT reverse charge apply?

The reverse charge will apply to supplies made on or after 1 October 2019 if:

- both the supplier and the customer are registered (or should be registered) for VAT;
- the supply is subject to VAT at either the standard or reduced rate (zero rated supplies are not affected by the reverse charge);
- the supply comprises construction services; and
- the supply is not an excepted supply.

What are construction services?

This term is defined in the same way as "construction operations" under the Construction Industry Scheme (CIS). It includes alteration, repair, demolition, site clearance, scaffolding, installation of systems (e.g. lighting, air-conditioning and drainage), internal cleaning during construction, painting, decorating and landscaping. It also includes any goods supplied as part of the service.

Some services are specifically excluded from being construction services, including the manufacture of materials, delivery to the site, the work of architects, surveyors or other consultants and the installation of blinds, shutters and security systems.

If a supply is a supply of a specifically excluded service (e.g. manufacture and delivery of a new staircase) but the supply contains an element (however small) of construction services (e.g. fitting the staircase) then the whole supply is a supply of construction services. If the joiner only delivered the staircase to the site and did not install it, the supply would be excluded from being a construction service.

What are excepted supplies?

There are four scenarios where the supplies are excepted supplies. If any of these scenarios apply then the reverse charge will not apply:

- The customer is not obliged to report the payments on a CIS return. A customer who is not part of the mainstream construction industry and who has not breached the threshold for registration as a deemed contractor for CIS purposes is not obliged to register as a CIS contractor nor report payments on a CIS return. Payments made gross under the CIS (where the supplier is registered with HMRC for gross payment) are reported on a CIS return and so gross payment status does not mean the supply is an excepted supply.

- The customer is an "end user" (someone at the end of the construction supply chain who is not making further supplies of construction services) e.g. the property owner.

- The customer is part of the same corporate group as the end user e.g. a design and build company.

- The customer has an interest in the site at the same time as the end user e.g. a tenant who receives landlord works which it supplies to its landlord.

Worked example

- A landlord employs an unconnected contractor, Builder A, to carry out a renovation programme on its housing stock. As the landlord is not supplying construction services to anyone else, it is the end user and the reverse charge rules do not apply to supplies by Builder A. Therefore, Builder A would charge the landlord VAT and pay that VAT to HMRC in the normal way.

- If Builder A sub-contracts part of the work to Builder B then the reverse charge rules would apply to supplies by Builder B to Builder A. Builder B should not charge VAT and Builder A should operate the reverse charge and pay the VAT straight to HMRC.

- If the landlord sold the housing stock part way through the renovation programme but agreed with the buyer that it would finish the renovation programme then, from that point on, supplies from Builder A to the now ex-landlord would be within the reverse charge as the ex-landlord would no longer be an end user.

Drafting construction contracts

The parties to a construction contract will have to consider what contractual protection they require in relation to the reverse charge. For example, it would be advisable for a supplier of construction services to obtain a contractual statement from its customer as to whether the supplies will be excepted supplies (e.g. because the customer is an end user) and an obligation on its customer to notify if the position changes. The parties may also want to agree how to correct the position where a mistake is made and the wrong party has accounted for the VAT.

Summary

The new rules represent a major change for VAT accounting in the construction industry and given the complexity of the new rules there is the potential for the wrong person to account for the VAT. Helpfully, HMRC have produced useful guidance and said they will apply a "light touch" for errors made in the first six months.

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Making the most of commercial assets

Many housing associations own commercial properties, such as retail units and office space, as part of their property portfolios. The number of commercial properties held and uses of those properties can vary significantly from association to association.

As commercial properties are ancillary to the residential purpose of housing associations, the value of commercial properties is often under-utilised. Active management of such assets can provide an additional income stream to housing associations and depending on the type and number of commercial properties owned may provide an opportunity to raise finance, secured against commercial properties.

Standard terms

When negotiating leases with commercial tenants, it is preferable for the leases to be on similar terms, as this simplifies the management of the leases. Whether this is achievable will depend on the covenant strength of the tenant negotiating the terms of the lease.

