Headleasing by the Department of Housing and Gearing as an Alternative Strategy

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1 Introduction

The NSW Department of Housing (DoH) is using headleasing as a means of increasing the supply of public housing. This paper examines some of the issues surrounding headleasing by the DoH and suggests gearing (ie. borrowing funds to purchase housing) as an alternative strategy.

2 Why examine headleasing?

2.1 The NSW Perspective

The Minister for Housing has consistently expressed strong support for a headleasing program. By headleasing, stock can be acquired for the cost of subsidising rent each year that the stock is leased rather than by paying the capital cost up front.

The Minister has also expressed strong support for a substantial increase in funding for improvements to existing publicly owned stock. This includes maintenance, upgrading and redevelopment. The dilemma is that without large amounts of additional funding, the backlog of major maintenance upgrading and redevelopment can only be met at the expense of cutting back in new stock. The Housing Policy Green Paper (1995: 19) states that this dilemma should be resolved by the use of more private sector funds. Headleasing is the DoH's only current use of private sector funds. In effect, funds made available by the short term reduction in costs provided by a headleasing program have been earmarked for spending on improvements to existing properties. (See section 4 for a discussion of long term and short term costs of headleasing and ownership.)

The DoH has traditionally provided mainstream public housing through a capital program, that is, by either purchasing or building properties. Recently, though, the DoH ran two pilots to provide mainstream housing by headleasing properties from private landlords or developers. They were:

- a pilot to spot lease 1 000 properties by June 1996; and
- a pilot to lease 400 properties through a build and leaseback agreement by mid 1996.

(See section 3 for an explanation of spot leasing and build and leaseback.)

No evaluations for either pilot have been released by the DoH. It is estimated, though, that around 800 spot leases were accomplished in the first pilot in 1995/96 and about 85 in the build and leaseback pilot, which was delayed until 1996/97. Informal discussions with DoH regions and the Office of Housing Policy (OHP) about the pilots suggest that several regions had difficulty in meeting their quotas for spot leasing and that the build and leaseback pilot was not cost effective and was consequently cut back.

On the basis of the spot lease pilot, the DoH planned to spot lease another 1,000 properties in 1996/97. The Commonwealth government, however, failed to provide funding certainty to the DoH by only offering six month's funding to the end of 1997, and as a result only 65 leases were achieved. This year the DoH's target for spot leasing is 400 properties, but again the achievement of this target is dependent on Commonwealth funding security. Negotiations between the NSW and Commonwealth governments are taking place on this issue at present.

2.2 The Commonwealth Perspective

The Commonwealth State Housing Agreement (CSHA) is the agreement governing Commonwealth funding to the States for housing. The CSHA provides a mix of capital (used to build and purchase housing) and recurrent funds, but recent attempts at housing reform have revealed the Commonwealth government's preference for providing recurrent funds only. Headleasing has recurrent costs and no capital costs, so it fits well with the Commonwealth's view of housing funding. Indeed, the Minister for Social Security, who is in charge of housing at the Commonwealth level, has recently expressed support for headleasing although the Commonwealth has made no commitment as yet. Another idea that fits well with the preference for recurrent funding is gearing, or borrowing money to pay for the purchase of new stock. (See section 5 for a discussion of gearing.)

The Commonwealth commissioned Coopers and Lybrand to prepare a study of the policy implications for using headleasing as a means of increase the supply of public housing. The study (1996) addressed: costs to government of headleasing compared to gearing; the likely market response to headleasing of public housing; operational issues of headleasing including implications for tenants; and relevant risk management and assessment issues.

Coopers and Lybrand found that it was not possible to determine which form of funding, headleasing or gearing, was the most cost effective in all situations. Depending on the circumstances of the market and conditions imposed by governments, either headleasing or gearing was more cost effective. Given this, the consultants concluded that it would be appropriate for governments to utilise a mix of headleasing and gearing.

2.3 Headleasing by Other Agencies

The Community Tenancy Scheme (CTS) is a headleasing scheme which has been in operation since 1982. Properties are spot leased by housing associations administering CTS funds. Leases are generally short term, however, some housing associations have negotiated longer leases. The refunding agreement is negotiated annually. The scheme is seen as extremely successful, but strategies for the growth of the community housing sector have focused on generating a capital base for the organisations (through purchase of properties and transfer of DoH stock) as recurrent funding is seen as a limited supply of funds.

