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**Technical supplement for co-ops
with CMHC-administered operating agreements**

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An introduction to CMHC's new replacement reserve guide

Canada Mortgage and Housing Corporation released its long-awaited replacement reserve guide on April 1. After hearing many concerns from our members over the years, CHF Canada had asked CMHC to study a new approach to replacement reserve spending. CMHC started its review nearly two years ago.

The result is a document called "The Replacement Reserve: A Guide for Use". It applies to co-ops administered by CMHC and is available in English and French.

The nine-page guide is intended to simplify and standardize the way your co-op uses replacement reserve funds. It does not take the place of your operating agreement, but builds on the agreement. It offers a working arrangement that cuts through a lot of the red tape of the past. The guide encourages co-ops to plan for replacement reserve spending, and offers incentives for those that do.

In this technical supplement, we'll walk you through the guide, looking at the key parts and helping you to understand what it has to offer. *But be sure to read the entire CMHC guide.* Luckily, it's written in user-friendly language.

THE PURPOSE OF THE GUIDE

The first page of the guide defines a replacement reserve and sets out the guide's purposes. The guide:

- describes what a capital item is
- tells when capital items should be replaced and what they should be replaced with
- says what can't be paid from the replacement reserve
- provides a standard list of capital items that can be replaced or repaired using replacement reserve funds
- sets out some exceptions and variations to the standard list, and
- sets out the rules for spending from the reserve.

There are three main parts to the guide. The first is about capital items – what they are, when they should be replaced, and what with. The second provides a set of spending guidelines for replacement reserve funds. And the third talks about CMHC approvals.

CAPITAL ITEMS *Definition of a capital item*

The replacement reserve guide sets out a definition of a capital item. It says that capital items are the major components of your buildings and property, most of which have long lifespans. Their useful life comes

to an end when it is more cost-effective to replace than to repair them.

The same part of the guide also says that major repairs or renovations that benefit more than one fiscal year may be considered capital items, if the cost cannot easily be paid from the annual operating budget. This is a key benefit for co-ops. It means that co-ops can now pay for large cyclical projects like exterior repainting of the buildings from the replacement reserves. In the past, CMHC considered these costs to be operating expenses even though they occurred only every several years. Co-ops either had to pay for them out of their operating budgets, or save for them outside of the replacement reserve. Now the cost can be planned like any other replacement reserve expenditure.

The standard list of capital items

A standard list of capital items follows the definition. In the past, the only list your co-op had of pre-approved capital expenses was the handful of items mentioned in your operating agreement. Everything else needed CMHC's specific approval. Now when CMHC is reviewing your replacement reserve plan it will be checking against a list of more than 40 items on which co-ops can spend replacement reserve monies. That list will be standard for all co-ops administered by CMHC. You will no longer have to rely on your local CMHC office to decide what is a capital item and what is not.

Adding to the standard list

As well, the guide allows additions to the standard list. The guide gives a sample list of acceptable items, calling them extensions to the standard list. Included are items that are usually expected to last as long as the building, but may require replacement or major repair before then. They include foundations, framing and retaining walls.

Co-ops need to talk to CMHC about these exceptions and have them fully investigated in order to get them added to the standard list. The ability to get these items added will be important to all co-ops, but especially to those that bought existing buildings.

Replacing capital items

The guide says when a capital item should be replaced and what standard of quality the replacement should meet. Generally, capital items should be replaced with ones of equivalent quality. But CMHC can approve a higher quality replacement if it will lead to future savings. Co-ops must carry out a cost-benefit analysis to get the approval, but this is a major step forward. In the past, CMHC often said that higher quality replacements were improvements and not eligible replacement reserve expenses.

What you can't use the reserve for

The guide also tells you what replacement reserves *can't* be spent on. The reserves can't be used to pay for normal property maintenance, for replacing items that are still performing satisfactorily even if they wouldn't meet standards for new construction, or for items that have been damaged through abuse or vandalism. In the latter case, the guide recommends that the cost of the replacement should be recovered from the person(s) responsible for the damage, or through a claim under the co-op's insurance policy.

SPENDING GUIDELINES

The purchasing rules

The purchasing rules vary depending on the amount the co-op needs to spend, but co-ops will find that in most cases the requirements match what they are already doing: getting quotations from at least three sources. For work costing more than \$30,000, a tender is recommended. If the

cost is over \$100,000, CMHC wants you to get bids from six sources, where possible, and asks for public tendering for construction work. That means placing a public notice that describes the work and invites qualified firms to submit a bid by a certain deadline.

Bulk purchasing programs

The notes to the purchasing rules contain good news for co-ops who participate in bulk purchasing programs. Purchasing requirements may be met through bulk purchasing programs, under three conditions: the program must be cost-effective; user fees cannot be charged to participating co-ops; and purchasing agreements with suppliers must not be for longer than three years.

