Mitigation Strategies for Capital Reserves Shortfalls

SHSC

Social Housing
Services Corporation

TABLE OF CONTENTS

1. *Capital Reserves and Renewal Background*

Many Service Managers across the Province have undertaken due diligence exercises on the social housing portfolio. Faced with capital stock that is, in some cases, approaching the first significant capital renewal cycle in the overall life of the building, Service Managers have begun trying to assess their overall capital liability over the short, medium and long term.

SHSC has conducted numerous studies, including one in March 2004 that attempted to understand the extent to which Service Managers (or their housing providers) had completed Building Condition Assessments, to determine the state of their stock, as well as to forecast, with some degree of accuracy, how the pooled capital reserve funds would perform in the long term.

It was found that about 52% of prescribed providers (as defined under SHRA, 2000 and for whom which SHSC has accurate reserve data due to its mandated role under the SHRA) have a capital plan or have done BCAs and are actively planning and managing the situation, while several indicated that although BCAs were a significant priority, budgetary considerations had kept them from implementing a portfolio-wide review. This sample of Service Managers/providers that had done capital reserves represented about 40% of the housing stock in Ontario.

Their study conclusions and findings demonstrate that the current level of annual contribution is not adequate to meet or sustain the capital needs of the Social Housing portfolio, although it was also noted that interpretation of the actual BCA played a role in actually assessing the extent, size and scope of the potential capital reserve shortfall.

2. *Mitigation Strategies and key stakeholders*

There is a growing dilemma about the adequacy of the reserve funds to preserve the non-profit housing portfolio. As noted previously, many projects have building elements, which are experiencing the end of their first life cycle, creating the first demands for capital reserve dollars**.** It is important to ensure the preservation of the physical asset. To manage this efficiently it is important to have a long-term capital plan to cope with the demands.

There are a number of strategies being pursued by Service Managers to deal with the under funding. This report summarizes some of these strategies below. For example, the individual BCA/RFS reports are very helpful management tools for the individual housing providers. Service Managers should undertake a detailed analysis of the findings in the BCA/RFS reports in co-operation with their housing providers to identify strategies to mitigate the impending funding shortfall.

However, there are also two stakeholders which will also have to be engaged in order to fully manage this situation. These are the actual housing providers (who will have ground-level preventative maintenance and management strategies which can help in the overall capital reserve strategy) and the various levels of senior government who fund social housing.

The involvement of the government in managing this issue is vital; it is clear that although Service Managers and housing providers will be able to generate some capital reserve savings and defer some costs through effective preventative capital maintenance strategies, as well through management of their capital reserve funds in a more efficient manner, these strategies are not enough to fully mitigate this problem.

Given the seeming magnitude of the capital reserves situation (SHSC projections from the above noted survey indicate that within 5 years there will be small capital reserve deficits potentially cropping up regionally, and by 10 years, the portfolio will be looking at a province-wide deficit of slightly under $1 billion) there needs to be support from senior levels of government. This magnitude of deficit is such that even with effective implementation of the strategies detailed in this report, Service managers and housing providers can not reasonably expected to be able to account for almost $1 billion in savings by 2013. A response is needed from senior government to address this situation, including (but not limited to) a significant injection of funds into the capital reserve system.

3. Provider Mitigation Strategies

3.1 Phillips, Hager and North (PHN)

Capital planning is an effective tool to support good corporate decision-making. A capital plan is not a requirement, however useful in planning investments based on long and short-term capital needs. The key objective is to increase the return on investments and supplement the available funds in the capital reserve funds. There are four social housing investment funds:

i) Social Housing Canadian Money Market Fund
ii) Social Housing Canadian Short-Term Bond Fund

iii) Social Housing Canadian Bond Fund and
iv) Social Housing Canadian Equity Fund

Housing providers should be encouraged to take advantage of the optimal investment strategy based on the existence of a capital plan and when the capital funds will be needed.

Currently, the majority of housing providers have not actively pursued the opportunity to match their long term capital needs (as determined through a comprehensive capital plan) and their capital reserve investment strategies. A more appropriate allocation, given the existence of a capital plan, would greatly increase the rate of return and could potentially mitigate the risk of insufficient return on investment.

3.2 Maintenance and Prevention Strategies

Housing providers can, in addition to following any recommendations in a BCA, pursue continuing education in areas which will help them manage the capital reserves in a more effective manner. This includes training and workshops currently delivered by SHSCFI on capital investment and capital planning as well as building on existing materials and information that sector organizations may have developed or gathered.

SHSC, as a centre of excellence for the ongoing best practices and performance indicators for both Service Managers and housing providers, is the ideal focal point for future ongoing training and education and as a repository for best practices in preventative maintenance and education that will reduce overall capital renewal costs, by preventing early life cycle breakdown in capital stock.