For some time, the Defence Housing Authority (DHA) has headleased properties as an adjunct to its purchase program. In 1990-91 it commenced a scheme in which it negotiated with small investors to purchase a property constructed for the DHA or an existing DHA property, and receive a guaranteed income stream for the first five to ten years. Although there has not been a formal evaluation of the scheme, the DHA Annual Report 1992-93 (1993: 24) stated the DHA's intention to seek no new headleases and return to purchasing stock as ownership was more cost effective. Despite this evidence, the DHA's scheme continues to be cited as a positive experience of headleasing.

3 What is headleasing?

Headleasing takes place when an organisation, such as the DoH (the head tenant), leases property on the private rental market, and then sublets that property to a tenant (the sub tenant). The sub tenant pays the head tenant the same amount of rent they normally would in a public or community housing dwelling (approximately 18-25% of his/her income). The head tenant then uses this rent plus a subsidy to pay the market rent for the property to the private landlord.

The two headleasing schemes the DoH piloted were spot leasing and building and leaseback.

Spot leasing is where the DoH finds a property in the private rental market, and leases that property from a private landlord. The property is sub-let to a public housing tenant who pays a rent based on his or her income. This is the form of headleasing used for the CTS. Headleases can be for short or long periods of time.

Building and leaseback is where a developer contracts with the DoH to build new dwellings according to DoH specifications and then to lease those properties back to the DoH. The DoH then sub-lets the property to a public housing tenant who pays a rent based on his or her income. The build and leaseback headlease in the DoH’s pilot is for four years with an option for another three years after that. In the pilot, the DoH sought to lease properties from developers who had suitable properties under construction.

The DoH also headleases its own properties to other social housing providers which sub-let to tenants. The headleasing arrangements between the DoH and housing co-ops are an example. These sorts of headleasing arrangements are not examined in this paper. The analysis focuses on the DoH headleasing properties from private landlords.

4 Issues to consider

4.1 Costs in the long and short terms

In the long term, headleasing is a more expensive way to provide housing than purchase of properties (Industry Commission, 1993: xviii). The Industry Commission based this finding on the experience of the DHA, which dropped its headleasing program in favour of purchase of properties because of the higher cost of headleasing. As there is no large up-front cost, though, headleasing is cheaper in the short term than purchase.

One way to understand the long term and short term costs is to think about a person with enough money to choose between paying cash to buy a home and leasing the same home. If they bought the property, the cost would be many times more than the rent they would pay in the first year. Paying rent for two or three years would still add up to less money than buying the property. In the short term it is cheaper to pay rent. But rent needs to be paid every year of occupation, and after a number of years the rent would add up to more than the purchase price of the property. In the long term, it would have been cheaper to have purchased the property.

4.2 Operating costs

The operating costs for public housing properties include property management, tenancy management, maintenance and rates. These costs need to be met by the DoH on owned property. For headleased properties, only the tenancy management cost remains with the DoH, although in many cases the DoH does maintenance work in return for a fee from the landlord. It should also be noted that as head tenant the DoH has responsibility for making good tenant damage and for maintaining the property should the owner not carry this out in a timely way.

Headleased properties incur other costs for the DoH as well. These include finding appropriate properties, negotiating leases, managing the agreement, organising maintenance with the owner and ensuring that it is carried out. As the majority of rental properties are owned by small investors, this means dealing with a large number of individual property owners or their real estate agents. Short term spot leases also risk a high turnover of stock, which increases costs. Build and leaseback can partly overcome this by providing more stock on longer term leases.

