OFFICE OF THE
DEPUTY PRIME MINISTER

Tenancy money: probity and protection

A consultation paper

November 2002

housing

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November 2002
Office of the Deputy Prime Minister

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CHAPTER 1

Summary – tenancy money issues

1. The private rented sector (PRS) accommodates about 10% of households in England. The Survey of English Housing (SEH) 2001-02 reveals that 70% of 2.21 million private rented sector tenants had paid a deposit. The average deposit is around £510, usually equivalent to one month's rent, and likely to be rising in line with rents. This suggests that in England nearly £790million is held in deposits.

2. In theory, at the end of a letting, if a landlord is happy with the condition of the property, and if the tenant owes no rent or other expenses, the landlord, or their agent, will return the tenant's deposit promptly and in full. If there are outstanding expenses or damage, the landlord/agent will deduct an appropriate amount from the deposit, or retain it in full, with the understanding of the tenant.

3. Most tenancies do end without dispute, or at least without recourse to legal action by either party. However, the most recent Survey of English Housing (SEH) 2001-02 reveals that 20% of households who had a private tenancy ending in the previous three years, said that part or all of the deposit from their most recent tenancy was unreasonably withheld. Although this is clearly a subjective issue (a tenant's experience of unreasonable deposit withholding could be a landlord's experience of justified charges) nevertheless 9% of households who had a private tenancy ending in the previous three years said that their landlord or agent gave no reason for withholding their deposit.

4. Tenants also frequently report that they withhold their final month's rent because they anticipate their deposit will be unreasonably retained. However, some tenants who default on the last month's rent may have caused damage, sometimes extensive, which the landlord will then have to cover in full.

5. Although bodies representing landlords and agents are seeking to bring a professional and transparent approach to landlord-tenant relations, perceived problems with deposit return and other aspects of private tenancy management can be damaging to the image of the private rented sector, and in turn to all landlords and agents. In any case less than a quarter of all letting agents are members of professional associations. (It is not know how many private landlords belong to trade associations; anecdotal evidence suggests the number is very small.)

6. Statutory schemes to safeguard tenants' deposits and landlords' property are run in other countries, including parts of Europe, Australia, New Zealand and Canada. In this country, many landlords and letting agents regard tenants' deposits as part of their working capital. Anecdotal evidence suggests that the majority of individual landlords do not hold deposits in ring-fenced accounts, and do not return any accrued interest to the tenant at the end of the tenancy.

7. A pilot scheme to safeguard tenants' deposits and provide independent adjudications in cases of disputes was launched as the Tenancy Deposit Scheme (TDS) in March 2000, administered by the Independent Housing Ombudsman (IHO). The TDS aimed to test whether a deposit protection scheme could be voluntary and self-financing, or whether statutory intervention was necessary.

8. In February 2002, the then Housing Minister Lord Falconer noted that slow take-up to the pilot suggested that there was a *"strong case for legislation on tenancy deposits"*. He stated, *"Landlords are very strongly advised to lend their support to the pilot now, so that in advance of legislation there is a proven alternative to regulating the use of tenancy deposits"*[1].

9. An independent evaluation of the TDS concluded that a national voluntary scheme would have little impact within the PRS, as take up of the pilot had been disappointing, and a voluntary scheme would attract only operators with existing good deposit management systems. The evaluation noted that tenants tended to anticipate difficulties with deposits, particularly as many had previously experienced the non-return of a deposit. Therefore a mandatory scheme, particularly if based on a custodial model, would be popular amongst tenants. By contrast landlords and agents viewed the management of deposits as unproblematic. They feel that a mandatory scheme would impose costs that would eventually be passed on to tenants across the whole sector, would be difficult and costly to enforce and therefore incapable of tackling the most serious abuses.

10. Tenants' and landlords' differing perceptions of deposit management suggested to the researchers that landlords and agents are neither conveying an intention to act fairly, nor instituting sufficiently professional procedures to offset the apprehension of malpractice. It seems clear that a broad industry approach to improve deposit protection could benefit the PRS by minimising the apprehension of difficulties and increasing professionalism and transparency. This could lead to increased confidence in the sector and the encouragement of institutional investors. A larger, better-run private rented sector brings knock-on benefits through encouraging greater mobility.

11. The pilot TDS was established to offer landlords the opportunity to make this a self-regulatory approach. Statutory intervention was seen as the alternative. The limited impact of the pilot to date suggests that legislation may be likely, although the costs and benefits of such intervention must be fully assessed.

12. A further private rented sector problem has been identified, together with options for addressing it. It is estimated that there are around 6,000-8,000 letting agents who do not belong to one of the three professional trade associations representing the interests of letting agents. Whilst many of these firms provide a good level of service, there are also many unscrupulous agents and others who, whilst well intentioned, do not have sufficient knowledge and experience to provide an adequate service. Currently, there is no statutory requirement for letting agents to register with or seek a licence to operate from any authority.

1 On 13 February 2002 in response to a parliamentary question from Lord Best.

13. The National Approved Letting Scheme (NALS), is a voluntary accreditation scheme which is designed to give owners peace of mind when choosing an agent to let and manage their property. NALS sets minimum standards for service and financial probity of agents in handling client money. It is appropriate, when considering the scope for legislation to protect tenants' monies, to consider the scope for a provision relating to letting agents from which landlords would benefit. This consultation paper therefore considers whether all letting agents should be required to operate to minimum standards in line with NALS.

14. Chapter 2 provides more detailed background on the subject of deposit-taking, and looks at the extent of the problem. Chapter 3 assesses the success of the pilot scheme, reflecting the evaluation carried out by the University of York as well as the views of the IHO and the Department. Chapter 4 outlines a number of options to take forward the issue of protecting deposits and other clients' monies, many of which would require primary legislation.

15. Although the Government cannot at this stage say if or when it might introduce a Bill that would make these provisions, responses to this consultation paper will inform a full Regulatory Impact Assessment (RIA) in order to ensure readiness to legislate when the opportunity is available. A partial RIA is attached at Annex 1.

Responses to the Consultation

It would be appreciated if respondents could complete and return the questionnaire at Annex 2. Further comments on the key issues mentioned and any other relevant issue raised by these proposals would also be welcomed. A list of the organisations that have been invited to respond can be found at Annex 3. This list is not exhaustive and comments from other individuals or bodies are welcomed.

Responses to this consultation, marked *"Tenancy Money Consultation"*, should be sent by **28 February 2003**, and preferably by email, to Elizabeth Girling at:

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or by post to:
Office of the Deputy Prime Minister (ODPM)
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Further queries should be addressed to Elizabeth Girling on the above email or postal address (phone 020 7944 3624) or to Alison Davis (phone 020 7944 3552).

Further copies of this consultation paper can be obtained, free of charge, from:
Free Literature Service, PO Box 236, Wetherby LS23 7NB
Tel: 0870 1226 236 (fax: 0870 1226 237).
Website: http://www.housing.odpm.gov.uk/information/index02.htm

This consultation paper follows the criterion laid down in the Cabinet Office's *Code of practice on written consultation* which is included at Annex 4. Responses may be made public in due course **unless respondents specifically ask the Department to treat their comments as confidential**. Confidential comments will, nevertheless, be included in any statistical survey of comments received or views expressed. There are no objections to the content of this paper being reproduced, in whole or part, for non-commercial purposes provided the source is acknowledged.

Any comments or complaints about the consultation process should be addressed to Michael Prior, Office of the Deputy Prime Minister (ODPM), Corporate Business and Delivery Division, Room 2.19, 26 Whitehall, London SW1A 2WH.

CHAPTER 2

How are deposits currently managed?

Taking deposits

1. Over the last century deposit taking has become increasingly common practice as the private rented sector has changed. Pre-second world war, when 57% of the population rented privately, most tenancies were unfurnished, subject to rent-control and occupied by the same tenants for many years. Eviction was governed by common law so that landlords could easily remove tenants in rent arrears. Post-war, legislation regulating eviction by means of court proceedings was introduced. From then and prior to the 1988 Housing Act, most privately rented unfurnished tenancies were regulated in terms of rents and security of tenure. Most newly-available tenancies were therefore furnished and deposits became reasonably common.

2. De-regulation since the 1988 Housing Act has given landlords greater control over their properties. They now tend to let on a short-term basis (assured shorthold tenancies), offering less security to their tenants.

3. Private renting has increasingly become the housing tenure for the mobile and transient – young professionals, students, those saving to buy – and for those for whom it is accommodation of the last resort. In turn this has encouraged the trend in landlords seeking deposits. Currently there is a turnover in the private rented sector of around 40% per annum, which may heighten landlords' uncertainty about the likely behaviour of their tenants.

4. Insurance policies are available to landlords to cover against loss of rental income or damage, the cost of which is potentially greater than the value of a deposit. However even though the cost of, potentially high, premiums could be met in higher rent payments, there is a risk that tenants may take less care of the landlords' property if their money is not at stake. Landlords like deposits because they engender a strong sense of a contractual relationship on the part of the tenant.

5. There is currently no legislation governing tenancy deposits. However common law has established that they may be charged as security against financial loss incurred as a result of the tenant's breach of contract. Such losses often relate to non-payment of rent or damage (beyond reasonable wear and tear) to furnishings. Most landlords charge the equivalent of one month's rent, although larger amounts are sometimes charged, particularly in areas of high demand.[2]

2 The charging of a sum larger than two months' rent tends to be regarded as a premium (under Section 15 of the Housing Act 1988) and may entitle the tenant to some limited additional rights to assign or sub-let (subject to the tenancy agreement and the Unfair Terms in Consumer Contracts Regulations 1999 No 2083[0]).

6. The private rented sector (PRS) now accommodates about 10% of households in England. The Survey of English Housing (SEH) 2001-02 reveals that 70% of PRS tenants (there are 2.21 million households in the PRS) had paid a deposit[3], with the average deposit being around £510 (and likely to be rising in line with rents).

7. This suggests that across England around £790 million is currently being held in deposits.

Holding deposits

8. Many landlords and letting agents regard tenants' deposits as part of their working capital. Anecdotal evidence suggests that the majority of individual landlords do not hold them in ring-fenced accounts, and do not assume that the tenant has an entitlement to any interest which may accrue.

9. Where a letting agency manages a property for a landlord, it may hold the deposit for the tenancy. It may do so as stakeholder, acting as a third party between landlord and tenant; or as agent for the landlord, acting as proxy for the landlord, and having to act on the landlord's instructions with regard to the return of the deposit. Problems can arise through a lack of clarity as to who is responsible for decisions on the repayment of deposits. Notably, this can occur where the tenant has not been properly informed of the basis on which the deposit is held (often because it is not even clear between landlord and agent), or where there is a suspicion that both landlord and agent are using the existence of the other as a delaying tactic.

10. The Association of Residential Letting Agents (ARLA) and the Royal Institution of Chartered Surveyors (RICS) require their members to hold deposit money in a separate client account and belong to a bonding scheme, and the National Association of Estate Agents (NAEA) has a voluntary bonding scheme for its members. There is no provision for independent adjudication in these schemes. The National Approved Letting Scheme (NALS, described in detail in Annex 5) runs an independent arbitration scheme operated by the Chartered Institute of Arbitrators. This however is open only to landlords.

11. Bodies representing landlords and agents are clearly seeking to bring a professional and transparent approach to landlord-tenant relations. However, less than a quarter of all letting agents are members of professional associations. The rest are subject to no regulation.

Returning or retaining of deposits

RANGE AND DEGREE OF PROBLEMS

12. The majority of tenancies end without dispute. Either the landlord/agent returns the deposit in full, without argument or delay, or the tenant withholds their last month's rent with the agreement of the landlord/agent, or both parties agree on the amount of deposit to be returned or retained.

3 70% of households and tenancy groups had paid a deposit on their previously private rented home, with the question only asked of those who moved during the last three years.

13. Where problems do arise at the end of a tenancy, they cover a range of practices of varying degrees of seriousness (see box 1). It should be noted that the amount of money owed to one party or the other could be in a range of a few pounds (e.g. where a small cleaning charge is cited) to hundreds of pounds (e.g. where carpet replacement is cited or where a deposit is withheld without reason), with either the tenant or the landlord/agent being the loser.

14. Tenants have no assurance of cheap or speedy redress through current legal procedures. Statistics on small claims relating to unjustifiably withheld deposits are not kept, but it is known that in 2001 the average length of time taken to hear a small claim was 28 weeks[4]. Issuing a claim for the average deposit of £510 would cost the claimant £80, with a possible further £45 payable to issue a warrant of execution (to enforce the claim). Apart from these issues of time and expense claimants may fail on procedural issues, or be unable to enforce the judgement.

15. Some of the options for change proposed in Chapter 5 would deal with the whole array of problems, whilst others would only improve the practice of people who are predisposed to improve. Some of the problems leading to disputes at the end of tenancies could never be resolved – the Government cannot legislate for human obstinacy.

Box 1

Anecdotal evidence suggests that the gamut of grievances or problems at the end of a tenancy is as follows:

(a) The landlord/agent goes bankrupt, "disappears" or is otherwise incommunicado. There have been well-publicised cases of letting agents going into receivership with the loss of both tenants' and landlords' money.

(b) The landlord/agent refuses to return the deposit without giving any reason.

(c) The landlord/agent agrees to return the deposit but delays doing so until the tenant gives up on getting it back.

(d) The landlord/ agent gives reasons for withholding the deposit, which would be perceived as unjustified by an independent adjudicator, for example, to cover damage for which there is no evidence, or where the costs charged are excessive in relation to accepted damage.

(e) The landlord/agent and tenant are in genuine dispute, with each side honestly believing they are in the right. An independent adjudicator would find the case finely balanced, but could make a decision on the basis of fact.

(f) The tenant genuinely believes, or claims to believe, that deductions are unreasonable, but an independent adjudicator would not agree (an example might be a charge to cover the cleaning of an unemptied fridge at the end of a tenancy).

(g) The tenant withholds their last month's rent without the agreement of the landlord/agent, but leaves the property clean and undamaged.

(h) The tenant withholds their last month's rent without the agreement of the landlord/agent, having created a large amount of damage and/or failed to maintain or clean the property.

4 The Court Service – Judicial Statistics 2001.

EXTENT OF PROBLEMS EXPERIENCED BY TENANTS

16. The extent of tenants' problems surrounding deposit-withholding can be determined from the results of a number of surveys.