In the event that commercial properties are offered to a funder as security for a loan facility, the funder will usually require the terms of the occupational leases to be in a standard form, and for the rental income generated to service the loan repayments.

Rent reviews

If the term of the lease is greater than three years, it is usual for the rent to be reviewed at regular intervals throughout the term of the lease. The most commonly used methods to assess and increase market rent is either with reference to open market rent or increasing the rent in line with the Retail Prices Index (RPI). Alternatively, the parties can agree to fixed rent increases throughout the term of the lease.

If rent is to be reviewed with reference to open market rent (this is usually on an upwards only basis), the rent payable by the tenant on rent review can require input from a surveyor or expert in this area, in the event that the reviewed rent cannot be agreed between the housing association and the tenant.

Rent reviewed with reference to RPI can provide certainty to both the housing association and tenant of the basis of the increase. At a time when RPI remains relatively low, this may mean that any increases are of a limited nature but are still likely to result in an increase.

By monitoring the rent review provisions in leases and agreeing and implementing rent review increases at the relevant time, housing associations can benefit from an increased rental income from assets.

Recovery of service charge

Where a commercial unit forms part of a larger building, for example, a retail unit with flats above, it is usual for the housing association to insure the entire building under its block insurance policy. If the property is situated within a wider estate owned and managed by the housing association, the commercial property may also benefit from services provided by the housing association, for the estate, such as maintenance of common areas.

When negotiating leases with tenants and where the housing association is obliged to insure the building, and provide services to the tenant, it is usual for the housing association to recover a fair proportion of the cost from the tenant. This could be in the form of a proportion of the cost of the insurance policy relating to the buildings insurance aspect of the commercial property only, or could be extended to include a fair proportion of the cost of maintenance of common areas which benefit the commercial property, together with the cost of any other services used by the tenants in common with the wider estate. The nature and extent of the service charge recoverable will depend on the nature and location of the commercial property.

For existing commercial leases, housing associations may wish to revisit the terms of the lease and the housing association's records to ensure that a fair proportion of the cost of the insurance premium, and other services provided for the benefit of the tenant is being demanded and received from the tenant.

Raising finance

In order to raise finance secured against commercial properties, it is most straightforward to do so if the commercial properties are registered under separate Land Registry title numbers, and have the benefit of rights necessary for the commercial properties to be separated from other land owned by the housing association and offered as security under housing finance loan facilities.

If commercial properties are part of a larger title the housing association could create a separate title by granting a long lease of the commercial property, to be owned by a separate entity and controlled by the housing association which could be offered as security to a funder.

As with dealing with any property assets owned by the housing association, wider tax, regulatory, governance and commercial implications would need to be taken into account before securing commercial properties, but it may provide a means of raising additional finance.

Conclusion

Whilst commercial property assets are not central to a housing association's purpose, they can provide a valuable additional stream of income, which can further the housing association's aims. By actively managing commercial property assets and the payments due under the terms of the leases, the housing association can maximise the sums received from the properties it owns.

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Plugging the pension fund gap

Trustees of defined benefit pension schemes are under more pressure than ever to ensure that sponsoring employers, including housing associations, put in place adequate funding arrangements to meet their pension obligations. For the most part, the starting point for trustees will be that "cash is king" in paying off a pension scheme's deficit.

However, in an uncertain economic climate, employer housing associations want a degree of flexibility and do not necessarily have the available cash to pay towards the deficit. They will therefore need to look at alternative solutions in the way of contingent assets, which are not immediately available to the trustees but will become so if one or more specified event occurs.

One of the most common forms of contingent asset for a sponsoring employer is a guarantee from a parent or group company. That said, trustees and employers are increasingly looking at alternatives which involve the employer granting the trustee to the pension scheme a legal charge over property owned by the employer. If a specified trigger event occurs, the trustees can then exercise their rights and enforce their security over the charged property.