4 Service Manager Mitigation Strategies

4.1 Development of Long Term Capital Plan

Many service managers are currently developing long-term plans using the data from their capital reserve initiative to work with their housing providers to cover the shortfall in capital reserve funds. Elements of the plan include:

- the impact on the new funding model
- impact of maturing mortgages and expiry of operating agreements
- impact of standards and 'best practices' (i.e. Phasing-in replacement activities over a number of years, rather than bulk replacement)
- impact of resident satisfaction and level of service
- the long term annual budget requirements and implications
- 5-year capital outlook
- the establishment of building standards, life expectancy guidelines and capital priority system to assess condition and need
- the potential ability of the Service Manager to provide funding from its own funds to address the shortfall in reserves
- the establishment of a Service Manager stabilization fund at the municipal level, regionally or centrally (i.e. with SHSC)
- providing technical advice (tenders, specifications) and referrals
- education/training to housing providers (i.e. providing preventative maintenance programs to extend the life of certain elements); and
- other funding strategies to deal with the shortfall

The long-term plan should be reviewed on an on-going basis assessing carefully the impact of the physical asset, the residents and financial resources.

4.2 Expiry of Operating Agreements

Some of our older non-profit housing projects, as well as buildings owned by local housing corporations are going to have their mortgages paid off in about 7 years. The impact of this is very project specific. There is no guarantee that there will be a new program to provide rent subsidy for rent-geared-to-income (RGI) assistance. The rents generated by RGI tenants combined with market rents and non-rent revenue may not be high enough to cover capital reserve contributions and the projected capital needs of the housing project.

Up until the mortgage expires, the annual replacement reserve contribution is funded from the operating budget into the capital reserve each year. It may be necessary to look at other funding options after the mortgage is paid off.

Service Managers should have a 5-year outlook of the expected expiry of operating agreements in their portfolio. The service manager should be prepared to deal with these situations globally and on a provider-by-provider basis. There is no financial obligation from the Federal or Municipal government after the expiry of the operating agreement. However, financial assistance may be required from the municipality to continue to provide affordable and rent geared to income housing in their communities and to keep the housing provider financially viable and to ensure the physical integrity of the physical housing project.

There is also a consideration with respect to the issue of a possible “top up” or accumulation of capital reserves dollars by housing providers during the period of the operating agreement. Because there is nothing in the SHRA preventing a housing provider from leaving the service manager once its operating agreement expires, there is a distinct possibility for providers to enjoy a relative cash “windfall” based on accumulated reserves surplus, which the Service Manager has committed funds to via subsidy in years past, but now has no control over. This potential loss means that Service Managers can leverage their existing subsidies (or a potential “top up” to rectify any existing reserve shortfall or deficiency) to re-negotiate or extend the existing operating agreement with their providers, in exchange for injection of capital dollars.

4.3 Establish Emergency Stabilization Fund

Some service managers have established an Emergency Stabilization fund at the municipal level in the event that housing projects that required emergency repairs and the housing provider had insufficient funds to complete the work.

Service Managers should consider setting up a fund to deal with periodic building reviews, capital repairs, and emergency capital funding requests that should be funded annually to keep abreast with the diminishing Capital Replacement Reserves.

With the limited funds available to deal with the capital replacement programs and expected shortfalls, it may be prudent and preferable to establish a centralized Emergency Stabilization Fund with Social Housing Services Corporation to assist municipalities with the projected funding pressures. The centralized fund could be set up as a revolving fund with lower lending rates; possibly with Philips, Hager and North. Criteria would be required to access these funds, and for the terms and conditions for repayment.

This fund would be used for “emergency” situations only and ideally, would accompany a provincial government solution to stabilize the situation in the short term, while helping to establish the emergency fund to be used in exceptional circumstances for providers in dire and crisis circumstances.

4.4 Accreditation and 3-5 Year Interval for Operational Reviews

Operational reviews are conducted by Service Managers of their housing providers every three to five years; it is recommended that this now be performed in conjunction with updated assessments of the building conditions and the capital reserve balances.

For a more detailed discussion of a possible accreditation system, please refer to the accompanying SHSC document on accreditation.

4.5 Federal Projects

The percentage of geared-to-income rent for Federal providers could be adjusted from 25% of gross household income to a maximum of 30% in an attempt to generate additional revenue. This would require cooperation from the Federal providers since there is no legislative requirement for the Federal providers to comply.

4.6 Re-financing Strategies and Borrowing on Equity Opportunities

Current legislation under the SHRA and the structure of social housing programs prevents providers from assuming liability or accessing their equity through re-financing or re-leveraging existing assets. This effectively prevents them from being able to access funds which could potentially alleviate the capital reserves issue.

Many housing provides will accumulate significant amounts of equity in their properties over time. Borrowing opportunities will be available to providers to assist with future capital demands. Drawing on equity needs should be the exception and used to deal only with very large capital replacements or applied to projects, which are close to having the mortgage paid off.

4.7 Year-End Operating Surpluses

The proposed new provincial funding model requires 50% of any year-end operating surplus to be returned to the Service Manager. Service Managers may wish to develop a policy that allows housing providers to retain this share conditional on it being deposited into a Service Manager Stabilization Fund or invested directly with Phillips, Hager and North (PHN).

4.8 Additional Strategies

Service managers should examine various means to reduce operating costs, such as energy efficiencies, or non-rental revenue initiatives.

Service Managers should ensure the housing providers have access to ongoing training on the management of their capital plan and investments. This would take the form of training that has already been rolled out from SHSC FI in 2004, which included capital planning and introductions to cash management and capital budgeting.

The re-allocation of federal funds relating to the LHC portfolio (which was downloaded without reserves) totaling approximately $100 million in 1998 (plus inflation factor) would be the obvious source for any such capital injection into the capital reserve system.