17. The Survey of English Housing (SEH) provides the most consistent, reliable and large-scale picture of the private rented sector. SEH 2001/2002 asked tenants what happened with the deposit for the tenancy that they left most recently in the previous three years[5].

18. The findings are as follows:

Return of deposit on most recent tenancy in last 3 years*	**2001-2002**	
Deposit returned in full	609,000	71%
Deposit withheld in part	137,000	16%
Deposit withheld in full	112,000	13%
TOTAL	**858,000**	**100%**

*all cases where a deposit was paid

View of householders about non-return of deposit	**2001-2002**
No view – deposit returned in full	*71%*
The deposit was justifiably withheld	9%
Less should have been withheld	6%
None should have been withheld	14%

Base = 858,000

19. Therefore SEH 2001-02 shows that in the previous three years, 20% of respondents considered that the landlord/agent from their most recent tenancy had retained too much of the deposit. The comparable figure for SEH 1999/00 bears this out, being 22%. This suggests that in a three-year period, a deposit-paying tenant in the PRS has at least a one in five chance of having some or all of their deposit unreasonably – in their opinion – withheld. The more times they move within the PRS, the more likely they are to have this experience.

20. In June 1998 the National Association of Citizens Advice Bureaux (NACAB) report *Unsafe Deposit* cited CAB evidence for a number cases. It was based upon a survey of 446 CAB clients (from 84 Bureaux) who had paid a deposit in the previous 5 years. Of these, 48% said that a landlord had unreasonably withheld some or all of a deposit in that time. It cited cases of households facing considerable hardship and even homelessness through their deposit being withheld, as they have no means to raise a deposit for the next letting.

21. Work conducted for the DETR by the Office for National Statistics' (ONS) Omnibus Survey in February-April 1998 involved a smaller but more random sample. The survey identified 322 people who had moved out of privately rented accommodation in the previous 3-5 years, of whom three-quarters had paid a deposit. 40% (95) of those people had some or all of their deposit retained by the landlord. 30% (74) considered that this withholding was unreasonable to some extent.

5 SEH 2001-02 calculates that 1.5 million private sector tenants had left at least one tenancy in the previous three years.

22. As part of its evaluation of the pilot Tenancy Deposit Scheme (TDS), York University carried out a postal survey of the private tenants in the pilot TDS. It achieved a response rate of 21% (330 cases), although the extent to which this constituted a representative sample might have been affected by a greater propensity of those involved in a dispute to respond. This survey of pilot TDS tenants showed that of the 149 tenants who had rented before their current tenancy, 39% had had a problem with their deposit in the past.

EXTENT OF PROBLEMS EXPERIENCED BY LANDLORDS

23. Disputes over deposits can also adversely affect landlords. As part of their evaluation, York University carried out a poll of landlords not participating in the Scheme, asking, *"On the issue of deposits generally, would you say that you have problems?"*; respondents were asked to indicate the frequency of difficulties on a scale of never, rarely, sometimes and all the time. 33% of respondents said that they sometimes had problems, and 6% said that they had problems all the time.

24. Of course, landlords may make deductions or retain deposits without considering it to be problematical. The English House Condition Survey 2001 asked 592 landlords how often they found it necessary to make a deduction or retain all of the deposit at the end of a tenancy. 29% said that they had to do this *"sometimes"*, with 16% having to do so *"frequently"*, *"usually"* or *"always"*.

25. Although there is no data available, a common complaint from landlords is that tenants sometimes withhold the last month's rent in lieu of the deposit. This strategy can defeat any attempt by the landlord to recover costs that might be legitimately charged against the deposit, such as damage to the property. On the other hand, very many landlords allow, or even encourage, tenants with whom they have had a good relationship to withhold their last month's rent.

26. People's perceptions are obviously subject to their position as tenant or landlord, and it is impossible to establish a true bottom line figure for the number of deposits that an independent adjudicator might judge to be unreasonably withheld.

27. However, it is worth noting that the perceived problem of landlords unfairly withholding deposit is significant, and almost certainly contributes to the common incidence of tenants not paying their last month's rent. This may also be prompted by more general problems during the tenancy. For example, a tenant who believes that their landlord has been reluctant to effect repairs promptly, or habitually entered the property without giving notice, may well be unconvinced that the deposit will be fairly returned.

28. This perception may well be exacerbated by the difficulties many tenants cite with getting their deposits back (e.g. having to repeatedly call agents or wait for a long time) even where there is no dispute. When it comes to resolving disputes, both tenants and landlords may find using the court process to be slow and costly and its awards difficult to enforce, as per the statistics on small claims quoted in paragraph 14.

29. These are all problems which could be rectified by a consistent, professional and transparent approach to the sector by all landlords, agents and tenants. Good practice does have inherent value. Although a national scheme to protect tenancy deposits cannot provide a cure for wrongs suffered by landlords that exceed the value of the deposit, it can play a valuable role in promoting and disseminating good practice.

CHAPTER 3

Improving deposit management

Mandatory deposit protection schemes in other countries

1. Statutory schemes to safeguard tenants' deposits and landlords' property are common in many parts of the world. It is known that there is provision in place – ranging from basic legislation to mandatory deposit protection schemes – in Germany, France, Belgium and parts of Spain, and in Australia, New Zealand and Canada. Information about schemes in other countries, particularly in mainland Europe, is welcomed from consultees.

2. In Germany deposits cannot equal more than three months' rent, must be held in a special account and generally returned with interest within a time limit of one year after the end of the tenancy. There is no independent decision on how the deposit should be allocated, and no specialised arbitration process for disputes. It is reportedly not unusual for tenants to experience difficulties when trying to get back their deposits, and legal cases concerning the return of deposits are common.

3. In France similar regulations apply. Deposits are limited to two or three months' rent and must be returned within two months of the tenant handing the keys back. No interest is payable to the tenant unless the time limit for the deposit return is exceeded. The landlord must provide evidence for any deductions they wish to make and a condition report on the property both at entry and exit of the tenant is also a legal requirement. However, if the landlord does not comply with the tenant's written request to provide such proof or return the deposit, the tenant must take the case to court.

4. In Belgium, the approach is rather different, with end-of-tenancy costs being guaranteed by the country's banks. Landlords are not allowed to hold deposits; rather, tenants deposit three month's rent in a blocked bank account which is in the tenant's name but controlled by both landlord and tenant. The money can only be released when both sign an agreement. The interest belongs to the tenant and disputes are taken to a civil court. A second Belgian option requires no deposit at all but is a form of insurance set up by the tenant, who pays a bank a handling charge and yearly fee to guarantee them against any damage or rent arrears.

5. In Australia and Canada, the state or provincial Government is responsible for housing legislation. These countries provide three models for a mandatory scheme, described in detail in Annex 6:

   (i) to require the landlord to return the deposit with interest within a set time limit;

   (ii) to require the landlord to hold the deposit in a separate trust account and return the deposit with interest within a set time limit;

   (iii) to require the deposit to be held and disbursed by an independent statutory body.

6. In New Zealand and the majority of the Australian states and Canadian provinces, disputes are referred to tribunals specialising in residential tenancy issues (rents and repairs as well as deposits), rather than general courts. Government departments or their agencies administer these tribunals.

The pilot Tenancy Deposit Scheme (TDS)

7. The pilot Tenancy Deposit Scheme (TDS) was set up with the objective of creating systems for protecting deposits and resolving disputes, and establishing whether those systems are effective, on (a) a voluntary and (b) a self-financing basis. The scheme's target was to cover 30,000 tenancies by the end of March 2002.

8. The pilot, which is overseen by a Steering Group chaired by the Department (details at Annex 7), initially covered 5 areas: Brent and Camden in London, Brighton and Hove, Birmingham/West Midlands, Norwich/Norfolk and Merseyside/West Lancashire. However, as various landlord and agent associations have joined the TDS, coverage has extended outside these areas, and it is now effectively national.

9. By the beginning of 2002, the pilot had signed up an insufficient number of landlords and agents to determine its potential to be self-financing. Further Government funding was provided to continue the pilot for up to a further two years.

10. The pilot TDS involves two options, both of which involve adjudication by the Independent Housing Ombudsman (IHO) in the event of a dispute between the landlord/agent and tenant about who has better claim to the deposit at the end of the tenancy.

11. The **custodial option** requires landlords, or agents acting on their behalf, to place a tenancy deposit in a ring-fenced account operated by the Nationwide Building Society for the purposes of the pilot. When disputes occur the IHO promptly decides who is entitled to what proportion of the deposit and instructs Nationwide to pay to each party accordingly. It is intended that the custodial option is funded from interest and there is no further charge to tenants or landlords.

12. The **insured option** was developed as an alternative to the custodial option, as landlords and agents wanted an option which allowed them to retain control of the deposit, and it is being used by the great majority of the landlords and agents who have joined the TDS.

13. The insured option enables landlords/agents to hold the deposit during the tenancy if they take out an insurance policy with an accredited insurance company – the CGU Guarantee Society for the pilot. They keep the interest on the deposit, unless they have agreed that the interest will be returned to the tenant, and are under no obligation to keep the deposit in a ring-fenced account. Where, in a dispute, the IHO determines that some or all of the deposit must be returned to the tenant, the IHO instructs the Scheme insurers to arrange its speedy payment. The insurers then ask the landlord or agent to reimburse that sum and a post-award insurance premium within 10 working days.

14. Both Nationwide and CGU/Norwich Union are committed to maintaining the protection arrangements for deposits in the Scheme for a further three years. The IHO has said that it will continue to handle disputes arising as long as it is in funds to do so.

15. The pilot is still ongoing and, as will be seen, few definitive conclusions can be drawn from it to date. Nevertheless, it is both desirable and possible to make an interim assessment in order to further the debate about the need to safeguard tenants' deposits.

THE TAKE-UP OF THE PILOT

16. The membership target for the first two years of the pilot was to attract 1,500 landlords/agents covering 30,000 tenancies. As at June 2002, 102 landlords and 74 agents had joined the TDS. It was possible to ascertain that 1,226 tenancies were covered by the custodial option.

17. It is not possible for IHO ascertain how many tenancies are covered by the insured option, because some landlords and agents have been reluctant to specify details of the stock they own or manage, and have not been pressed to do so, in case it provided a disincentive to join the voluntary scheme[6].

18. In December 2001 the IHO wrote to over 180 participants in the Scheme to establish information on the size of their involvement. The response was disappointing – only 16 agents and 3 landlords replied. The relevant data provided was as follows:

Agents (16)	**Numbers**	**%age**
How many properties do you manage?	15,244	100
How many properties do you have on a let-only basis?	6,707	44
How many of these are currently covered by TDS?	**2,371**	**16**
How many of the rest do you expect to bring into TDS in the next 12 months?	8,821	58
Landlords (3)		
How many properties do you own or manage?	19	100
How many of these are currently covered by TDS?	**11**	**58**
How many of the rest do you expect to bring into TDS in the next 12 months?	5	26

19. The IHO suggests that the number of letting agents' tenancies covered by the insured option may be estimated as follows. The majority of agents have joined only since ARLA acceded to it in July 2001. The IHO is informed by ARLA that the average agent's portfolio covers about 1,250 properties. On that basis, there could be up to 92,500 agent-managed properties in TDS. However the extent to which those tenancies have or will become part of the Scheme hinges on decisions of individual landlords under tenancy and management agreements to make tenancy deposits subject to the Scheme. As at November 2002 the IHO was writing to landlords and agents requesting details of their tenancies in the scheme prior to invoicing for membership fees.

6 York University and the Department's auditors have commented on the unwillingness of landlords to provide this data.

PROSPECTS FOR FUTURE TAKE-UP

20. The membership is likely to expand as agents and larger landlords bring further stock into the Scheme with the renewal or creation of tenancies. However, it should be noted that membership may decline as well as increase; BPT (previously Bradford Property Trust), the largest single landlord in the TDS accounting for around 90% of the tenancies in the custodial option, is selling many of its properties to landlords who do not wish to be in the TDS.

ADJUDICATIONS

21. There have been few disputes requiring adjudication (61 external adjudications had been commissioned by mid August 2002), but the vast majority have reached a satisfactory conclusion within the required time-scale. The comparatively low number of adjudications may partly reflect the fact that only the best landlords have joined this voluntary scheme. It is as likely to be due to the deterrent nature of the scheme.

22. Information – where known – about disputes and adjudication, is presented in the following table, which indicates the position at August 2002. There have been too few disputes to date (and too little information available about tenancies in the insured option) to draw any conclusions about the number of tenancies which are likely to lead to adjudication. As adjudications are the largest variable cost, this lack of information is a major drawback to analysing the scheme's potential costs, and therefore its viability.

	Insured option	**Custodial option**
Tenancies covered/deposits protected	NOT KNOWN	1,857
Tenancies ended/deposits withdrawn	NOT KNOWN	744
Average deposit	NOT KNOWN	£738
Average deposit in cases of dispute	£1,584.08	£896.16
Average amount disputed	£1,018.75	£843.28
Number of adjudications completed		
(a) brought by landlord	10	11
(b) brought by tenant	31	4
(c) total	**41**	**15***
Number of adjudications completed:		
(a) where landlord major beneficiary	18	6
(b) where tenant major beneficiary	23	9
Average amount awarded to landlord	£490.74	£381.92
Average amount awarded to tenant	£527.96	£416.42
Average cost of adjudications	£208.12	£102.50

*Seven of these were sufficiently straightforward for IHO to arbitrate a satisfactory conclusion without bringing in an external adjudicator.

23. It should be noted that the average deposit protected by the pilot is considerably higher than the national average. This may due to a number of factors. Many of the tenancies protected will be in the pilot areas of London and Brighton, amongst the most expensive parts of the country. It is also possible that those landlords and agents who are predisposed to join the pilot TDS are managing properties at the more expensive end of the market, and/or that those tenants predisposed to dispute their deposit handling are accommodated at the upper end of the market.

FUNDING AND COSTS OF THE PILOT

Custodial option

24. The custodial option is intended to meet its costs through the interest on deposits. This raised around £11,800 in 2001-02. 429 custodial option tenancies ended in this time period, almost exactly half as many as the 970 which started (although some of those which ended would have begun in 2000-01). Seven of the 429 – about 1.5% – resulted in disputes requiring external adjudication[7]. The seven are estimated to have cost around £1,800.

25. There are indications that over the next two years income from interest will remain about the same and adjudication costs will rise as the numbers of tenancies leaving the custodial option may be increasing slightly faster than the numbers signing up to it.