Housing associations quite often own potentially valuable commercial units which are either unencumbered, or are charged to a security trustee or lender at nil value where the unit forms part of a larger title containing housing. It is typical that a loan facility to a housing association only places value upon and requires security over housing stock.

Frequently, the commercial units are located at the ground floor of buildings containing flats. In such circumstances, it is difficult to grant a charge over that unit without taking additional steps to "carve it out" of the remainder of the property to create a distinct unit.

One way of doing so would be to create a long leasehold interest which can then subsequently be charged to the pension fund or "sold" to an independent third party and the cash used to meet the housing association's pension obligations. Where the building is already charged, the consent of the security trustee or lender will be required. Given that the commercial unit owned by the housing association is usually included in a charge at nil value, such consent should not be withheld.

From a governance perspective, this type of transaction would need to be intra vires so that any disposals, including the granting of a leasehold interest or disposal to a third party, would need to be for market value. Tax implications (including SDLT, VAT, and corporation tax) would also require consideration.

Another solution would be to charge the offices occupied by the housing association to the pension fund. If these are standalone units, this should be relatively straightforward. However, given that the pension fund will not usually have a standard form of report on title, as used in traditional funding transactions, they will normally require a City of London Long Form Certificate of Title to be given by the housing association's lawyer. These certificates are reasonably involved and require a fair amount of property due diligence, which will, of course, have cost implications.

As a result of the charge over the property, employers can often expect certain benefits in terms of the funding approach which the trustees are able to agree. The provision of a charge over property can lead trustees to conclude that it is appropriate for them to agree a longer recovery plan or a back end loaded recovery plan if they have a contingent asset they can rely upon if the employer housing association is unable to make the contributions it owes to the scheme.

There is another benefit to providing a contingent asset in the form of a charge over property in that it can reduce the levy which the scheme must pay to the pension protector fund (PPF). The PPF pays compensation to members of eligible defined benefit schemes where the employer becomes insolvent, and the scheme is unable to pay its protected liabilities. The PPF is funded by levies paid by eligible schemes, one of which is calculated by reference to how much the scheme is underfunded by and the probability that the scheme may enter the PPF in the next year (i.e. its insolvency risk). In order to reduce this portion of levy, schemes can secure a reduction if they have in place certain contingent assets which may include a charge over its commercial property.

The employer housing association will have to assess whether their current borrowing arrangements present any restrictions on their giving any further security in relation to properties they own, or any charge which ranks in preference to or on the same footing with security given to the lender. Some trustee boards will insist on taking a first charge, but others may settle for a second charge if that is all that is possible.

The trustees are not guaranteed to accept a charge over property if they believe there are other more liquid ways of addressing the pension scheme's liabilities. A charge over a property does not give trustees immediate access to the asset and the trustees may encounter practical issues when they try to enforce security. But this is certainly an avenue which should be explored by the employer housing association. A starting point may be preliminary property due diligence on those commercial units to ascertain whether there are any restrictions on disposals, including creating leasehold interests and charging, and also commissioning a valuation.

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Leasehold reform update – Part 1

The leasehold sector has come under significant scrutiny in recent years with many viewing it as an unsatisfactory form of property ownership subject to abuse. There is pressure on the Government to push for reform which, if implemented, will offer a much higher level of protection to leaseholders.

The proposals started in 2014 with a study by the Competition and Markets Authority (CMA) on residential property management. The CMA report made various recommendations for the sector and was followed by the DCLG consultation paper in July 2017 – 'Tackling unfair practices in the leasehold market'.

In December 2017 the Government issued their response to the consultation and proposed, amongst other things:

- banning leases of new build houses (save in specified circumstances such as shared ownership);
- ground rents in all leases to be zero or a peppercorn;
- considering future issues and reviewing of some of the relevant legislation relating to enfranchisement / lease extension, the right to manage and commonhold; and
- giving freeholders equivalent rights to leaseholders to challenge service charges.

