Institute
and Faculty
of Actuaries

Leasehold Enfranchisement Team
Law Commission
1st Floor, Tower, 52 Queen Anne's Gate
London, SW1H 9AG

6 November 2018

Dear Sir / Madam

Leasehold home ownership: buying your freehold or extending your lease

The Institute and Faculty of Actuaries (IFoA) notes and welcomes the Law Commission's recent consultation paper seeking to simplify the enfranchisement regime for leasehold houses and flats. This is a complex area of the law and simplifying it will be in the interests of leaseholders, freeholders and society more widely. A key issue raised in the consultation paper is the calculation basis that should be used to calculate the premium due on enfranchisement. This involves placing a value now on amounts payable in the future. Much of the work of actuaries centres on such calculations of the "time value of money" as they arise in an insurance, pensions or investment context. As such, familiarity with the relevant mathematical concepts forms a key part of the syllabus of the examinations required to qualify as a Fellow of the IFoA.

IFoA members have an interest in the ongoing debate around leasehold reform in a number of capacities. Many of our members work for insurance companies who have invested in receiving the ground rents due under a freehold interest in property, and use this investment to match insurance liabilities. Other members work to advise pension schemes that hold similar investments to fund benefits payable to pensioners. Indeed, many of our members will themselves be leaseholders given the prevalence of leasehold property tenure in England and Wales. Finally, as a professional body the IFoA's mission includes, in the public interest, to advance all matters relevant to actuarial science and its application.

This letter is written in the context of this public interest mission. As the Law Commission sets out in its consultation paper, landlords and leaseholders have competing interests with regards to the calculation of an enfranchisement premium. The intention of writing this letter is not to seek to influence this debate in favour of either group, but to ensure that the debate takes place in the context of a correct application of the relevant mathematical principles.

The example calculations set out by the Law Commission in the consultation paper make some errors in the application of these mathematical principles. Whilst these calculations are only intended to be indicative, errors of this nature have the scope to mislead a non-technical audience and give rise to ill-informed debate. We therefore set out two areas of technical background that are of relevance to the calculations:

1. Nominal and real interest rates
2. Decomposition of an interest rate into a risk free component and a premium for risk

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The discussion in this letter is intended to be only a brief summary of the mathematical background. We trust that this is useful and would be delighted to provide more information on any point if needed.

1 Nominal and real interest rates

Some leases have ground rents that are fixed in absolute or "nominal" terms (either a fixed monetary amount, or specified fixed review terms such as doubling). Other leases specify the ground rent in "real" terms, requiring that the actual ground rent paid be adjusted for the value of an inflation index. When calculating the present value of a stream of future ground rent cash flows, it is important to apply a discount rate that is consistent with the cash flows that are being discounted. Figure 22 of the consultation paper uses the discount rate of 4.5% throughout. In part (1) of the calculation, this is applied to nominal cash flows. In part (5) of the calculation, this same discount rate is applied to real cash flows. The application of the same discount rate to both types of cash flow is inconsistent. If 4.5% is intended to be a nominal discount rate, then calculation (5) should first convert the ground rent cash flows into nominal terms based on expected future inflation. Alternatively, a real discount rate could be used to discount the real cash flows. Real discount rates are lower than nominal discount rates by approximately the expected rate of inflation. We note that there are examples of similar confusions between real and nominal discount rates in past Land Tribunal decisions. However, paragraph 14.98(2) highlights a recent Tribunal case where following evidence from financial market professionals, a lower discount rate was selected as appropriate to apply to real cash flows (i.e. those specified in today's prices, before adjustment for inflation).

2 Decomposition of an interest rate into a risk free component and a premium for risk

Long term interest rates can be decomposed into two conceptually distinct parts. Firstly, the "risk free" component is the return that an investor would demand on an investment with no material risk. The yield on government bonds of an appropriate term are a commonly used proxy for this risk free rate. Secondly, a risk premium, which reflects the compensation that an investor would demand for the risk that they are taking in their investment. The size of this premium depends on the level of risk inherent in the asset. For example, an investor purchasing a bond from a well-respected corporate entity with a strong credit rating would only demand a small additional premium over the risk free rate. Conversely, investors in highly speculative assets demand a much higher premium. If the cash flows and market value of an asset are known then the risk premium can be observed by finding the discount rate such that discounting the cash flows at this rate gives the market value and then subtracting the risk free rate.

This is relevant to the calculation of enfranchisement premiums in two respects. Firstly, even assuming that investors' attitudes to risk remain constant over time, fixed prescribed capitalisation and deferment rates (or other methods that have a similar effect such as a fixed prescribed multiple) would not be appropriate. This is recognised in paragraph 15.68, although the appropriate reference rate should be a proxy for a risk free rate of an appropriate term (such as the yield on government bonds), rather than a short term interest rate such as the Bank of England base rate. Secondly, this decomposition of a discount rate into risk free plus a risk premium highlights that the assertion of footnotes 1366, 1367 and 1369 is incorrect. These footnotes assert that if the ground rent to be taken into account in the calculation was capped then a higher discount rate would be appropriate. Capping the ground rent clearly does not affect the risk free rate. We must therefore consider the impact on the risk to the investor. Applying a cap to the ground rent does not increase the investor's risk. In fact, it could be argued that the investor's risk has now reduced as there is less scope for future intervention that further reduces his/her cash flow. This risk of future changes in the law that give rise to the leaseholder paying lower amounts than those specified in the lease is a core portion of the risk to which a ground rent investor is exposed. The capped cash flows would also be more affordable to the leaseholder, reducing the risk that the leaseholder is unable or unwilling to pay them. Therefore, the appropriate discount rate is either unchanged or reduced.

The basis for the assertion of the footnotes referenced above is set out in the Law Commission's July 2018 paper "Leasehold enfranchisement: A summary of proposed solutions for leaseholders of houses". Footnote 20 links the discount rate to the demand for the asset. Footnote 20 is in principle correct, but the principle has not been correctly extended to this context. The higher the demand is for an asset, the lower the risk that if an investor wishes to sell the asset then he/she will be unable to find a willing buyer. This reduces the risk premium, reducing the discount rate. The question is not of attractiveness as such, just availability of willing buyers. This is one of many factors influencing the risk premium. When considering the risk premium demanded by a ground rent investor, the applicable considerations are as set out in the previous paragraph.

If you would like to discuss any of the points raised please contact me in the first instance.

Yours sincerely,

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On behalf of Institute and Faculty of Actuaries

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