Insured option

26. Only individual landlords joining the Scheme would be expected to pay an initial premium for a specific tenancy. Those joining the Scheme as part of a trade association package may be covered by the bonding arrangements of that body without regard to the numbers of landlords/tenants/deposits covered (as in the case of the bodies NAEA, RICS and ARLA covering the agents). Alternatively they may be covered by insurance arrangements separately negotiated by the trade body from those available to private landlords under the Scheme (as for the Southern Private Landlords' Association and landlords' bodies in Liverpool, the Wirral and the Midlands).

27. However, the Steering Group recognised early on that maximising the financial contribution from participants in the scheme would work against achieving its widest possible adoption. Efforts to maximise take-up have taken priority, and so in the two and a half years the pilot has run to date, none of the individual landlords in the insured option have been invoiced for their initial insurance premiums. Nor have any of the scheme members in the insured option, whether individuals or affiliated to a trade association, been invoiced for their TDS membership fee (£1.02 per tenancy per year).

28. However, both insurance premiums and TDS fees will shortly be required to fund the scheme. This is essential if its self-financing potential is to be properly tested.

29. In 2001-02, there were15 disputes requiring external adjudication arising from the insured option, at an estimated collective cost of around £3100. It is not known how many tenancies were covered by the insured option, although if the proportions leading to the dispute in the custodial option are a guide we could surmise that around 1,000 insured option tenancies came to an end in 2001-002, of around 2,000 tenancies protected by the option.

Government funding

30. Government funding was offered to the IHO in February 2000 to cover the staffing and running costs of the pilot including the production of information and publicity material for the Scheme, and the administration of the adjudications.

7 This reflects the situation in the Queensland and New Zealand custodial schemes (see Annex 9) where the percentages of disputes are 3% and under 2% respectively.

31. In February 2002 further Government funding of the pilot to March 2004 was authorised to further test the basis for a self-financing national voluntary scheme, or the extent to which membership of such schemes would need to be a legislative requirement. This further funding amounts to a maximum of £300,000 (£150,000 per year). It may be provided to the end of March 2004, but only if the conditions of the grant are met.

32. The pilot TDS has cost the Government around £490,000 as at end of September 2002 (around £380,000 to the end of March 2002, and a further £109,000 so far this financial year).

PROSPECTS FOR A SELF-FINANCING TDS

33. There is not yet sufficient data to make a reasonable estimate of the costs of running the scheme. IHO argues that experience to date shows that the costs will not be daunting and a take-up of between 250,000 and 350,000 units could allow the insured option to be self-financing at subscription levels comparable with the IHO statutory scheme for registered social landlords. IHO also believes that a statutory scheme will pay for itself by virtue of the volume of landlords and agents it will draw in.

34. An audit of the pilot TDS was carried out by Government auditors in June 2002 (further details at Annex 8). The aim was to establish whether monies provided by the Government were adequately accounted for by the IHO and whether there was any evidence that the current, voluntary scheme could become self-financing before Government funding runs out in March 2004. The latter aim was not possible given the lack of accurate information about membership levels at the time of the audit.

Independent evaluation of the pilot

35. The Government commissioned an independent evaluation of the pilot TDS by York University[8] which is summarised at Annex 9. The research, which was carried out between January 2001 and May 2002, could only be inconclusive on the subject of whether legislation is necessary, as the researchers found that the pilot provided insufficient evidence to assess fully the nature and extent of the problem.

36. The researchers also considered that the pilot's systems had been insufficiently tested to draw definite conclusions on the IHO's ability to deal effectively with basic administrative functions. The number of landlords and agents involved in both options had been small and the throughput of tenancies limited. The dispute resolution function appeared able to arrive at decisions considered fair by tenants and letting agents.

37. However the researchers considered that problems might arise from the fact that no limits had been set on the costs attached to dispute resolution. They also suggested that a mandatory deposit protection scheme along the lines of the pilot TDS, might well require further Government subsidy as it was phased in.

38. On the issue of whether legislation would be required, the researchers weighed up a range of pros and cons drawn from interviews with tenants, landlords and representative bodies and came to the following conclusions:

8 The full report is separately available from the ODPM Publications Sale Centre, Unit 21, Goldthorpe Industrial Estate, Goldthorpe, Rotherham S63 9BL, Tel: 01709 89318 (fax: 01709 881673), or at www.housing.odpm.gov.uk

- A mandatory scheme, particularly if based on a custodial model, would be popular amongst tenants, many of whom had had previous negative experiences of the non-return of a deposit by a private landlord and amongst whom the expectation of being badly treated was high.

- In contrast, small landlords in the pilot areas who had not signed up to the pilot TDS felt that deposits were not enough of a problem for them to join a voluntary scheme.

- Both landlords and tenants concurred that the system of deposit taking was open to abuse by unscrupulous landlords. Landlords felt that most difficulties arose from poor management practices rather than an intention by landlords to exploit tenants, and that the imposition of a mandatory scheme would:

  a) impose costs that would eventually be passed on to tenants across the whole sector;
  b) be difficult and costly to enforce;
  c) not be capable of tackling the most serious abuses.

Strengths and weaknesses of the pilot

STRENGTHS

39. The pilot TDS has two major strengths. In the first place as a "flagship" for deposit management, it has played a valuable role in identifying and establishing good practice. The IHO believes that the pilot is helping to change perceptions about the value of deposit protection schemes. Once satisfied that the scheme could produce fair and timely dispute resolution, ARLA decided to actively encourage its members to join. BPT were surprised to discover how much its tenants supported its participation and how much this enhanced its reputation. BPT and a number of substantial agents overhauled their procedures, documentation and management practices, often at considerable expense.

40. Secondly (in the same way that speed cameras tend to deter motorists from speeding) by putting deposit management issues on record, the pilot scheme by its very nature tends to improve deposit management. It may well be the case that the comparatively low number of disputes stemming from the pilot thus far is due to landlords and agents managing deposits in an efficient and fair way **because** they are in the pilot.

41. The TDS has also shown unexpected applications. The IHO has developed a version of the insured option that will benefit deposit guarantee schemes, by allowing them to spread their resources further and to reassure landlords that an independent decision-maker will resolve disputes. The same refinement can be applied to relocation agents, who frequently report difficulties in resolving deposit disputes with landlords.

WEAKNESSES

42. The pilot has not achieved take-up targets, because surrendering control of deposits is unpopular with landlords and agents, and also because of the lack of a perceived need for such a scheme.

43. The pilot is unable to indicate whether the TDS could be self-financing on a statutory basis, mainly due to the way the insured option has been set up. Most landlords and agents in the pilot have preferred to sign up to the insured option as it does not require them to surrender control of the deposit. Early in the development of the pilot, landlords' and agents' representatives made strong representations for the insured option to be as attractive as possible to landlords – by making it free to join and by not requiring members to divulge details or even numbers of tenancies managed. The Department, the IHO, and other members of the Steering Group agreed to these requests, but with hindsight, it has prevented adequate monitoring of the pilot.

44. It has hindered, amongst other things, the determining of what proportion of tenancies lead to disputes requiring adjudication, and how much, therefore, membership fees need to be in order to meet the scheme costs. Scheme members are shortly to be invoiced their membership fees, however, they will need to divulge the number of tenancies they manage for this process to be accurate. Moreover, if they do not divulge detailed information on their tenancies, they can potentially under-claim the numbers managed whilst diverting disputes from any of their actual tenancies to the adjudication systems.

CHAPTER 4

Options for new legislation and alternative approaches

1. The Government seeks views on the future of tenancy-deposit holding. We ask consultees to indicate their views on whether Government intervention on this issue is necessary. We further ask consultees to indicate, should it be agreed that intervention is necessary, which of the following options they believe would be most effective, and on what grounds.

2. Many of these options could and should work in conjunction with each other, and we welcome indications of multiple preferences from consultees. Suggestions for further options, legislative or non-legislative, are also welcomed.

OPTION 1 – NO GOVERNMENT INTERVENTION: VOLUNTARY CUSTODIAL DEPOSIT PROTECTION SCHEMES, VOLUNTARY INDUSTRY ACCREDITATION SCHEMES

3. Landlords and agents could continue to join the voluntary TDS, officially expanded to cover the whole of England, in the hope that it would expand to the point where it no longer requires Government funding. The TDS or a similar scheme could also be operated in Wales and Scotland, subject to agreement from the Welsh Assembly Agreement and Scottish Parliament.

4. Landlords or tenants could opt to join local deposit-protection schemes where available. Many of the Bond Schemes operating on a local basis (for example in Cardiff, see Annex 10) involve public subsidies and were initially set up to help provide deposits for people on low incomes, but there appears to be a trend for such schemes to increasingly encompass custodial deposit protection and arbitration services.

5. Tenants and landlords not belonging to voluntary schemes would have to continue to use Small Claims procedures in the civil courts.

6. The advantage to the industry of using voluntary custodial schemes is that if the majority of landlords and agents could be persuaded to sign up to them, they could continue to be subject only to self-regulation. In this way market forces and the industry itself could exert pressure on the worst landlords and agents to improve their practices, which in turn should lead to greater confidence from tenants.

7. However, if landlords and agents continue to show the reluctance for voluntary self-regulation which has resulted in low take-up for the pilot TDS, the Government may have to intervene. It is certainly the case that if take-up to the pilot does not improve significantly, it will not survive. Government funding may be provided to the end of March 2004, but only if the conditions of the grant are met.

8. Voluntary custodial schemes could work well in tandem with industry-run voluntary accreditation schemes such as the National Approved Letting Scheme and smaller-scale regional projects.

9. For example, in Bournemouth and Poole the local authority and the local landlords' association run a scheme for accrediting landlords, properties and tenants (see also Annex 10). Disputes are dealt in accordance with the complaints and disciplinary procedure of the landlords' association. If necessary, arbitration is carried out by an external arbitrator, who may be from the council's Housing Services or another relevant body, such as The Rent Service or Housing Ombudsman.

10. With regard to deposit management, these schemes can, as a minimum, provide for adjudication in the event of a dispute. This would involve the full value of the deposit being passed by the landlord to the adjudicator at the start of the adjudication process, although if landlords did not comply, tenants' only recourse would continue to be Small Claims procedures, with the attendant problems of enforcing a judgement.

11. If backed up by a national policy on accreditation[9], perhaps linked to special incentives for members of such schemes, accreditation schemes of this kind could provide an alternative to specific legislation. However, landlords would have to sign up to such schemes in considerably larger numbers for the Government to be convinced that legislation is not necessary.

OPTION 2 – STATUTORY TENANCY MONEY PROTECTION SCHEME(S):

2.1 Statutory custodial deposit protection scheme(s).

12. Deposits are collected and managed, and disputes resolved, by an independent third party. Initially the current pilot, managed by IHO, could be extended to provide this service on a mandatory basis. Further schemes could be approved by the Secretary of State.

13. It would be illegal for a landlord to hold a deposit for a tenancy and it would be a statutory requirement for landlords/agents to demonstrate membership of an approved custodial scheme prior to taking the deposit.

14. This is arguably the simplest way of ensuring that tenants who honour the terms of their tenancies get their deposits back, and is in economic terms far more certain than an insured option (see 2.2 below) of becoming self-financing, especially if money was held in one large 'pot' rather than a multiplicity of small ones.

15. There is considerable hostility from landlords to the idea of a mandatory custodial scheme, as they feel it would be unnecessarily bureaucratic and interfere with their right to run their businesses as they wish.

16. There is considerable support for this option from tenants and organisations representing tenants, who consider that it is wrong for landlords and agents to consider tenants' monies as part of their working capital.

9 The establishment of the National Accreditation Network in May 2002 offers an extra encouragement to the use of accreditation schemes by local authorities, universities, landlords and tenants.

2.2 A statutory custodial scheme and approved insured alternatives

17. As 2.1 above with a single custodial scheme, but with an additional scheme or schemes (approved by the Secretary of State) in which the landlord holds the deposit and pays an insurance premium against problems with deposits, that is, a mandatory version of the current insured option.

18. Unless they were a member of an approved scheme it would be illegal for a landlord to hold a deposit for a tenancy. It would be a statutory requirement for a landlord to identify to the tenant which scheme the landlord was signed up to.

19. This option is somewhat less unpopular with the industry as landlords and agents can retain control of tenants' deposits if they join up to an insured scheme.

20. However, there is a major risk inherent in an insured scheme as, to date, the pilot TDS can provide no evidence that the insured option could cover its costs. Indeed, with increased numbers of less reputable landlords and agents joining up to a mandatory scheme, there may be a strong chance of increased defaulting from paying the insurance premiums.

21. An attendant risk is that if a number of smaller schemes were approved, none would cover sufficient tenancies to have a chance of becoming cost-effective. This might be somewhat balanced by competition in the provision of insurance cover.

2.3 Statutory membership of either a custodial deposit-protection scheme or an approved trade association or accreditation scheme

22. This would enable professional bodies such as the National Federation of Landlords (NFRL), Small Landlords' Association (SLA), ARLA, NAEA and RICS, and industry-run accreditation schemes, such as NALS, to set up their own deposit management schemes, approved by the Secretary of State, to safeguard tenants' monies and provide independent adjudication of disputes. The existence of adjudication for tenants would be a new provision since it is not currently a feature of any of the industry schemes.

23. A custodial deposit scheme, such as the IHO's pilot, would continue to run as the default option for landlords and agents who did not want to join a professional or trade association.

24. This option would allow the professional end of the industry internal control over deposit management and arbitration, and should help to encourage other landlords and agents to work to the standards of the best. This option would work in conjunction with Options 6 and 7 below.

OPTION 3 – DEPOSIT PROTECTION THROUGH THE TENANCY AGREEMENT, USING THE LAW COMMISSION'S APPROACH

25. The Law Commission has been reviewing housing tenure law[10] with a view to proposing a simpler regime, reflecting the approach of the Office of Fair Trading in applying the Unfair Terms in Consumer Contracts Regulations 1999 to tenancy agreements.

10 Consultation Paper No.162 *Renting Homes – Status and Security* – April 2002.

26. The Commission's paper takes the following broad lines:

- People who pay rent for their homes should be subject to the type of protection that the law provides for consumers of other goods and services.
- The scope of statutory protection should encompass the vast majority of those people who rent their homes, with a very limited number of exceptions.
- Written contracts are needed for rental agreements. These should be clearly and straightforwardly expressed so that occupiers and landlords understand their respective rights and responsibilities.