Here we consider the consultations that have been published by the Law Commission in recent years covering reforms to enfranchisement and lease extension, the right to manage and also commonhold.

Leasehold home ownership: buying your freehold or extending your lease

This consultation closed on 7 January 2019 and the Law Commission's final report is now awaited.

The Law Commission was asked to review the current enfranchisement process to make it simpler, quicker and more cost effective. They have examined the options to reduce the price payable by leaseholders to enfranchise, while also providing enough compensation to landlords to reflect their legitimate property interests.

The proposal is for a single procedure under which any of the proposed enfranchisement rights can be claimed. If the proposals are implemented, the rights will be contained in a single piece of legislation which, amongst other things, will provide for standard notices, limited costs liability for leaseholders, more power for the tribunal to decide disputes and a new right to participate in an earlier enfranchisement. It is clear that the reforms will significantly enhance and improve the rights for leaseholders.

The Commission's view is that a single procedure will remove inconsistencies and reduce the risk that any party will make a mistake by confusing one procedure with another. They hope this will reduce opportunities for one party to take tactical advantage of the other.

Leasehold home ownership: exercising the right to manage

This consultation closed on 30 April 2019.

Qualifying tenants are currently entitled to exercise a right to manage pursuant to the 2002 Act. These tenants can force the transfer of the management functions of their building to a "right to manage" company of which the leaseholders are members. There is no need to demonstrate mismanagement to exercise this right, although unfortunately this is often at the core of a lot of right to manage claims.

The Law Commission have reviewed the right to manage procedure under the Commonhold & Leasehold Reform Act 2002 (2002 Act) and their proposals aim to make the process simpler, quicker and much more flexible. They propose the following changes:

- that the qualifying criteria is relaxed so that leasehold properties with more than 25% non-residential use can participate;
- permitting multi-building RTM companies on estate;
- reducing the number of notices that leaseholders must serve;
- giving the tribunal the discretion to waive procedural mistakes;
- clearer rules for the transfer of information about management functions; and
- favourable changes for the leaseholders to the costs rules (tribunal costs and non-litigation costs).

Reinvigorating commonhold: the alternative to leasehold ownership

This consultation closed on 10 March 2019 and the final report is awaited.

The Government asked the Law Commission to propose reforms to reinvigorate commonhold as a workable alternative to leasehold, for both existing and new homes. It is clear that commonhold under the current legislative structure is not working with limited commonholds being created since it was introduced by the 2002 Act.

Commonhold allows freehold ownership of individual flats, houses and non-residential units within a building or estate. The rest of the building or estate forming the commonhold is owned and managed by the unit-holders through a commonhold association. A commonhold community statement sets out the rights and obligations of the commonhold association and the leaseholders.

In this consultation the Law Commission have made proposals they hope will overcome the shortcomings in the current legislation. In particular their proposals will:

- enable commonhold to be used for mixed-use developments with residential properties and also commercial units (which may include retail units, restaurants and leisure facilities);
- improve mortgage lenders' confidence in commonhold, something which has historically been problematic;
- provide homeowners with more control over the service charges of the commonhold and require early decisions in relation to costs to be spent on maintenance;
- allow certain limited types of leases to continue to be used within a commonhold scheme. Shared ownership leases are specifically mentioned in the consultation as an exception to the general rule that long leases are not permitted within a commonhold structure; and
- make the conversion of an existing leasehold scheme to commonhold easier. However, the proposals are still very complex and many feel not sufficient to provide leaseholders, freeholders and mortgagees the confidence to convert current schemes.

The proposals are extensive and it is still not entirely clear how they would work in practice with a number of issues that need further clarification. However, it is apparent that the Government wants to ensure that commonhold is promoted as a viable alternative to leasehold moving forward.

Summary

Leasehold law is set to change significantly. The Government continues to be under pressure to ensure that changes are implemented and so, whilst many feel that the reforms may be some way off, we need to be prepared for the changes which now seem inevitable.

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