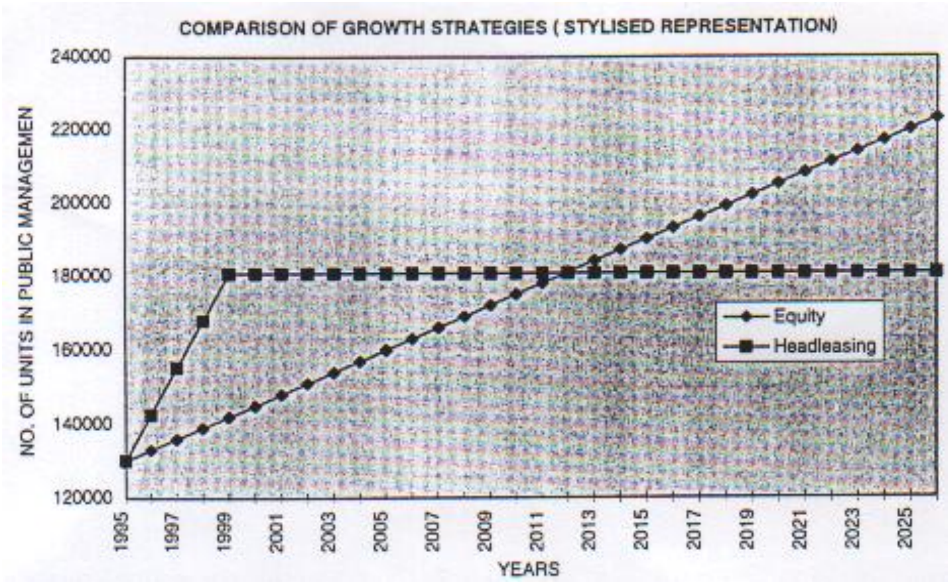
The Community Housing Infrastructure Study (1994: Appendix 7, 12) compared the operating costs of CTS and DoH properties. The report estimated that CTS management costs for headleased properties are 50% more than for properties owned by the DoH. The report acknowledged, however, that the comparison did not take into account the different client groups serviced by the CTS, the quality of client services provided by housing associations, the higher turnover amongst CTS clients, and other services provided by some housing associations. These were estimated to add about 25% to CTS management costs.

The CTS Budget Strategy (1997: 7) bears out this difference in costs. It estimates that it costs around 60% more to manage privately-leased stock compared to capital stock, but attributes the major gap in management costs to the way stock is held.

4.3 Impact on the waiting list

Headleasing is cheaper in the short term, but more expensive in the long term. This means that headleasing can house more people in the short term than purchase of property, but in the long term fewer people are housed by headleasing.

The following graph shows the number of people housed in the short and long term by headleasing and purchase strategies. The graph is from the OHP Background Paper, "Private sector involvement in the provision of public housing" (1995: 15).



<u>ASSUMPTIONS (based on NSW)</u>
1. Commonwealth funding fixed in real terms at $390 m per annum
2. Equity costs per dwelling: $130,000
3. Headleasing costs: 7% of capital costs ($130,000) plus 1% costs less client contribution estimated at $52 per week
4. New headleased properties are phased over 4 years.

The major difference not shown in the comparison above is that purchasing property creates an asset held in public hands, while headleasing continues to transfer funds (as rents) to private landlords.

4.4 Impact on wait time

Spot leasing can allow suitable, well-located housing to be speedily added to public housing stock. This would assist people who have been unable to access public housing because existing stock is not appropriate, for example, a tenant who needs to be near a hospital for treatment, or a large family that needs several bedrooms. However, housing these tenants is dependent on the supply of suitable accommodation on the private rental market at an affordable price. Location of private rental housing, similarly to public housing, is patchy, being concentrated in some suburbs and scarce in others. Achieving locational advantage for tenants may prove just as elusive in the private rental market as it does in public housing generally. Indeed, some regions of the DoH have commented on how hard it is to find certain types of accommodation on the private market, such as ground floor flats and dwellings with several bedrooms.

The build and leaseback strategy cannot provide accommodation as quickly as spot leasing because of the time needed to design and build the properties.

It has been suggested that a mix of purchase, spot leasing and build and leaseback approaches would allow the DoH to manage issues of speedy response and appropriateness.

Some suggest that speedier additions to public housing stock enabled by spot leasing will mean that clients will get immediate housing. It is important not to confuse speedy additions to stock with changes in allocations policy. Unless the DoH decides to change its allocations policy, headleasing will only assist people at the top of the waiting list or people approved for immediate housing.

4.5 Impact on discrimination

Some people suggest that spot leasing avoids the discrimination which occurs in the private rental market, particularly against aboriginal applicants and young people. This is because a neutral third person (the DoH) is placed between the public housing tenant and the private landlord.

There have been mixed reports about this issue from DoH regions engaged in spot leasing. Some have been able to obtain appropriate spot leases only by stating what sort of clients will be placed in the accommodation. For example, one region is housing aged clients in its headleased properties because private landlords see them as the least likely to damage these properties. Others, though, are able to house people from their immediate housing list without interference.