27. For the rental agreement, a legally prescribed set of terms is proposed, based on core terms relating to the parties and the property concerned, compulsory or legally implied terms and negotiable or default terms. It is proposed that the definition of core terms is left to consumer legislation rather than included in a Housing Act[11], although they would include basic details of the landlord, tenant, property and tenancy.

28. Whilst not specifically addressing the question of whether or not tenancy deposits should be regulated[12], it suggests that a requirement for payment of a deposit would be regarded as a core term but that a term dealing with the return of a deposit at the end of the agreement would probably not be[13]. The Law Commission plans to reflect consultees' responses to the paper in a draft Bill to be published in summer 2003.

29. For the purposes of deposit protection, the option is that Law Commission proposals for prescribed tenancy agreements be adopted, with both deposit protection and return be included in core terms. In this way deposit protection is included in the gamut of reforms to the contractual nature of tenancies, and is not looked at as a separate issue.

30. Subject to the provisions of the Law Commission's Bill, such terms could be supplemented by the requirements of accreditation schemes.

OPTION 4 – A STATUTORY BANK GUARANTEE SCHEME

31. A radical shift in current thinking would be to adopt a scheme on a Belgian model which puts the onus on the tenant to provide a bank guarantee. No deposit is taken, but the tenant pays their bank to guarantee to cover the debt should the tenant default.

32. This would require a cultural shift to be acceptable in the UK, but anecdotal evidence suggests that it provides effective protection to both tenants' deposits and landlords' properties, with minimum recourse to the courts. It would have to work in conjunction with Option 6 below to be effective. It might also be difficult for tenants who do not already have a bank account or building society account to set up such a guarantee; it is estimated that at least 10% of the population are in this position.

11 Ibid. Paragraph 6.53.
12 Ibid. Paragraph 1.85.
13 Ibid. Paragraph 6.51.

OPTION 5 – A BAN ON DEPOSIT-TAKING, NO STATUTORY DEPOSIT PROTECTION SCHEME

33. It would be illegal to take a deposit for a tenancy. Landlords make their own insurance arrangements (or use a bank guarantee scheme as above).

34. The advantages of banning deposits in this way are that tenants don't risk losing their money, the industry doesn't face the threat of regulation, and landlords and agents don't risk being owed more than the sum of the deposit, as any arrears or damage will be covered by their insurance.

35. The disadvantages are that insurance premiums would be significant and have an impact on the rents that tenants paid, penalising good tenants and bad alike, and in any case, insurers would be unlikely to cover negligence on the part of a tenant. It would also require a cultural shift to be acceptable and landlords believe that tenants treat properties better if they have, effectively, a stake in them.

Further legislative options to protect clients' monies and prevent unreasonable charges

OPTION 6 – STATUTORY REQUIREMENTS WITH REGARD TO INVENTORY-TAKING, REGULATION OF "NON-DEPOSIT" FEES AND CHARGES

36. Many disputes over the return of deposits arise over the inadequacy of inventories and the standards and costs of cleaning required by the deposit-taker. Landlords need to make clear at the start of a tenancy the sort of costs that might have to be met out of a deposit at the end of a tenancy. These would be subject, of course, to common law tests for reasonableness, such as the existing non-liability of tenants for fair wear and tear, and the deposit not being used to fund an improvement in the condition of the property. This increased clarity would help avoid disputes and ensure the speedy resolution of those that may still arise.

37. Such a requirement could be prescribed in statute (or a power to do so by secondary legislation could be sought). Since the proposed legislation will give tenancy deposits a statutory basis for the first time, there is a case for a power to define by secondary legislation the costs that might have to be met out of a deposit.

38. In making legislative provisions the Government will need to address the risk of landlords/agents seeking to avoid compulsory deposit provisions by 'converting' the deposit into an up-front charge. They might simply add an extra charge onto prevailing rents – although that would be open to challenge by a tenant (and to the effect of prevailing market forces).

39. Many agents already do add charges at the start or renewal of a tenancy: 'finder's fee'[14], agreement cost, referencing, check-in/inventory and check-out fees. Some of these charges may be reasonable, but many, arguably, should be covered by the commission the landlord is paying for the agent's services in arranging/managing the tenancy – anything up to 15% of the rent. Further, there may be no attempt to make the charge resemble the costs involved (a recent Departmental enquirer cited an agent charging £750 for referencing and a pro-forma agreement).

40. There is a case for legislation to deal with unjustified charges for which no specified cost is actually incurred, or to prescribe a proportionate limit for uncertified charges. The proposed legislation could prohibit landlords and agents from making charges (say in lieu of a deposit) that are neither rent nor a security against a breach of the terms of the tenancy (e.g. tenancy renewal fees), or limit such charges. Indeed, this was the position (under the Rent Act 1977) until 1989. However, such a measure could risk a charge of being unduly prescriptive and over-regulating.

OPTION 7 – STATUTORY PROTECTION OF CLIENTS' MONIES HELD BY LETTING AGENTS

41. With regard to letting agents, any statutory requirement to protect tenants' deposits would apply to them as agents of the landlord. However, letting agents are also responsible for landlords' monies, for which there is also currently no statutory protection. The Housing Green Paper recognised that many small landlords need help with letting and management but do not know how to get hold of a good agent or are deterred by stories of unscrupulous agents.

42. There are three professional bodies which represent the lettings industry: the Association of Residential Letting Agents (ARLA), the National Association of Estate Agents (NAEA) and the Royal Institution of Chartered Surveyors (RICS). Together they represent about 4,000 lettings offices. Their membership criteria vary and even where landlords are aware of the significance of membership of a professional body, they may find it difficult to relate that to the minimum level of service that this guarantees and exactly what protection is being afforded.

43. It is estimated that there may be between 6,000-8,000 non-attached letting agents (i.e. agents who do not belong to one of these professional bodies). Whilst many of these firms provide a good level of service, there are also many unscrupulous agents and others who, whilst well intentioned, do not have sufficient knowledge and experience to provide an adequate service.

44. Currently, there is no statutory requirement for letting agents to register with or seek a licence to operate from any authority.

14 This does not infringe the Accommodation Agencies Act 1953 so long as finder's fees are charged only in respect of accommodation the tenant accepts.

45. Letting agents are subject to the Unfair Terms in Consumer Contract Regulations 1999. The Regulations protect consumers from one-sided standard contracts favouring traders; in the context of housing, this means contracts between tenants and landlords/agents, and between landlords and agents. Under the Regulations a consumer is not bound by a standard term in a contract with a trader if that term is judged unfair. The only exception to this is for price setting (i.e. rent) terms and those which give details of the property and the length of the tenancy, provided these terms are in plain and intelligible language.

46. The activities of letting agents are also governed by general consumer protection legislation which entitles consumers (in many cases both landlords and tenants) to expect that a service is carried out with reasonable care and skill, within a reasonable time and at a reasonable charge, if no price has been fixed in advance.

47. Despite the consumer protection afforded by the above legislation, complaints about letting agents persist. In recent months there has been adverse publicity relating to two high profile letting agencies defaulting on payments to landlords. In the first 9 months of 2001 588 consumer complaints were registered with the Office of Fair Trading in the category "letting agents and management". However, the true level of complaints is likely to be significantly higher as many complaints received against estate agents relate to letting activity. These complaints may go unrecorded because the authorities are unable to take action relating to letting activity under the Estate Agents Act 1979.

48. The Act requires, amongst other things, that client money is accounted for in a precise way. Deposits must be kept in a client account and there are detailed rules on how these accounts must be operated. Although it ensures that estate agents act in the best interests of their clients with regard to property buyers and sellers, the Estate Agents Act 1979 does not apply to agents' activities with regard to lettings, even where estate agents undertake both property selling and letting.

49. The Government believes that this is an unacceptable situation given that most estate agents, and specialist letting agents, hold significant sums of money on behalf of landlords and tenants. The Government proposes that there should be a statutory requirement for letting agents to safeguard their clients' monies by means of an approved scheme that:

- adequately ring-fences such monies;
- protects such monies from misappropriation through suitable insurance such as professional indemnity insurance and client money protection insurance;
- provides for independent adjudication.

50. All of the professional organisations have such procedures in place which are a requirement of membership and the National Approved Letting Scheme (NALS) has recently set up a client money protection insurance scheme which will enable non-attached agents to join (see Annex 5). Therefore, it is proposed that membership of ARLA, NAEA, RICS or NALS would serve as evidence that a letting agent met the statutory requirement. It is also proposed that the Government would have powers to approve further schemes that met the statutory requirement.

51. The introduction of this requirement would need to be phased in order to allow time for agents to ensure that they can meet the statutory requirement. Agents which did not meet the statutory requirement would not be able to hold client money.

Alternative adjudication providers

52. The Institute of Rent Officers and Rental Valuers have previously suggested that it would be appropriate for rent officers to take on the adjudication function, collecting and disbursing deposits locally and arbitrating on disputes. Deposits could be accounted for centrally by what is now The Rent Service (TRS) and the interest would be used to cover the costs. Early in the development of the pilot the suggestion that TRS should carry out this function was rejected. However, TRS has recently taken over many of those adjudications in the pilot TDS which call for Rent Officers' valuation expertise. It is possible that the TRS could either run a statutory deposit protection scheme on its own, or in conjunction with an administrative body (as in the Bournemouth and Poole scheme, see Annex 10).

53. The Rent Assessment Panels already provide a regional network of independent quasi-judicial public committees and tribunals, which adjudicate on disputes over rents, and management of leasehold properties. It would be possible to extend their role to cover rent deposit disputes. This would have running cost implications, particularly if they were to deal with cases more quickly than they do at present (a rent case takes on average more than 16 weeks), unless they also held, and so were able to earn interest on, the deposits.

Enforcement

54. In the event of a mandatory deposit or client-money protection scheme being introduced, effective enforcement measures will be needed, to indicate how a tenant (landlord) may enforce their rights should their landlord (agent) fail to comply with a statutory requirement that deposits should be so protected. The easiest course would be for the landlord or agent, prior to or at the start of a tenancy, to issue to the tenant a document (of which the landlord would keep a copy), which:

- in the case of a custodial option would require the tenant to post a deposit of a required sum in a named account within, say, 7 days;
- in the case of an insured option would require the tenant to pay to the landlord a deposit of a required sum within, say, 7 days;
- in the case of a bank guarantee option would require the tenant to provide the proof of guarantee of a required sum within, say, 7 days.

55. The document would provide a statement of the tenant's rights under the scheme, and names, addresses and phone numbers of either the deposit holder, insurer or bank and references to the account or insurance policy concerned. It would also provide similar details of the body (such as the IHO) providing independent resolution in the event of a dispute. The tenant would then have an opportunity to check the veracity of this document before parting with a deposit.

56. In the event that a landlord had failed to comply with this statutory obligation the tenant might seek the assistance of a local authority either:

- **As a consumer issue:** Trading Standards Officers already have a role under the Accommodation Agencies Act and in the general context of letting agents as traders; or

- **As a housing issue:** Tenancy Relations Officers already deal with matters concerning rent books or offences concerning a failure of private landlords to provide certain details.

57. Local authorities may perceive that the enforcement role would fit within their housing role, particularly under the tenancy relations function. Private Sector Housing Advisors/Tenancy Relations Officers are already advising on agreements under Unfair Contract Terms, and this is also a key point to the Law Commission's consultation paper on Renting Homes.

58. Legislation could also provide that if a tenancy deposit had been wrongly taken then either the tenant or the local authority could seek a court judgement for the return of the deposit and for the landlord, for a second or third offence, to receive a fine. In the event of further offences the local authority could seek a declaration that the landlord was not a 'fit & proper person' (as envisaged for HMO licensing) and seek to impose an alternative manager.

CHAPTER 5
Conclusions

1. It is almost impossible to ascertain the extent of unreasonable deposit withholding by landlords, as it is an emotive issue, revolving around money, rights and responsibilities, and subject to the differing perceptions of tenants, landlords and agents. It is similarly difficult to quantify the negative impact on landlords when tenants cause damage to the property.

2. However, it is possible to say that of the people who left a private rented sector tenancy in the last three years, at least one in five believed that all or part of their deposit was unreasonably withheld by the landlord or agent.

3. There is also considerable anecdotal evidence to suggest that previous experiences of bad deposit management, and perhaps a perception that unfair deposit withholding is common, may often lead to tenants defaulting on their final month's rent. The Department plans to test this hypothesis through the rolling ONS survey.

4. With regard to the pilot Tenancy Deposit Scheme, the mechanics of the custodial option and the adjudication processes seem to work although they have been applied only to very small samples to date. The indications are that that they may be viable on a national statutory basis, although further Government funding might be required whilst a statutory scheme was phased in.

5. The mechanics of the pilot's insured option have not been sufficiently tested to tell whether it would work on a statutory basis, or even on a larger-scale voluntary basis. An inherent risk of the insured option is that if it became part of a mandatory arrangement, less responsible landlords might default on paying premiums.

6. The pilot seems to have suffered from the conflicting nature of its two main aims; to be (a) voluntary and (b) self-financing. It has also been hampered by the reluctance of the industry to give up holding deposits, to divulge information about their tenancies or to pay membership fees for a deposit protection scheme. In order to test whether the mechanics of the pilot work on a voluntary basis, the IHO have decided to concentrate on encouraging as many landlords and agents to join as possible. In order to encourage as many to join as possible, essential information – and fees – have not been required. Therefore, the pilot has not so far had an opportunity to test its self-financing capacity.

7. The work carried out on deposit protection issues in general, and the pilot TDS specifically, strongly indicates that landlords and agents are averse to any kind of regulation. This is borne out by the low take-up to the National Assured Lettings Schemes. Nevertheless, the industry would benefit inordinately from the improvements in practice – and in image – which would arise from an assured approach to the safeguarding of tenants' deposits and other client monies.

8. The pilot TDS was established (as was NALS) to offer landlords the opportunity to make this a self-regulatory approach. Statutory intervention was the alternative. Although the costs and benefits of such intervention must be fully assessed, the limited impact of the TDS to date suggests that legislation may be inevitable.

ANNEX 1

Partial Regulatory Impact Assessment

Tenancy money: probity and protection

ISSUE

1. It is common practice for private landlords and letting agents to require a deposit, usually equivalent to one month's rent, from tenants at the beginning of a residential letting. In theory, at the end of a letting, if a landlord is happy with the condition of the property, and if the tenant owes no rent or other expenses, the landlord, or their agent, will return the tenant's deposit promptly and in full. If there is damage or expenses are outstanding the landlord/agent will deduct an appropriate amount from the deposit, or retain it in full.