The ban on user fees does not mean that federations cannot recover their administration costs through the purchasing agreements with their suppliers. It simply means that they cannot add on an extra charge to co-ops just for using the program. The time limitation on purchasing agreements means that these agreements must be evaluated at least every three years to make sure they remain competitive. This should not present a problem – co-ops will let their federations know long before if bulk purchasing programs are not cost-effective.

CMHC APPROVAL FOR RESERVE SPENDING

The final section of the guide covers CMHC approvals for replacement reserve spending. It is deliberately designed to encourage replacement reserve planning.

In the past, the only pre-approved replacement reserve expenditures were those listed in the operating agreement. Everything else required CMHC's advance approval. Now there are two sets of

conditions for getting your reserve spending approved.

1. Spending approval for co-ops with replacement reserve plans

CMHC believes replacement reserve planning is very important for co-ops, with good reason. Many, perhaps most co-ops are not putting aside enough money in their replacement reserves to cover all their replacement costs in the future. The key question is, how much *is* enough? The only way to find the answer is to do a replacement reserve study.

What are replacement reserve studies?

Replacement reserve studies begin with a survey of the property to make a complete list of capital items and their condition. The next step is to estimate how long these items will last and what it would cost to replace them at today's prices. This is combined with projected inflation and interest rates to produce a long-term replacement reserve financial forecast and a new estimate of the amount you should be putting aside in your replacement reserve each year.

How to get a study done

Reserve fund studies are often carried out by specialists such as structural engineers. But the guide does not require co-ops to use engineers (although it is a good idea to do that if your co-op can afford it). Some co-ops have done studies themselves, to CMHC's satisfaction. Co-ops can also produce their own financial forecasts, or use the computer program that CMHC has developed to do these forecasts.

Getting approval for spending

The guide says that if a co-op does a replacement reserve study and gets CMHC to approve it, all the items in the plan will be pre-approved for replacement reserve

spending. You can get approval for your plan by sending it to CMHC.

The plan must be comprehensive – that is, it must include all the capital items you think will need replacing. If co-ops do their own financial forecasting, or get a consultant to do it for them, that forecast must be sent to CMHC too. And the forecast's cash flow estimates must fall within 4% of the results that CMHC's own forecasting program produces. If they do not, or if you don't send in a financial forecast, CMHC will use the results of its own program to determine your replacement reserve cash flow needs.

Once your plan is approved, you will not need CMHC's permission for each replacement reserve expenditure. But there are conditions. You must update your plan every three years and the expenditure must be made within the three-year period the plan covers. For example, if your plan says the roof needs replacing in year three and you have to replace it in year one, the replacement is pre-approved; if you were expecting to replace the roof in 10 years and you have to do it now, you will need CMHC's approval to change the plan. By the way, you don't need to use an expert to review your plan every three years. CMHC will let co-ops do the review themselves.

2. Spending approval for co-ops without a replacement reserve plan

Co-ops do not have to have a replacement reserve plan. For those co-ops that don't have one, the guide says that all the items that are listed in the operating agreement are still pre-approved, as are emergency replacements. These co-ops will still enjoy the benefit of having a standard list of capital items to refer to – there will be no more inconsistency on CMHC's part when it comes to deciding what you can spend your replacement reserve on. But unless the

replacement is listed in the operating agreement or is an emergency, co-ops without replacement reserve plans will need CMHC's permission each time they want to spend from their replacement reserve, just as they do now.

Emergency replacements

Whether or not a co-op has a reserve fund plan, the guide says that emergency replacements do not require CMHC's prior permission. An emergency replacement is one where delay would create a health or safety hazard. For example, if your co-op's heating system goes down in winter, you are free to fix it right away and to replace any major components, such as a boiler, without asking CMHC first. But you have to tell CMHC as soon as possible after the fact. This provision of the guide simply recognizes standard property management practice. There is no listing of pre-approved emergency spending, so co-ops will have to use their own judgement when deciding what is an emergency. The guiding principle? Put the health and safety of your members first.

Reporting

The new guide will enable co-ops to get CMHC to pre-approve a far greater degree of replacement reserve spending. In return, CMHC wants co-ops to report on their spending in their annual audited financial statements. The guide says that a detailed list of replacement reserve expenses must be included in the statements, showing the work done and the cost. This information can be shown as a separate schedule, or it can be included in the notes. This is something that many co-ops are already doing.

AND, FINALLY. . .

The new CMHC replacement reserve guide is going to make life a lot easier for housing co-ops. As our properties get older, co-ops will need to replace or make major repairs to capital items more often. The guide will make it simpler to get that work done with a minimum of delay. It should also make co-ops less reluctant to keep all of their capital funds in the replacement reserve, since all of a co-op's capital items are now eligible for replacement reserve spending, and since co-ops with a reserve plan are now allowed to put as much money as they need in the reserve.

If you have any questions about this supplement or the guide itself, or you need help to get a copy of the guide, call CHF Canada at 1-800-465-2752.