Reports from housing associations administering the CTS scheme are that many of them have managed to establish relationships with real estate agents and landlords which allow them to lease properties without discussing the characteristics of tenants to be placed in them. They comment that real estate agents may not suggest properties belonging to discriminatory owners. They also suggest that their excellent track records in repairing any damage helps overcome any reluctance of landlords and agents. Community management may humanise the market by reducing discrimination, but not all community managers are totally non-discriminatory. Also, the type of stock available in an area may reduce flexibility to target applicants and this could be seen as a de facto form of discrimination against people who do not fit into that stock.

4.6 Relationship with real estate agents

Some workers administering CTS have suggested that the DoH is not well suited to running a spot leasing program. They emphasise the importance of developing good relationships with local real estate agents and owners to spot lease properties and to manage them. One described this as a "subtle process" with no blanket rules, other than the Residential Tenancies Act. The workers suggested that staff movement within the DoH made it difficult to develop those relationships. Also, issues such as responsibility for the costs of maintenance are negotiable elements in current community headleasing practice, which might not be as easily achieved in DoH practice.

The build and leaseback option involves negotiations with developers rather than real estate agents.

4.7 Dependence on the market

A central issue for a spot leasing program is the condition of the private rental market. If vacancy rates in the private rental market are high, then a wider range of properties will be available at lower rents. If there are few properties on the market, then rents will be higher and it will be harder to find suitable properties.

In a spot leasing program, the DoH is dependent on private landlords to decide what stock is available for lease. In some areas suitable stock may not exist, or may not be available for lease. Experience in the late 1980s, when market rents doubled in a few years, demonstrates how volatile the private rental market can be. This inevitably impacts on budget forecasts and the cost of headleasing.

4.8 Impact on private tenants

One concern with headleasing is that it may reduce the amount of stock available to private renters, causing rent increases and making it more difficult to rent a home. This has been of particular concern in rural communities where the private rental market is very small. Clearly, the size of the headleasing program in any area will determine how much its local rental market is affected.

4.9 Impact on location of public housing

One proposed advantage of headleasing is that it improves the location of public housing. It is widely acknowledged that much of the existing public housing stock is poorly located, providing tenants with difficulties in accessing employment, transport and services.

Spot leasing properties gives the DoH a high level of flexibility in locating public housing. When a lease expires, the DoH may choose not to renew the lease and may lease another property in a better location, if suitable accommodation is available. The obvious constraint on this flexibility is cost. If headleasing is to be done to respond to need, not just to take up opportunities where there is cheap stock, it may be expensive.

Build and leaseback arrangements involve leases of a number of years and so provide much less flexibility in location. Again, the location is dependent on cost and market willingness to provide properties in the chosen location.

It has been suggested that vigorous asset management of purchased properties may offer a higher level of flexibility than the build and leaseback strategy. Where properties are owned by the DoH, those in unsuitable locations can be sold and more appropriately located properties purchased immediately the need is identified.

4.10 Impact on accommodation for people with disabilities

Modifying headleased properties to accommodate people with disabilities requires the agreement of the landlord. It is not always possible to obtain his or her agreement. Modifying rented properties involves significant expense and this investment is lost when the lease ends.

This issue raises the discriminatory potential of introducing headleasing with some groups of people being offered only purchased properties, which are more secure accommodation, while others are offered only headleased properties, which are less secure accommodation.

4.11 Impact on security of tenure

Headleases are for a defined period of time, and therefore it is not possible for a tenant to have security of tenure within the one dwelling. Tenure within the one dwelling is dependent on agreement between the DoH and the private landlord to renew the lease and the rate of renewal is not yet known. At present, tenants housed in spot leased properties have been assured of accommodation when the headlease runs out and will be paid moving expenses. If tenants in headleased properties move frequently, removal expenses could become quite substantial.

The 1996 CSHA (1996: 8) guarantees security of assistance to public housing tenants rather than security of tenure. This waters down a long established right for public tenants. There have been some concerns that the DoH may introduce limited tenure for new public housing tenants and may do this in conjunction with the headleasing program. This may not be the intent of the present governments at either State or Commonwealth level, but it increases the possibility of such a step with any change in administration. This remains highly speculative, but raises serious concerns.

4.12 Impact on the individual public housing applicant/new tenant

Where a headleased property is offered in a non-selective way to the next household whose turn is reached, there is a strong possibility of disadvantage for this tenant as they have to deal with lack of security of tenure and possible landlord interference.

This would be overcome if headleasing was not regarded as a program to bring about rapid increase in housing opportunities generally, but rather only resorted to at the applicant's request when they have a very particular need that cannot be met in a more appropriate way.