2. In practice, there is evidence to suggest a rather different picture. The most recent Survey of English Housing (SEH) 2001-02 reveals that 20% of households which had a private tenancy ending in the previous three years, said that that part or all of the deposit from their most recent tenancy was unreasonably withheld. This "unreasonableness" might not hold up to independent adjudication in all cases but nevertheless creates a widespread perception amongst tenants that unfair deposit withholding is commonplace. 9% of tenants who had a private tenancy ending in the previous three years, said that their landlord or agent gave no reason for the full or partial withholding of the most recent deposit.

3. Tenants frequently report that poor practice on the part of their landlord/agent in the course of the tenancy leads them to withhold their final month's rent in the belief that their deposits would otherwise be unreasonably retained. Indeed the practice of withholding the last month's rent is often condoned by many landlords who have had a good relationship with their tenant. However, some tenants who default on their last month's rent without agreement will also have caused damage, sometimes extensive, which the landlord will then have to cover in full.

4. Expectations that problems are likely to arise over the return of deposits are damaging to the image of the private rented sector, and as a consequence to landlords and agents.

5. This is similarly true of a further private rented sector problem identified in the consultation paper, together with options for addressing it. It is estimated that there may be between 6,000-8,000 letting agents who do not belong to one of the three professional trade associations which represent the interests of letting agents. Whilst many of these firms provide a good level of service, there are also many unscrupulous agents and others who, whilst well intentioned, do not have sufficient knowledge and experience to provide

an adequate service. Currently, there is no statutory requirement for letting agents to register with or seek a licence to operate from any authority. It is appropriate, when considering the scope for legislation to protect tenants' monies, to consider the scope for a provision relating to letting agents from which landlords would benefit.

OBJECTIVES OF SCHEMES TO PROTECT TENANCY MONIES

6. To remove the risk of misappropriation of tenants' deposits by landlords and letting agents and of the misappropriation by their agents of money belonging to landlords, through measures prescribed in new legislation or by other means.

7. To reduce the risk of tenants defaulting on their last month's rent and the consequential risk that landlords will have to cover costs for damage and cleaning, through the establishment of more appropriate tenancy management practices.

RISK ASSESSMENT

8. The Survey of English Housing shows that 70% of the 2.21 million private rented sector tenants had paid a deposit, with the average deposit being around £510 (and likely to be rising in line with rents). This indicates that across England around £790 million is currently being held in deposits.

9. The provisional results from the 2001/02 SEH indicate the number of tenancies finished each year where there is disagreement about the amount held. Of the 905,000 tenancies finished each year, approximately 127,000 are in disagreement[15].

10. We can therefore estimate the **maximum** amount of money which could possibly be unjustifiably withheld (in tenants' views) each year.

    £510 (average deposit) x 127,000 = £64.8 million.

15 This is calculated as follows:
905,000 x 70% to indicate the proportion that paid a deposit = 633,500
633,500 x 16% to indicate those deposits withheld in part = 101,360
633,500 x 13% to indicate those deposits withheld in full = 82,355
Where deposits had been withheld, 31% of tenants thought the deposit was justifiably withheld, 21% thought less should have been withheld, and 48% thought none should have been withheld. This gives rise to the table:

	Deposit part withheld	**Deposit fully withheld**
Tenant's view: less should have been withheld	21% of 101,360 20,982	21% of 82,355 17,047
Tenant's view: none should have been withheld	48% of 101,360 48,957	48% of 82,355 39,777

This table sums to 126,763.

11. It is possible to begin a very tentative assessment of how much of this money might be considered unjustifiably withheld **by an independent adjudicator**. A pilot scheme to protect tenancy deposits (further discussed on page 5) has so far resulted in 56 adjudicated disputes. Statistical analysis indicates that tenants are due around 31% of the deposits disputed.[16] Therefore the amount of money wrongfully withheld from tenants can be expressed as:

    127,000 x 31% x £510 = **£20.1 million**

12. It must be emphasised that the sample of disputes from the pilot scheme can only be taken as representative of a voluntary scheme. It has been argued that the pilot scheme has attracted as members those landlords and agents most predisposed to good practice. A sample of disputes taken from a national mandatory scheme might reveal a quite different picture (i.e. tenants might be adjudged as due considerably more than 31% of disputed deposits).

13. It is not known how much client money, apart from tenants' deposits, is wrongly taken by letting agents through either deliberate misappropriation or poor practices.

14. Individuals have no assurance of cheap or speedy redress through current legal procedures. Statistics on small claims relating to unjustifiably withheld deposits are not kept, but it is known that in 2001 the average length of time taken to hear a small claim was 28 weeks[17]. Issuing a claim for e.g. the average deposit of £510 would cost the claimant £80, with a possible further £45 payable to issue a warrant of execution (to enforce the claim).

IDENTIFYING OPTIONS

15. We have identified a wide range of options. Our initial assessments point to Options 1 and 2 as being the most effective. These options consider taking (1) non-legislative and (2) legislative approaches to the question of managing deposits and other tenancy monies. The costs and benefits of each of the two options have been considered, following consultation over time with the bodies represented on the Department's Steering Group on the pilot Tenancy Deposit Scheme. Their comments have been taken into account in drawing up these proposals.

16 This is calculated as follows using a sample of 51 disputes (excluding 5 adjudications regarded as outliers), giving the average values and 95% confidence intervals (assuming that the sample mean follows a normal distribution irrespective of the distribution of the original variable – i.e. relying on the Central Limit Theorem).

Deposit: £987± £174
Amount disputed: £669 ± £175
Awarded to landlord: £367 ± £161
Awarded to tenant: £ 301± £92

Obviously these Confidence Intervals (CIs) are enormous. To reduce the CI on 'Awarded to landlord' to around ± £ 30, a sample of around 500 would be needed. Furthermore, the average deposit in these instances is far larger than the average deposit nationally. Therefore it is more appropriate to express them as percentages:

Amount disputed: 68% of deposit
Awarded to landlord: 37% of deposit
Awarded to tenant: 31% of deposit

The last figure indicates that in all instances of dispute **(bearing in mind the small size of the sample, and that the pilot scheme is voluntary)** the tenant is entitled, on average, to 31% of the deposit. This is regardless of whether all or part of the deposit was withheld – the data on the pilots covers both.

17 The Court Service – Judicial Statistics 2001.

16. We welcome views on all of the options listed below and will use responses to inform the policy development.

Option 1 – No Government intervention: voluntary custodial deposit protection schemes, voluntary industry accreditation schemes.

Option 2 – Statutory tenancy money protection scheme(s):

2.1 Statutory custodial deposit protection scheme(s).

2.2 Statutory custodial deposit protection scheme(s) and approved insured alternatives.

2.3 Statutory membership of either an approved custodial deposit protection scheme or an approved trade association or accreditation scheme based on insurance or bonding.

17. A further range of options have been identified, considering alternative approaches to the issue of deposit protection, and regulatory approaches to other aspects of tenancy management and to the protection of clients' monies by letting agents.

Option 3 – Deposit protection through the tenancy agreement, using the Law Commission's approach.

Option 4 – A statutory bank guarantee scheme.

Option 5 – A ban on deposit-taking by landlords/agents (with no statutory custodial deposit protection scheme)

Option 6 – Statutory requirements with regard to inventory-taking, regulation of "non-deposit" fees and charges.

Option 7 – Statutory protection of clients' monies held by letting agents.

OPTIONS

1. No Government intervention: voluntary custodial deposit protection schemes, voluntary industry accreditation schemes.

18. The Independent Housing Ombudsman has been running a pilot, the Tenancy Deposit Scheme (TDS), to safeguard tenants' deposits and to adjudicate in cases of dispute, since March 2000. It was set up after the government had challenged private landlord and tenant organisations to set up a voluntary scheme to ensure that tenants' deposits were held safely and to provide an independent arbitration service to deal with disputes. The aim of the pilot was to establish whether a self-financing voluntary scheme could operate effectively and without statutory intervention. Initial Government funding was provided to fund the start-up costs of the pilot. However take-up from landlords and agents has been disappointingly low and Government funding has continued to meet most of the costs of the pilot scheme.

19. A number of small-scale deposit protection and adjudication schemes also operate, for example in Cardiff and in Hastings and Rother. These have mainly grown out of rent guarantee schemes (which help homeless people into permanent accommodation) and are for that reason supported by Local Authority and other public funding.

20. Voluntary deposit protection schemes could work in tandem with voluntary accreditation schemes. This is the case for at least one regional accreditation scheme; in Bournemouth and Poole the local authority and the local landlords' association run a scheme for accrediting landlords, properties and tenants, which includes mechanisms for dealing with disputes.

21. In the case of letting agents, the industry-run National Approved Lettings Scheme (NALS), a pilot to provide security for landlords through accreditation of lettings agents, is supported with Government funding. Like the TDS, NALS has not so far attracted as high a voluntary membership as was hoped for.

COSTS

22. Once Government funding of the pilot scheme ends, no new costs are intended to fall to the Government. There may also be the costs of such inducements as local authorities or other operators of schemes can offer – we welcome the views of those operating accreditation and deposit protection schemes on this point.

23. Legal costs to tenants in dispute with landlords and agents (and landlords in dispute with agents) who are not members of voluntary schemes. For example if 100% of disputed tenancies were taken through the Small Claims process annually it could incur costs of up to £10.2 million.[18]

BENEFITS

24. This is effectively the Government's "do nothing" option. The main benefit to the industry of using voluntary schemes is that if the majority of landlords and agents signed up to them, they could improve management practices whilst continuing to be subject only to self-regulation. They would be able to be able to use the deposits as working capital if so desired, therefore any accruing interest – potentially a vast sum of money when all deposits are considered as a lump sum – would remain within the industry's control. Indeed it could be passed on to the tenant (to whom it arguably belongs), although this rarely happens in reality. Well-promoted voluntary schemes could help to increase professionalism and transparency, and thus confidence in the sector, with consequential benefits.

25. However it is clear from the low take-up to the pilot TDS (and NALS) that the industry as a whole is unlikely to be voluntarily self-regulating. It is also likely that such schemes are attracting members who already have good management practices in place.

26. Voluntary schemes are not therefore providing the anticipated benefits to tenants and indeed landlords and agents. There could still be up to £20million misappropriated

18 Calculated as: £80 (fee to issue a small claim for the average deposit of £510) x 127,000 (tenants who felt that some or all of their deposit was unreasonably withheld)

annually in cases where landlords are unreasonably withholding deposits from tenants. Many tenants would continue to distrust their landlords/agents, and withhold their final month's rent, arguably being more likely to leave damage but no wherewithal to cover it.

2. STATUTORY TENANCY MONEY PROTECTION SCHEME(S)

2.1 Statutory custodial deposit protection scheme(s)

27. Deposits are collected and managed, and disputes resolved, by an independent third party. Initially the current pilot, managed by IHO, could be extended to provide this service on a mandatory basis. Further schemes could be approved by the Secretary of State. It would be illegal for a landlord to hold a deposit for a tenancy and it would be a statutory requirement for landlords/agents to demonstrate membership of an approved custodial scheme prior to taking the deposit.

COSTS

28. Running costs of the scheme, including staff and office costs, costs of dispute adjudications and information/ publicity costs. Little is currently know, or can be extrapolated, about the set-up and running costs of a mandatory custodial deposit scheme. It may be assumed that the per-unit costs of a well-run scheme would be quite considerably lower than those of the pilot TDS. It is also worth noting as a benefit the fact that if the IHO were to continue to run the TDS as a mandatory national scheme, the set-up would be already in place.

29. Maximum annual adjudication costs can be roughly estimated by multiplying the average cost of adjudication to date (around £150) by 127,000 (the number of tenants who might feel they had cause to go to adjudication – see paragraph 9). This comes to just over £19 million.

30. It should be noted that although calculations have to be considered as if 100% of disputed cases were to go to adjudication, it is most unlikely that maximum costs would be incurred. It is currently estimated that of those pilot TDS tenancies which have ended, only around 1.5% have led to an adjudication. Custodial deposit schemes in Queensland and New Zealand report the percentage of disputes as 3% and under 2% respectively. **It should also be noted that this does not imply that only 1.5% of tenants have a genuine problem with the way their deposit is returned.** The pilot TDS has tended to attract those landlords and agents who are already predisposed to good practice. Furthermore, an inherent feature of such a scheme is that it deters bad practice on the part of its members.

31. Negligible administrative costs to landlord/agents, for example photocopying scheme paperwork and attaching to tenancy agreements. This could amount to perhaps £1.50 per tenancy (approximately £1,357,500 annually).

32. Landlords may seek to recoup the costs of membership of an approved tenancy deposit scheme through higher rents where market conditions allow. It would not be correct to count the interest raised on a custodial scheme (see 34 below) as a cost borne (in foregone interest) by landlords, as this would be double-counting the costs of running the scheme.

33. The costs of enforcement which are presently impossible to quantify (although it may be worth noting that from the small sample to date, the pilot TDS has experienced no problems of landlords/agents refusing to abide by adjudication decisions).

BENEFITS

34. A considerable amount of tenants' money would be returned, which would previously have been wrongfully withheld; up to £21 million.

35. If £790 million, the amount estimated to be currently held in deposits, were held in a single custodial deposit scheme for a year, it would raise £31.6 million in interest (calculated at the Bank of England's current base-rate). Obviously the larger the amounts of interest raised, the greater the potential increasing funds through investment. Therefore the potential for increasing funds would decline if the number of approved statutory custodial schemes increased.

36. Such funds could be utilised in number of ways. The Queensland and New Zealand schemes are self-financing, using the additional interest to fund provision of residential accommodation, research on the private rented sector and loans to low income tenants who cannot afford to raise a deposit.

37. Other benefits are difficult to quantify but could have a far-reaching impact. For example increased professionalism and transparency, and the removal of the atmosphere of mutual suspicion, could lead to increased confidence in the sector and the encouragement of institutional investors. It could also discourage potentially unscrupulous landlords from entering the sector. A larger, better-run private rented sector brings knock-on benefits through encouraging greater mobility.

38. There are also equity and distribution issues concerning transfers from landlords, traditionally from higher income deciles, to tenants. 63% of private rented sector households earn less than £300pw, compared to 51% of households across all tenures (SEH 99/00). The forthcoming Treasury Green Book, which sets out guidelines on appraisal of central government proposals, recommends adjusting non-Exchequer monetary costs and benefits according to the relative prosperity of those receiving the benefit or bearing the cost. Whilst it is not proposed to carry out such analysis in this instance, it is worth noting that the proposals are likely to disproportionately benefit lower income earners.

