Guide *to the* CMHC Net Operating Revenue Policy

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Co-operative Housing Federation of Canada

Good news for Section 95 Co-ops on net operating revenue!

After many rounds of discussion with CHF Canada and housing co-ops, Canada Mortgage and Housing Corporation (CMHC) has agreed to a new policy for the treatment of net operating revenue in Section 95 co-ops. It means that these co-ops will get to keep any net operating revenue they may earn. This is very good news. For a long time CHF Canada has said that net operating revenue should stay with the co-ops that earn them. We've argued that Section 95 co-ops need to use net operating revenue for additional subsidy, to add to their replacement reserves and, sometimes, other reserves, and to cover future losses. With some conditions the new policy allows Section 95 co-ops that can earn net operating revenues to do all of those things.

In this guide we're going to explain the new policy on net operating revenues in detail. We're also including a copy of the actual policy for you to refer to. You'll find some background about net operating revenue in the short question and answer panel on the right, as well as more handy background information in side panels on other pages.

CMHC's new policy on co-op net operating revenue

CMHC's policy on net operating revenue is short, which is good. But the different parts of it might need some explanation. So we're going to look at the policy section by section to see what it means for your co-op.

Section 1: unused income-tested assistance

This part of the policy does not actually talk about net operating revenue. It simply confirms CMHC's right under the operating agreement to a refund of unused income-tested assistance in certain cases. See the Net Revenue Q & A on this page for more about these refunds.

Section 2: net operating revenue and accumulated deficits

If your co-op has spent more money than it has earned over the years, it will have an accumulated deficit (see side panel on Page 6). Section 2 of the policy says that any net operating revenue you earn will go first towards reducing or eliminating an accumulated deficit. If you still have net operating revenue left over after that, or if your co-op doesn't have a deficit to begin with, then you can put net operating revenue to work for the future of your co-op. Section 3 of the policy tells you how.

Net Revenue Q&A

What is net operating revenue?
Co-ops earn net operating revenue if their audited financial statements show that their operating revenues were higher than their eligible operating expenses[1] for the year.

Why is net operating revenue an issue?
Starting in 1995, CMHC began asking for a subsidy refund from co-ops that earned net operating revenues[2]. CMHC would work out what part of the net operating revenue came from Income-tested Assistance—the subsidy used to reduce the housing charges of income-tested members. Then it would ask for that amount back or take it from future subsidy payments. Co-ops called these forced refunds "clawbacks". Co-ops didn't think CMHC should be taking away net operating revenue. They said they needed to keep the money for the future.

Aren't refunds to CMHC a normal part of the Section 95 program?
Yes they are, but those refunds are different. A co-ops that doesn't use all its Income-tested Assistance gives CMHC a refund if it already has at least $500 per unit in its Subsidy Surplus Fund, not counting any interest the fund has earned. The clawbacks were different. They were amounts of subsidy that had been used to reduce the housing charges of income-tested members.

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1. *Eligible operating expenses are the costs of operating your housing co-op that, under your Section 95 operating agreement, can be paid for from a subsidized housing charge. You'll find much more on this subject in CHF Canada's bulletin Ineligible expenses in federal co-op housing programs. Just give us a call if you would like a copy.*
2. *Some co-ops earn "non-subsidized" revenue, such as earnings on member shares and deposits. This revenue can be reported separately on your audited financial statements. Co-ops can use this revenue as they wish. It was not affected by the clawbacks and it is not subject to CMHC's new policy for net operating revenue.*

CMHC-approved replacement reserve plans

What is a CMHC-approved replacement reserve plan? To understand we have to look at CMHC's 1998 Replacement Reserve Guide. The guide helps co-ops get pre-approval for all replacement reserve spending. The guide says that if a co-op:

- does a replacement reserve study and a reserve fund cash forecast (or uses CMHC's help to do the forecast); and
- gets CMHC's approval for the study and the forecast

then the co-op has a CMHC-approved replacement reserve plan, which will also mean approval for adjusted annual contributions and funding limits for the replacement reserve.

The CMHC guide has information about updating the plan and getting quotes for spending replacement reserve money. And it tells you a lot about "capital items"—the things you can spend the reserve on.

If you don't have the CMHC replacement reserve guide at your co-op you can ask your local CMHC office for a copy, or call your nearest CHF Canada office.

Special reserve plans

The same requirements apply to the special reserves mentioned in section 3(b) of the policy. To get approval to fund a special reserve CMHC will want to see a plan that sets out the reasons for the reserve and a forecast of the amount of money needed.

If you think you need to ask CMHC to let you fund a special reserve, contact us at CHF Canada first. We can give you some advice on making a proposal.

Section 3: putting net operating revenues to work for your co-op

Section 3 of CMHC's new policy sets priorities for using net operating revenues. In order, Section 95 co-ops can put net operating revenues to work in these ways.

Section 3(a): first, to add to the Subsidy Surplus Fund where the need is demonstrable

CMHC's policy says that co-ops should first put net operating revenue into the Subsidy Surplus Fund, where the need is "demonstrable". But you can't put money there if that would take the balance of the Fund above $500 per unit, not including interest. The subsidy surplus fund is where co-ops put unused Income-tested Assistance.

The policy doesn't say what demonstrable need means. But CMHC has told us that a co-op can transfer net operating revenue to the Subsidy Surplus Fund as long as the balance of the fund is less than $500 per unit, not counting interest, and the co-op does not have an accumulated operating deficit.