4.13 Impact on repair work

The legal responsibility for repairs and maintenance of a spot-leased property lies with the private landlord. Theoretically, when a tenant requests repairs, the DoH asks the private landlord to do the work. Difficulties would occur if the private landlord was not keen on doing the repairs. Indeed, Tenant Advice and Advocacy Services have reported a few cases of inordinate delays in getting repairs and maintenance done in some headleased properties.

4.14 Impact on asset management

One of the suggested uses for headleasing is to provide stock in areas of declining population, such as small rural communities. This would allow the DoH to avoid building properties which would become vacant in a few years. Informal comment from one non-metropolitan region of the DoH is that they are unable to find suitable properties in contracting rural communities. For example, there is a high demand for ground floor units for older people in these communities, but they are rarely available.

5 Gearing as an alternative to headleasing

5.1 What is gearing?

Gearing, often termed debt financing, involves borrowing money to purchase properties.

There are a number of ways in which private funds can be used by governments for this purpose, such as interest only loans and housing bonds. This paper examines only one form of borrowing, the credit foncier loan. Like a loan taken out by an individual, interest is charged on the amount borrowed and repayments are made at regular intervals until the loan is paid off. This form of gearing gives the DoH ownership of the property.

There are two main differences between this form of gearing and the existing purchase strategy of the DoH. Firstly, gearing allows the DoH to pay for the property over the life of the loan, rather than in a single up-front payment. Secondly, gearing requires the DoH to pay interest costs as well as the capital cost of the property.

5.2 Benefits in the short and long terms

Like headleasing, this form of gearing is cheaper in the short term than the cash purchase of a property because payments are made over the life of the loan, rather than as a single up-front payment.

In the long term, this form of gearing is likely to be cheaper than headleasing. Governments can obtain loans at cheaper rates than investors and borrowing avoids the administrative expenses of negotiating with property owners or developers which is inherent in headleasing. Furthermore, governments financially benefit from gearing as they are left with an asset at the end of the purchase period.

5.3 An example

In 1993 the Industry Commission estimated that the DoH’s debt to equity ratio was 18 per cent. A debt to equity ratio of 18 per cent is like owing $18,000 on a house worth $100,000. Using the Industry Commission’s methodology, it can be derived that in 1995/96 the DoH’s debt had dropped to 15 per cent of its equity[1]. If that level was increased to 20 per cent, for example, it would provide an extra $600 million for public housing stock expansion in NSW. At an average cost of $132,500 per new public dwelling[2] that would equate to an extra 4,500 dwellings.

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[1] The Industry Commission compared the current level of debt with the current value of housing stock. The DoH has a current debt of $2,026 million (NSW DoH, 1996) and the current value of its stock is $13,240 million (Industry Commission, 1997). Using this methodology then the DoH’s level of debt is $2,026 million divided by $13,240 million or 0.15, which is 15%.

[2] This figure was provided by the DoH and represents the average cost of building and acquiring stock in 1995/96. The figure includes the market value of land for properties that were both acquired and built. But, as the DoH normally builds on land that it already owns, the land component of the cost for building properties is not an actual cost. Consequently, this figure over-estimates the actual cost of production of new stock.

5.4 The barriers to gearing

Two major reasons have been given as to why the NSW government is not using gearing to provide public housing. Loan Council guidelines is the first. Loan Council Global Borrowing Limits determine the maximum amount of funds which the State government and State government authorities can borrow. On investigation, the NSW government is well within Loan Council limits and can therefore borrow more money if it so chooses.

The second reason is that while the DoH would be able to borrow a large amount of money against its assets, it would meet real difficulty in repaying this debt. Currently the DoH allocates almost a third of its income to repaying debt to Commonwealth and State governments. As a result, it is argued increasing the level of debt to income would be an unsustainable proposition.

It is true that without a subsidy to assist the DoH in servicing the extra debt associated with gearing the strategy would be financially unsustainable. The DoH, however, is able to use a portion of the funding it allocates to headleasing stock as funding for a gearing program. If this funding were to be guaranteed over the long term, so that the DoH could be sure of a funding stream to service its debt, it would enable gearing to proceed.

Shelter NSW considers that gearing is a strategy Commonwealth and State governments should pursue. In fact, in the context of growing demand for housing and long public housing waiting lists, NSW has a strong case for the use of gearing as a housing supply strategy.

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