39. There may also be resource savings related to the freeing up of the justice system, as it may be assumed that few cases will be taken up through the small claims mechanism.

2.2 Statutory custodial deposit protection scheme(s) and approved insured alternatives

40. As in 2.1 above, with the statutory requirement that deposits be protected either by a custodial scheme, or by an additional scheme or schemes (approved by the Secretary of State) in which the landlord holds the deposit and pays an insurance premium against problems with deposits. An "insured option" is currently being tested alongside a custodial option in the pilot TDS. Unless a member of an approved insured scheme it would be illegal for a landlord to hold a deposit for a tenancy. It would be a statutory requirement for a landlord to identify to the tenant which scheme the landlord were signed up to.

COSTS/BENEFITS

41. The costs and benefits are broadly similar to 2.1 above. However there would be considerably less potential for raising revenue through interest, as fewer deposits would be held in one custodial scheme.

42. A deposit protection scheme with insured options would be easier to introduce to the industry as it would receive a less hostile reception from landlords and agents. However, a mandatory insured option has an inherent risk. With increased numbers of less reputable landlords and agents joining up, there may be a strong chance of increased defaulting from paying the insurance premiums. An attendant risk is that if a number of smaller schemes were approved, each could not cover sufficient tenancies to have a chance of becoming cost-effective. This might be somewhat balanced by competition in the provision of insurance cover (although the TDS pilot could only find one insurance provider willing to partake in the scheme).

2.3 Statutory membership of either an approved custodial deposit protection scheme or an approved trade association or accreditation scheme based on insurance or bonding

43. This would enable professional bodies (such as the National Federation of Landlords (NFRL), Small Landlords' Association (SLA), ARLA, NAEA and RICS) and industry-run accreditation schemes, such as NALS, to set up their own deposit management schemes, approved by the Secretary of State, to safeguard tenants' monies and provide independent adjudication of disputes. The existence of adjudication for tenants would be a new provision since it is not currently a feature of any of the industry schemes.

44. A custodial deposit scheme, such as the IHO's pilot, would continue to run as the default option for landlords and agents who did not want to join a professional or trade association. This option would allow the professional end of the industry internal control over deposit management and arbitration, and should help to encourage other landlords and agents to work to the standards of the best. This option would work in conjunction with Option 6 and Option 7.

COSTS/BENEFITS

45. As for 2.1 and 2.2 above. This option has an added benefit over 2.2 in that if those landlords/agents who wished to continue to hold deposits were required to belong to an approved accreditation scheme, they would need to meet minimum standards in other fields apart from deposit-holding. This could lead to still greater professionalism and transparency in the industry.

Further options for comment

3. DEPOSIT PROTECTION THROUGH THE TENANCY AGREEMENT, USING THE LAW COMMISSION'S APPROACH

46. The Law Commission has been reviewing housing tenure law with a view to proposing a simpler regime, reflecting the approach of the Office of Fair Trading in applying the Unfair Terms in Consumer Contracts Regulations 1999 to tenancy agreements. They consider

that people who pay rent for their homes should be subject to the type of protection that the law provides for consumers of other goods and services. This should be provided by clear written contracts containing a legally prescribed set of terms. Both deposit protection and return could be included in these core terms, thus including deposit protection in the gamut of reforms to the contractual nature of tenancies.

COSTS/BENEFITS

47. The approach is discussed in a Law Commission paper[19] which has asked consultees to provide views on the regulatory impact of the approach.

4. A STATUTORY BANK GUARANTEE SCHEME

48. A radical shift in current thinking would be to adopt a scheme on a Belgian model which puts the onus on the tenant to provide a bank guarantee. No deposit is taken, but the tenant pays their bank to guarantee to cover the debt should the tenant default.

COSTS/BENEFITS

49. Consultees are being asked to comment on this option and their view will inform the preparation of the full Regulatory Impact Assessment.

5. A BAN ON DEPOSIT-TAKING BY LANDLORDS/AGENTS (WITH NO STATUTORY CUSTODIAL DEPOSIT PROTECTION SCHEME)

50. It would be illegal to take a deposit for a tenancy. Landlords make their own insurance arrangements.

COSTS/BENEFITS

51. The advantages of banning deposits in this way are: that tenants do not risk losing their money; that the industry does not face the threat of regulation; and that landlords and agents do not risk being owed more than the sum of the deposit, as any arrears or damage will be covered by their insurance. The disadvantages are that insurance premiums would be significant and have an impact on the rents that tenants paid, penalising good tenants and bad alike, and in any case, insurers would be unlikely to cover negligence on the part of a tenant. It would also require a cultural shift to be acceptable and landlords believe that tenants treat properties better if they have, effectively, a stake in them.

52. Furthermore, landlords, and perhaps more particularly letting agents might create new, non-returnable charges in lieu of deposits, so in order for this option not to create more problems than it solves it would have to work with Option 6 below.

19 Consultation Paper No.162 "Renting Homes – Status and Security" – April 2002. It did not include a Regulatory Impact Assessment.

53. Consultees are being asked to comment on this option and their view will inform the preparation of the full Regulatory Impact Assessment.

54. Two other legislative options have been identified which would work in conjunction with Option 2 and possibly 4 and 5 above to protect clients' monies and prevent unreasonable charges.

6. STATUTORY REQUIREMENTS WITH REGARD TO INVENTORY-TAKING AND EXTRA CHARGES. REGULATION OF "NON-DEPOSIT" FEES AND CHARGES

55. Many disputes over the return of deposits arise over the inadequacy of inventories and the standards and costs of cleaning required by the deposit-taker. Landlords need to make clear at the start of a tenancy the sort of costs that might have to be met out of a deposit at the end of a tenancy. Alternatively, these issues could be incorporated into the Law Commission's proposed core terms for tenancy agreements, see Option 3 above.

56. There is a case for legislation to deal with the risk of landlords/agents seeking to avoid compulsory deposit provisions by 'converting' the deposit into an up-front charge. This might ban charges for which no specified cost is actually incurred, or prescribe a proportionate limit for uncertified charges.

COSTS/BENEFITS

57. This increased clarity would help avoid disputes and ensure the speedy resolution of those that may still arise. However, in the case of non-deposit charges, it involves an element of regulation of the sector that the current regime under the Housing Act 1988 – which removed the previous prohibition on premiums for the granting of tenancies – has mainly sought to avoid.

58. Consultees are being asked to comment on this option and their view will inform the preparation of the full Regulatory Impact Assessment.

7. STATUTORY PROTECTION OF CLIENTS' MONIES HELD BY LETTING AGENTS

59. Letting agents are also responsible for landlords' monies, for which there is also currently no statutory protection. The Government proposes that there should be a statutory requirement for letting agents to safeguard their clients' monies by means of an approved scheme that adequately ring-fences such monies, protects such monies from misappropriation through an approved insurance and provides for independent adjudication.

60. The simplest way to implement this might be to require agents to join either NALS or one of the professional trade associations (Association of Residential Letting Agents, National Association of Estate Agents and Royal Institute of Chartered Surveyors). Agents which did not meet those standards would not meet the legal requirement to protect client money.

COSTS/BENEFITS

61. Consultees are being asked to comment on this option and their view will inform the preparation of the full Regulatory Impact Assessment.

RESULTS OF CONSULTATIONS

62. Consultations on Options 1 and 2 have taken place with the bodies represented on the Department's Steering Group on the pilot Tenancy Deposit Scheme. Their comments have been taken into account in drawing up these proposals.

63. This is the first opportunity for most consultees to look at further options and their views will inform the preparation of the full regulatory impact assessment.

THE SMALL BUSINESS SERVICE

64. The majority of landlords affected by this proposal would be regarded as small businesses. Many own only one or two properties – often as a part-time business in addition to other business activity. Representatives of both the National Federation of Residential Landlords and the British Property Federation served on the Tenancy Deposit Scheme Steering Group during the development and piloting of the TDS.

65. The Small Business Service will be invited to comment as part of this consultation process and their view will inform the preparation of the full Regulatory Impact Assessment.

ENFORCEMENT AND SANCTIONS

66. As a result of this consultation the Government may seek to legislate to require that all landlords and agents should safeguard tenancy deposits and other clients' monies by membership of an approved scheme. If this were the case, then if a landlord or agent who is not a member of a scheme (or otherwise fails to comply with statutory requirements) wrongly takes a deposit, the legislation could provide that either the tenant or the local authority might seek a court judgement for the return of the deposit. They could also seek for the landlord to be fined for a second or third offence.

67. The views of consultees are particularly invited on the steps that might be taken in the event of further offences. For instance the local authority could seek a declaration that the landlord was not a 'fit & proper person' and seek to impose an alternative manager. This would reflect what is envisaged in proposed legislation for the licensing of Houses in Multiple Occupation, for the Selective Licensing of Landlords in areas of Low Housing Demand and for the management of long-term empty homes.

68. In effect, however, it would amount to a form of 'negative licensing' for the private rented sector.

MONITORING AND REVIEW

69. If legislation were introduced, local authorities would follow the Secretary of State's statutory guidance, which would be kept under review. Once the necessary legislation and guidance were in place, the Department would monitor the operation of statutory schemes to ensure they were working effectively.

COMPETITION FILTER

The Department has completed the Office of Fair Trading's Competition filter[20]. This requires that policy makers consider the market that will be affected, i.e. the firms that compete against one another to sell the same or similar products or services.

70. The main markets affected are landlords and residential letting agents, none of whom have more than 10% of the market share. The costs of the regulation should not affect some firms substantially more than others, with the proviso that a small increase in administrative costs would be more easily subsumed by bigger firms. Regulation would not result in higher set-up or running costs for new firms that existing firms do not have to meet and the market is not characterised by rapid technological change.

71. There is an outside chance that regulation might affect the number of operators in the market, as smaller (part time) landlords in particular might decide the imposition outweighs the advantages. It is also possible that firms operating in areas of low demand for private rented property would be unable to increase prices to compensate for the increased administrative costs of regulation.

72. Cabinet Office guidelines suggest that there is unlikely to be a negative competitive impact from the new regulation and no detailed assessment is required.

20 See www.cabinet-office.gov.uk/regulation/guidance/competition/index.htm

ANNEX 2

Questionnaire for consultees

We would be grateful if consultees could complete and return the following questionnaire, although we welcome further general or specific comments.

1. IN WHICH CAPACITY ARE YOU RESPONDING? PLEASE DELETE AS APPROPRIATE.

(a) As an individual tenant/landlord/letting agent?

(b) As a representative of an organisation representing tenants/landlords/letting agents? (Please state your organisation and role)

(c) As another individual with an interest (Please state your interest)

(d) As a representative of another organisation with an interest e.g. Local Authority, Voluntary Sector Housing Organisation (Please state your organisation and role)

2. IS THERE A PROBLEM?

(a) Is it reasonable for landlords/agents to take a deposit? Yes/No

(b) If yes, how much should it be for? One month's rent/two month's rent/other

(c) Is there a significant problem with landlords/agents unfairly withholding deposits? Yes/No

(d) If yes, is there a role for Government in addressing this problem? Yes/No

(e) Is there currently effective redress for the tenant who has experienced unfair withholding? Yes/No

(f) Should deposit-takers be required to account properly for their decisions? Yes/No

(g) Is there a significant problem with tenants defaulting on the final month's rent and leaving damage? Yes/No

(h) In principle, to whom does interest earned on the deposit belong? Tenant/landlord/landlord's agent (if applicable)

(i) Is there a need for additional protection for tenants' deposits beyond the current framework? Yes/No

(j) Should the protection of client monies held by letting agents be left to voluntary arrangements such as membership of a professional organisation or accreditation scheme? Yes/No

(k) Is it right for Government to impose statutory requirements about the handling of client monies by letting agents? Yes/No

(l) In principle, is it reasonable to make tenancy charges apart from the deposit (for example, 'finder's fee', referencing, issue of written agreement)? Yes/No

(m) Should such charges be banned altogether, or restricted in some way (for example according to a standard scale or on the basis of work actually done)? Yes/No

We welcome detailed comments on the following questions (please attach):
Why do landlords charge deposits? How important are they in the letting and management of private sector tenancies?

How extensively are they used? Under what circumstances do landlord charge/not charge deposits?

What other approaches do landlords take to safeguard themselves against the risks of damage/non-payment?

What kind of problems do a) landlords and b) tenants have in relation to the return of deposits at the end of the tenancy?

How frequently do these problems arise?

Are these problems preventable?

How could these problems best be resolved?

What kind of problems do tenants experience in relation to other tenancy charges?

What kind of problems do landlords experience in relation to receiving rental payments from letting agents?

3. HOW IS THIS ISSUE DEALT WITH IN OTHER COUNTRIES?

Please provide views/information based on experience about deposit protection schemes in other countries.

4. STANDARDS OF PRACTICE

(a) Is there a case for formal independent guidance on standards of letting and deposit management (for example, inventories, standards of cleaning, proof of costs incurred)? Yes/No

(b) Is there is a logical relationship between the protection of tenants' deposits with regard to landlords/agents, and the protection of landlords' monies with regard to letting agents? Yes/No

(c) Should there be a minimum standard of practice for letting agents to ensure financial probity of client monies they hold?

(d) Is the standard set by the National Approved Letting Scheme an appropriate minimum standard for letting agents?

Further comments welcomed.

5. THE FOLLOWING OPTIONS FOR DEALING WITH THE MANAGEMENT OF DEPOSITS AND OTHER CHARGES ARE IDENTIFIED IN THE CONSULTATION PAPER. PLEASE INDICATE WHETHER YOU FAVOUR EITHER NUMBER 1 OR ONE OF NUMBERS 2.1, 2.2 AND 2.3.

1. No Government intervention: voluntary custodial deposit protection schemes, voluntary industry accreditation schemes.

2. Statutory tenancy money protection scheme(s):

   2.1 Statutory custodial deposit protection scheme(s).

   2.2 Statutory custodial deposit protection scheme(s) and approved insured alternatives.

   2.3 Statutory membership of either an approved custodial deposit protection scheme or an approved trade association or accreditation scheme based on insurance or bonding.

Please indicate if you favour any of the following options, either in addition to or instead of Options 1 and 2.

3. Deposit protection through the tenancy agreement, using the Law Commission's approach.

4. A statutory bank guarantee scheme.

5. A ban on deposit-taking by landlords/agents (with no statutory custodial deposit protection scheme)

6. Statutory requirements with regard to inventory-taking, regulation of "non-deposit" fees and charges.

7. Statutory protection of clients' monies held by letting agents.

Please provide reasons for your choice(s)

ANNEX 3

List of consultees

Views have been sought from the following bodies. This list is not exhaustive.

All Local Authorities in England
Association of British Insurers
Association of Housing Advisory Services
Association of London Government
Association of Residential Letting Agents
Association of Residential Managing Agents
Association of Student Residential Accommodation
Association of Tenancy Relations Officers
British Banking Association
British Property Federation
Cardiff Bond Board
Chartered Institute of Housing
Chartered Land Agent Society
Committee of Vice-Chancellors and Principals/Standing Conference of Principals
Confederation of Health Authorities & Trusts
Consumers Association
Council of Mortgage Lenders
Country Landowners Association
Dorset Residential Landlords Association
Federation of Small Business
Financial Services Authority
Flat Owners' Association
Greater London Authority
Home Office
Housing Corporation
Housing Law Practitioners Association
Independent Housing Ombudsman
Institute of Legal Executives
Institute of Professional Housing Managers
Joseph Rowntree Foundation
Law Centres Federation
Law Commission
Law Society
Lord Chancellors Department
Local Government Association
National Accreditation Network
National Approved Letting Scheme
National Association of Citizens Advice Bureaux
National Association of Estate Agents
National Association of Probation Officers
National Consumer Council
National Federation of Residential Landlords
National Housing Federation
National Housing Forum
National Housing & Town Planning Council
National Landlord Association
National Rent Deposit Forum
National Support Lodgings Service
National Union of Students
Office of Fair Trading
Police Federation
Residential Landlords Association
Royal College of Nursing
Royal Institution of Chartered Surveyors
Royal Town Planning Institute
Salvation Army
Scottish Executive
Shelter
Small Business Service
Small Landlords Association
The Rent Service
Trades Union Congress
UK Association of Letting Agents
Welsh Assembly Government

ANNEX 4

Cabinet Office consultation criteria[21]

1. Timing of consultation should be built into the planning process for a policy (including legislation) or service from the start, so that it has the best prospect of improving the proposals concerned, and so that sufficient time is left for it at each stage.

2. It should be clear who is being consulted, about what questions, in what timescale and for what purpose.

3. A consultation document should be as simple and concise as possible. It should include a summary, in two pages at most, of the main questions it seeks views on. It should make it as easy as possible for readers to respond, make contact or complain.

4. Documents should be made widely available, with the fullest use of electronic means (though not to the exclusion of others), and effectively drawn to the attention of all interested groups and individuals.

5. Sufficient time should be allowed for considered responses from all groups with an interest. Twelve weeks should be the standard minimum period for a consultation.

6. Responses should be carefully and open-mindedly analysed, and the results made widely available, with an account of the views expressed, and reasons for decisions finally taken.

7. Departments should monitor and evaluate consultations, designating a consultation co-ordinator who will ensure the lessons are disseminated.

21 From the Cabinet Office's "Code of practice on written consultation" (November 2000)

ANNEX 5

The National Approved Letting Scheme (NALS)

1. The National Approved Letting Scheme (NALS) is an industry-run voluntary accreditation scheme for letting agents, launched in 1999 by the three representative organisations for the lettings industry – ARLA, NAEA and RICS – in conjunction with the Empty Homes Agency.

2. The objective of the scheme is to give reassurance to owners thinking of letting their properties through an agent that a NALS accredited agent will operate to nationally defined standards. To be eligible to belong to NALS, agents must demonstrate minimum property management standards and money handling guarantees. The scheme's main objective is to promote a nationally recognised service level for professional residential lettings and management agents to landlords and tenants.

3. Membership of NALS has been open only to firms who have a director, principal or partner who is a member of ARLA, NAEA or RICS, and to housing associations registered with the Housing Corporation, if they undertake to:

   - only provide residential lettings and management services on written terms that meet defined service standards and provide a written statement setting out their services and charges;

   - maintain and operate a customer complaints procedure and legally binding arbitration;

   - maintain professional indemnity insurance and have in place acceptable client money protection cover (not applicable to Registered Social Landlords).

4. The Government agreed to fund an expansion of the scheme in 2001 to enable it to become self-financing from income from increased membership fees. In return it was agreed that the scheme would be opened up to agents who do not belong to one of the professional bodies who agree to be bound by the service standards of the scheme. In order to achieve this, NALS has recently put in place a client money insurance scheme available to "non-attached" agents. This is an important step without which non-attached agents would not be able to obtain the necessary insurance required to belong to the scheme.

5. NALS bears comparison to the pilot Tenancy Deposit Scheme, particularly in being a voluntary scheme likely to reach only the more responsible agents. This begs the question of whether a scheme to safeguard clients' monies ultimately needs the prescription of a statutory provision.

6. It seems appropriate, when considering the scope for legislation to protect tenants' monies, to consider the scope for a provision relating to letting agents from which landlords would benefit.

ANNEX 6

Mandatory deposit protection schemes in other countries

1. In 1998 the Department carried out a review of measures operating in other Commonwealth countries (in Canada and Australia, these operate on a regional basis) and Western Europe. This annex provides a partial updating of this review, looking at the following models for the protection of tenancy deposits:

   - Setting a time limit for return of deposits as only form of regulation.
   - A separate trust account for deposits and time limit for return.
   - Holding deposits in a custodial rent deposit scheme.

SETTING A TIME LIMIT FOR RETURN OF DEPOSITS AS ONLY FORM OF REGULATION

2. Three of the Canadian provinces require the landlord to pay interest to the tenant on the deposit held and set time limits, typically 15 days, for landlords to return the deposit at the end of the tenancy. The landlord is required to provide a statement of account and the tenant must agree any deductions in writing.

3. If the landlord wishes to withhold some or all of the deposit and the tenant does not agree, either can apply to a special residential tenancy tribunal or to the small claims court. If the landlord does not return the deposit, the tenant can apply. The landlord may not be able to claim any of the deposit unless an inspection report on the premises has been carried out at the start and end of the tenancy.

4. Where the tenant has difficulty enforcing an order granted by a tribunal, they generally have to apply to the court for enforcement proceedings. Government Departments investigate tenants' complaints and bring legal proceedings against landlords who fail to comply with the legislation.

5. Similar models operate in Germany and France.

6. The potential advantages of applying this model here are:

   - landlords would be required to return the deposit with interest;
   - landlords would be required to return deposits within statutory deadlines and give reasons for withholding any money;

- landlords would be required to follow clear procedures if they wished to withhold the money which should encourage them to negotiate with the tenant, reducing the number of disputes and delays.

7. The potential disadvantages are:

   - bad landlords would simply ignore the requirements and it would be impossible to monitor and enforce compliance adequately;

   - landlords might argue that the requirement to pay interest on their deposit would reduce their returns which they would have to recoup by charging a higher rent.

A SEPARATE TRUST ACCOUNT FOR DEPOSITS AND TIME LIMIT FOR RETURN

8. Three of the Canadian provinces require the landlord to place the deposit money in a separate trust account for each tenant, with interest being payable to the tenant. No deduction can be made for wear and tear, and none for damage unless the landlord has provided a "condition of premises" report at the beginning and end of the tenancy. The deposit must be returned to the tenant within 10 days of the end of the tenancy with a statement of account.

9. If the landlord wants to retain all or part of the deposit, he or she must serve notice on the tenant and return any undisputed amount. The tenant must apply to a special residential tenancy tribunal or the court within 15 days for resolution of the dispute, otherwise the landlord can retain the money. If the landlord does not return the deposit or notify the tenant that he or she intends to retain it, the tenant can apply direct to the tribunal or court. In one province, the landlord must lodge the deposit with the tribunal, pending resolution of the dispute. Government Departments investigate tenants' complaints and bring legal proceedings against landlords who fail to comply with the legislation.

10. The Victoria Government in Australia used to operate a similar scheme, under which landlords were required to put the deposit money into a Government approved trust account. The interest from these deposit accounts was paid to the State Government and largely funded the residential tenancies tribunal system and tenants' advice services. The difficulty of enforcing compliance with this system is one of the reasons Victoria moved to a centralised custodial deposit in 1998. The Canadian Government does not report this as a problem.

11. The potential advantages of applying this model here are:

    - landlords would be required to put the money in a ring-fenced account, so ensuring its availability for return, thus reducing numbers of disputes and delays;

    - It would help to formalise the terms under which the deposit was held and the circumstances under which the landlord could claim it;

    - Landlords would be required to follow clear procedures if they wished to claim the money, encouraging them to negotiate with the tenant, so reducing the number of disputes and delays.

12. The disadvantages are:

- bad landlords would ignore the requirement to put the money in a separate account and it would be impossible to monitor and enforce compliance adequately;

- it could be difficult and complex for landlords to operate under UK tax laws. The tenant would have to pay tax on the interest from the trust but the landlord would have to pass tax certificates to the tenant; anti tax avoidance provisions would make the system particularly bureaucratic and complex for landlords with joint tenants, a rapid turnover of tenants or a large number of lettings;

- as the landlord would be one of the trustees (there should be between 2 and 4 trustees), it could still be difficult for the tenant to get the landlord to pay the money back. To enforce the trust, the tenant would still have to go to court.

HOLDING DEPOSITS IN A CUSTODIAL RENT DEPOSIT SCHEME

13. The first custodial tenancy deposit scheme was established in New South Wales, Australia, in 1977 and has been used as a model for schemes in other Australian states, New Zealand and one province in Canada. Statutory public bodies of Government departments operate these schemes, although in Victoria, Australia, the Government is tendering the management of the scheme to the private sector.

14. The landlord must lodge the tenant's deposit money with the Board within 7 days of receipt. The tenant will receive notification that the deposit has been paid in and can therefore alert the Board to non-compliance. At the end of the tenancy, if both parties agree how the deposit should be paid out, payment should be made by the Board within a few working days.

15. If the landlord and tenant cannot agree, either party can apply to the Board for the deposit to be returned. The Board notifies the other party and unless the other party gives notice that he or she has commenced proceedings in court or a residential tenancies tribunal within 14 days, the Board returns the deposit to the applicant. Payment is usually made within 20 working days. Tribunal hearings are usually held within a month of application. The hearing uses as evidence the written "condition of premises" report that the landlord must agree with the tenant at the start of the tenancy. The scheme offers bond transfer arrangements when the tenant moves so that money does not have to be paid in and out each time the tenant moves.

16. With the substantial amounts of deposited money at its disposal, the Board can make investments at a very favourable interest rate, creating a significant income. Not only does this cover the Board's administration costs, half the cost of operating the residential tenancies tribunals and tenancy service, and a network of tenants' advice and advocacy services, it allows the tenant to receive a basic rate of interest. The board is also able to invest in and provide residential accommodation using some of the interest accruing on the deposit. In 1993/94, the interest on bond deposits was $25m of which $7m was credited to tenants' accounts and $12m was spent on rental bond processing.

17. The other custodial schemes do not pay interest to tenants. The Queensland and New Zealand schemes are also self-financing and use the additional interest to fund provision of residential accommodation, research on the private rented sector and loans to low income

tenants who cannot afford to raise a deposit. In New Zealand it covers 30% of the cost of the network of dispute resolution offices which provide a mediation, arbitration, education and advice service to landlords and tenants.

18. Figures provided by the New South Wales Bond Board show that about 77% of claims for refund are agreed by the landlord and tenant. 21% are paid following a claim from one party which is not challenged by the other party, and under 2% are disputed and decided by a tribunal (reportedly a 90% reduction since the scheme was introduced). The percentage of disputes in Queensland and New Zealand are 3% and under 2% respectively.

COMPLIANCE WITH MANDATORY CUSTODIAL SCHEMES

19. The New Zealand Government estimates that about 10% of landlords do not comply with the law. The Queensland Government says there is strong evidence that the degree of non-compliance is small. All the Governments using these schemes claim that they have widespread acceptance within the rental industry and there has been no evidence to show that it has acted as a disincentive to landlords to let property. In particular, in Queensland the bond scheme is supported by the Real Estate Institute of Queensland representing estate agents. Analysis of growth in private rental housing since 1989 for the state shows that there have been small steady increases in the sector each year: there was no noticeable impact on rental housing availability from the introduction of the bond scheme.

20. In New South Wales a survey for the Bond Board reported that over 80% of real estate agents rated the Board's activities and performance as excellent or very good (although this view is not necessarily shared by landlords, who feel that the disputes system does not operate fairly). The state introduced in 1998 the Rental Bond Internet Service (RBIS), a free service which allows landlords direct viewing access at all times to the rental bond records for properties managed by their agency. This is a significant development as real estate agents manage about 85% of all residential rental properties in NSW on behalf of landlords. Tenants also benefit from RBIS through quicker bond refunds.

21. There has not been any specific evaluation carried out of the operations of New South Wales' Rental Bond Board in the last few years, as there appears to be minimal criticism of the current rental bond system. In Queensland, the law was reviewed in 1995/96 through a process which sought public submissions. The review concluded the system was generally effective with only minor legislative amendments required.

22. The potential advantages of applying this model here are:

- there would be a reduction in the number of disputes as landlords would have to take active steps to claim the money and justify their case for it;
- where the tenant has been awarded at least some of the deposit, they are guaranteed to get it back even if the landlord disagrees with the decision-maker's decision;
- it would be possible to ensure compliance in those cases where the tenant was willing to report non-compliance;

- as well as providing some interest for tenants, the scheme could be self-financing and could also provide resources for other housing services. It could also provide a direct source of data on the private rented sector;

- NACAB and tenants' organisations are lobbying for the adoption of the Australian custodial bond scheme model.

23. The potential disadvantages are:

- it would introduce unnecessary bureaucracy for those landlords and tenants who can reach agreement on who has the best claim to the deposit themselves – the majority;

- notwithstanding the figures quoted above, it might act as a disincentive to small landlords to let property or encourage landlords to do away with bonds but not to take higher risk tenants;

- it would be difficult to monitor and enforce compliance where the tenant was unwilling to report non-compliance.

RELEVANCE OF OVERSEAS MODELS TO THE ENGLISH PRIVATE RENTED SECTOR

24. In Australia, New Zealand and Canada, the private rented sector houses a larger proportion of households than here: 20% (as of 1999), 19% and 30% respectively compared with 10% here. The social rented sector houses 8%,6% and 6% of households respectively. This might suggest that the private rented sector has more of a social housing role in those countries which might justify greater regulation of the sector (in terms of risk to landlords as well as tenants).

25. However, private tenants in Australia and New Zealand have little security of tenure and there are virtually no rent controls. The regimes are similar to ours although there are more controls on the terms of the tenancy, including a requirement for a written agreement.

26. In the UK a custodial scheme could operate on a national or regional basis, for example based on Government Office areas (which contain roughly the same size of population as the Commonwealth schemes) which would provide economies of scale. A local authority based service is unlikely to generate sufficient income to cover running costs and could be inconvenient for landlords with properties in more than one local authority area.

ANNEX 7

Pilot TDS Steering Group

1. The Government set up a Steering Group in June 1999 to oversee the pilot Tenancy Deposit Scheme. Its terms of reference were as follows:

   "The Steering Group is an advisory body overseeing the successful implementation and development of the tenancy deposit dispute resolution scheme. Its members comprise the Department of the Environment, Transport and the Regions[22], the Independent Housing Ombudsman and bodies representing landlords, agents and tenants. The Group is chaired by an official from the Department of the Environment, Transport and the Regions.

   The Steering Group gives advice to the Department of the Environment, Transport and the Regions on the development of the tenancy deposit dispute resolution scheme, and any amendments to the rules or scheme literature which they consider are needed. They also advise on the scheme's coverage, publicity, monitoring, and any other arrangements for the operation of the scheme, and on the development of policy on rent deposit issues.

   Advice on particular issues may be requested from members co-opted to the Steering Group, or from non-Steering Group members on an ad hoc basis."

2. The participating bodies agreed that the pilot Tenancy Deposit Scheme should be developed, implemented and administered by the Independent Housing Ombudsman (IHO). The IHO has been responsible for publicising the Scheme in the pilot areas and in seeking new members. The IHO has been responsible for arranging for adjudication in the event of disputes.

3. The TDS Steering Group is made up of one representative from each of the following:

   - The professional agents' bodies (i.e. Association of Residential Letting Agents, National Association of Estate Agents and Royal Institute of Chartered Surveyors)
   - Association of Local Government
   - Birmingham Bond Scheme
   - Brent Private Tenants Rights Group
   - Brighton & Hove City Council
   - British Property Federation
   - Independent Housing Ombudsman
   - London Borough of Brent
   - London Borough of Camden
   - National Association of Citizens Advice Bureaux
   - National Federation of Residential Landlords
   - Shelter
   - South Norfolk District Council
   - Thomas Winter Insurance Brokers
   - University of York Centre for Housing (to June 2002)

22 Subsequently the Department of Transport, Local Government and the Regions and currently the Office of the Deputy Prime Minister.

ANNEX 8
Audit of the TDS pilot

1. Government auditors carried out an audit of the Tenancy Deposit Scheme in June 2002. The aim was to establish that monies provided by the Government were adequately accounted for by the IHO and whether there was any evidence as to the prospect of the current scheme becoming self-financing in the next year or so.

2. The auditors did not seek to analyse how any future (legislative or non-legislative) scheme would work. Nor did they seek to comment on whether the good that would come from protection of tenants' monies would justify any additional outlay that might be necessary from the Department.

3. The auditors noted that funding of the grant for 2002-2004 was dependent on the Scheme meeting the terms of the Appropriation Act. One of these terms was that it had to be a true pilot scheme and that, if the results did not match up to expectations, the options that had to be considered were to abandon the scheme or make radical amendments to it.

AUDIT VIEW OF TARGETS AND RISKS

4. The auditors considered that the objectives of the present pilot as seen by IHO were as follows:

   - To devise a tenancy deposit scheme that as many landlords as possible are content to join; and

   - To devise a process that can be self-funding until legislation is in place.

5. The auditors felt that it had not been clear as to whether the Government's objective was:

   - To ensure that, if tenants pay deposits, their money is safeguarded where appropriate with a scheme that would help the most vulnerable members of society; or

   - To encourage good practice.

6. They also felt that the criteria by which the pilot's success was to be measured were not clear, and that the IHO was, perhaps understandably, concentrating on keeping the TDS running until legislation rather than looking critically at whether the pilot could be adopted.

7. The auditors noted that the pilot had targets of 1,500 landlords signed up by March 2002, and 30,000 tenancies. They remarked that there was little hard evidence to gauge whether those targets had actually been achieved, largely because a significant number of landlords had refused to divulge the number of tenancies that they had, and also had not answered IHO's questionnaire on the matter.

8. The auditors considered this reluctance of landlords to state the number of tenancies they had is a major risk both to the pilot and to the Department's objectives, and needed to be addressed. There was a danger that the Scheme as it stood concentrated on those landlords who were least likely to have disputes with their tenants.

9. An additional risk to the pilot was that, of the 1,200 or so tenancies reported to be covered by the custodial option, over 90% belonged were accounted for by a single landlord. This risk was exacerbated by the fact that this landlord was now selling many properties to landlords who were withdrawing from the pilot TDS.

AUDIT VIEW OF PROSPECTS FOR SELF-FINANCING

10. The auditors were asked to consider the number of tenants needed to sign up to the pilot scheme in order for it to be self-financing; an impossible exercise given the lack of information available on the actual number of tenancies covered by the scheme. The auditors could only note that the IHO's database showed 150 landlords or agents who were in the Scheme and currently had tenants; of these 29 were in the custodial option.

11. The auditors were critical of the performance targets set for the pilot and suggested that a better risk analysis of both the pilot and the problem it was seeking to address would have lead to the problems with the pilot being noticed earlier.

12. Subsequent information arising since the audit suggests that very approximately 3,000 tenancies left the TDS in 2001-02, 970 from the custodial option. The average length of tenancy is thought to be around 9 months. This would suggest that around 3,000 tenancies joined the TDS in 2001-02. Following a formula created by the auditors, and knowing that the IHO plan to charge £1.02 per tenancy for membership of the insured option in autumn 2002, a membership income of about £2,300 for 2002/3 can be tentatively forecast. Income from interest on the custodial option in 2001/2 was £11,764, giving a projected 2002/3 income of at least £14,000.

13. A formula created by the auditors suggests that if 33% of memberships were in the custodial option, a figure based upon interest upon the average deposit, calculated to be £510, earning interest at 1% per annum (the rate provided by the Nationwide Building Society), plus the membership fee for the insured option, would point to each additional tenancy generating about £2.35. In 2001/2 each member cost £1.63 in adjudication costs (£4,900 adjudications costs for 3000 tenancies) so each member is only generating £0.72 to provide scheme running costs. Therefore to cover the scheme's projected 2002/3 running costs (£160,000 exclusive of income stream and adjudication costs) it is tentatively concluded that the scheme would need a further 115,000 tenancies. However, those additional members would create additional running costs, so in fact an estimated further 35,000 tenancies would be needed for the scheme to be self-financing.

14. Given that the pilot scheme probably had only around 3,000 members after two years, it is unlikely to take on 150,000 members by March 2004, and cannot, as presently run, be self-financing.

ANNEX 9

Independent evaluation of the pilot

1. The Government commissioned an independent evaluation of the pilot TDS by York University[23]. This, essentially qualitative, research looking at scheme tenancies only in the pilot areas, began in January 2001 and the fieldwork was completed in May 2002. The research team's brief was to assess the success or otherwise of the pilot's administration and implementation to date, and to consider the need and potential for a national scheme, whether mandatory or voluntary.

2. In administrative terms, the researchers found that the pilot's systems have been insufficiently tested to draw definite conclusions on the IHO's ability to deal effectively with basic administrative functions. The number of landlords and agents involved in both options has been small and the throughput of tenancies has been limited. Like the Government auditors, the researchers noted that the operation of the insured option, in particular the lack of a consistent requirement to pay premiums provide details of tenancies, has prevented a clear judgement as to whether it meets landlords' and agents' needs.

3. The dispute resolution function appears able to arrive at decisions considered fair by tenants and letting agents although the researchers had not been able to interview landlords involved in disputes that had also involved an agent. However the researchers considered that problems might arise from the fact that no limits had been set on the costs attached to dispute resolution.

4. Assessing the cost-effectiveness of the pilot TDS was impossible given the general lack of information on costs, particularly those associated with the operation of the insured option.

5. The researchers considered that at the time of evaluation the pilot TDS administration and costs had been insufficiently tested to inform a decision to introduce a mandatory deposit protection scheme based on the pilot. They also considered that subsidy of a mandatory TDS would still be required until costs had been established and a steady income stream generated from income payments. They recommended that the remainder of the time-limited subsidised pilot should ensure more rigorous testing of its administration and cost-effectiveness.

6. On the issue of whether legislation would or should be required, the researchers weighed up a range of pros and cons drawn from interviews with tenants, landlords and representative bodies.

23 The full report is separately available from the ODPM Publications Sale Centre, Unit 21, Goldthorpe Industrial Estate, Goldthorpe, Rotherham S63 9BL, Tel: 01709 891318 (fax: 01709 881673), or at www.housing.odpm.gov.uk

IS A VOLUNTARY DEPOSIT PROTECTION SCHEME FEASIBLE?

7. There appeared to the researchers to be little evidence to support the view that a national voluntary scheme would have widespread impact within the sector. Take up of the pilot TDS had generally been disappointing. There was also a broad consensus amongst those managing and developing the pilot, and amongst tenants, landlords and agents, that a voluntary scheme would only cover responsible landlords and agents, and these are operators that might already have good systems in place for managing deposits.

IS A MANDATORY DEPOSIT PROTECTION SCHEME FEASIBLE?

8. The researchers found insufficient evidence to judge whether the incidence of difficulties with deposits would merit the setting up of a national scheme. Landlords interviewed who were not in the pilot TDS claimed that they rarely had problems with deposits. Many landlords felt that most difficulties arose from poor management practices rather than an intention by landlords to exploit tenants[24]. However there was general agreement amongst tenants, landlords and agents that the way in which deposits are generally managed was open to abuse by a small minority of unscrupulous landlords and agents.

9. Although landlords and agents generally viewed the management of deposits as unproblematic, there was a very real anticipation of difficulties from the perspective of tenants, many of whom had had previous negative experiences of the non-return of a deposit by a private landlord.

10. This perception strongly suggested to the researchers that landlords and agents are not conveying to tenants an intention to act fairly with respect to deposit return, nor are they instituting sufficiently processional procedures to offset the widespread apprehension of malpractice[25].

11. A mandatory scheme, particularly if based on a custodial model, would therefore be popular amongst tenants. Landlords on the other hand feel that not only would the imposition of a mandatory scheme impose costs that would eventually be passed on to tenants across the whole sector, but that it would be difficult and costly to enforce and therefore incapable of tackling the most serious abuses.

24 DETR Accessible thresholds in new buildings: guidance for house builders and designers. Stationery Office, 1999.

25 BRE Level external thresholds: reducing moisture penetration and thermal bridging. BRE Good Building Guide GBG 47, CRC, 2001.

ANNEX 10

Local voluntary alternatives to the pilot Tenancy Deposit Scheme

THE CARDIFF CUSTODIAL BOND SCHEME

1. The Cardiff Bond Board was established in 1992 to provide rent and deposit guarantees for low income tenants. It established a three-year pilot deposit protection scheme in July 2001; a custodial set-up whereby a landlord and tenant agree to lodge a deposit in the Scheme's client account with Barclays Bank. An adjudication process is provided to deal with disputes concerning the return of rental bonds and an independent Appeals Panel can be called upon if either tenant or landlord dispute the Board's decision.

2. The scheme is endorsed by the city's higher education institutions who recommend that all students to use participating landlords/agents. Landlords and agents dealing with the student market are keen to have their good management practices approved of by Student Unions and Accommodation Officers.

3. It is open to all private sector tenants and any landlord/agent providing that they agree to its terms and condition, excluding landlords who have been successfully prosecuted by Cardiff County Council for matters relating to tenant or benefit abuse. Properties known to be dangerous and those with outstanding works on them are also excluded.

4. The Scheme has been funded by the Welsh Assembly under Section 180 of the Housing Act 1996, at about £40,000 per annum. In the first few months it had taken on 43 bonds with a total value of £10,940. No decision has been made on the use of the interest accrued on this account. It may be used to offset the cost of the running the Scheme but would not become self-financing by this means, unless take up was particularly high on a voluntary basis or if the Scheme became compulsory.

5. It is too early to come to any conclusions as to the success of this scheme. At present all 43 tenants are still resident in their properties and consequently no disputes have been lodged. The efficiency of the adjudication, appeals and returns process will become apparent in the next 6 to 12 months.

THE POOLE ACCREDITATION SCHEME FOR THE PRIVATE RENTED SECTOR

6. This scheme was established in 1998 by the Borough of Poole in partnership with the Dorset Residential Landlords Association (formerly Bournemouth and Poole Residential Landlords Association). It now covers the whole of Bournemouth and Poole. The key aim of the scheme is to have accredited landlords renting accredited property being occupied by accredited tenants. Scheme members use a standard form of tenancy agreement.

7. Accredited landlords are expected to be members of the Dorset Residential Landlords Association, to comply with the Association's Code of Practice, meet certain minimum standards and attend training seminars. Accredited properties meet certain standards in respect of fitness, repairs, health and safety and management.

8. Accredited tenants are those who comply with their tenancy agreement and statutory obligations and receive a 'Reference of Full Accreditation' from the landlord at the end of a tenancy.

9. When a tenant is in dispute with an accredited landlord, they refer the problem to the local authority and are then be directed to arbitration, in accordance with the complaints and disciplinary procedure of Dorset Residential Landlords Association. If these internal procedures are exhausted, arbitration is undertaken by either a representative of General Housing Services of the Borough, or any other relevant body (which could include the Rent Service or Housing Ombudsman) or a neutral solicitor.

10. Any costs liable to arise from the arbitration are quoted beforehand so that both parties can make arrangements for paying their share, and apportioned by the arbitrator according to the outcome of the case.

11. The scheme's objectives are to:

- Improve and promote private sector rented housing conditions.
- Provide tenants with confidence in the quality and management of the accommodation they are renting.
- Recognise and encourage landlords who are prepared to provide good quality accommodation at an appropriate rent.
- Improve liaison and communication between landlords and local authorities.
- Promote good practice in the private rented sector.
- Improve and promote the public image of the private rented sector.