But remember. Although you may be able to use your net operating revenue to cure a shortage of Income-tested Assistance, you may have other urgent uses for net operating revenue—such as topping up your replacement reserve if it is short of money.

Section 3(b): second, to add to special reserves specifically approved by CMHC

What might a special reserve be needed for? The policy gives an example—to create a fund to help a co-op purchase its land. Another example could be a reserve to help a co-op to prepay an extension to an expiring land lease.

Co-ops have to prepare a plan to get CMHC's approval for a special reserve. CMHC's requirements for these plans and for adding net operating revenue to special reserves are the same as they are for the replacement reserves. The side-panel to the left has more details about reserve planning. If you think your co-op needs to keep a special reserve you will have to get CMHC's approval and prepare a special reserve plan. If you think you need a special reserve and want help with the planning or getting CMHC's approval, just give us a call here at CHF Canada.

Section 3(c): third, to add to the replacement reserve

CMHC's policy says that co-ops can put remaining net operating revenues into the replacement reserve. But topping up the reserve cannot cause the balance to exceed the requirements forecast in the co-op's CMHCapproved replacement reserve plan. See the panel on page 3 for more details about replacement reserve planning.

What does CMHC mean when it talks about not exceeding the requirements for your replacement reserve plan? Let's use an example to explain.

Say that a co-op's replacement reserve plan shows it will need $1 million for replacements over the next 20 years. To save that money the co-op is putting $50,000 into the reserve for 20 years, less what it expects to earn in interest. CMHC's policy means that a co-op may add net operating revenue to the replacement reserve as long as the balance of the reserve doesn't go over $1 million at any time during the forecast period—even if that means putting more than $50,000 into the reserve in a given year.

You can see that co-ops need to do replacement reserve planning to get the most out of the new policy. Because without a plan a co-op won't know what its replacement reserve needs are. Neither will CMHC. The policy says that CMHC will estimate a co-op's replacement reserve needs if it doesn't have a plan in place. But it is far better to study your co-op's replacement reserve needs properly.

Section 3(d): fourth, to add to statutory reserves.

All provinces and territories have legislation that governs co-ops. The legislation is usually referred to as the "Co-op Act" or a name close to that. Many of these co-op acts say that co-ops must put money from net operating revenue into a reserve fund. We call these funds "statutory reserves".

CMHC's policy says that these reserves can be funded if there is net operating revenue left over after adding to the reserves we've talked about above—unless your co-op act requires you to put net operating revenue into the statutory reserve before you add it to other reserves. So you should know about the statutory reserve requirements for your co-op, if any. The panel on this page sets out the requirements for each province and territory. But the rules don't say if this reserve should be funded first. You should check that with your co-op's lawyer.

The rules for statutory reserves

Here is a list of the provinces and territories with rules for statutory co-op reserves, together with a summary of the reserve requirements, according to CHF Canada's most recent research. But these requirements can change if the laws affecting co-ops are amended. So you should always check the most recent version of the provincial or territorial co-op act that applies to you.

PEI: 10% of net earnings, indefinitely; a further reserve for education is required;

New Brunswick: 5% of net earnings until the reserve equals 30% of the co-op's paid-up shared capital;

Quebec: 20% of net earnings until the reserve equals 25% of the co-op's debts;

Saskatchewan: 5% of net earnings until the reserve equals 20% of the co-op's assets;

BC: 10% of net earnings until the reserve equals a stipulated percentage of the co-op's assets; the percentage falls from 30% to 10% as the amount of share capital rises and is set at the co-op's discretion where share capital exceeds $100,000;

Yukon: 20% of net earnings until the reserve equals a stipulated percentage of the co-op's assets; the minimum percentage, applying to co-ops with assets of over $50,000, is 10%;

NWT: co-ops with share capital, 20% of net earnings, until the reserve equals $35,000 plus 10% of the value of the co-op's assets in excess of $150,000; co-ops without share capital, the entire net earnings, indefinitely.

Remember: to find out if you should fund these reserves before any others, you should ask your co-op's lawyer.

Replacement reserve reviews

If your co-op has a replacement reserve plan in place you have taken a very big step towards looking after your property in the future.

But things change. Maybe your plan called for you to replace your roof in 10 years—later on you find out it will last longer. Or, you expected to buy new flooring at a certain cost and the cost has changed over time. These kinds of changes will change your replacement reserve plan. That's why it needs to be reviewed from time to time.

To keep your plan CMHC- approved—land get the benefit of pre-approval of replacement reserve spending—you need to review your plan at least every three years. In fact CMHC's advice is to review it every year if you can, although that's not a requirement to keep CMHC's approval for your plan.

A review doesn't mean you have to start all over again, with a new study of your buildings. It does mean deciding whether

- the timing of replacements that you put in your plan is still accurate
- the costs of replacements need to be adjusted
- the replacements you had planned for the last three years were made
- you need to change the cash flow estimates in your plan.

Adjusting your cash flow will be important if you have added net operating revenues to your replacement reserve. That could mean you have more cash in the reserve than you expected—which will affect how much you have to put into the reserve in the future.

Replacement needs change over time—so should your replacement reserve plan.

More on replacement reserves....

We've now covered all the different ways you can use net operating revenue under CMHC's new policy. The policy also talks about reviews of your replacement reserve—and what happens if you've added more than you need to it.

Section 4: replacement reserve reviews

Periodically, CMHC will review your co-op's replacement reserve requirements. See the panel on this page for more on replacement reserve reviews.

Section 4 of the net operating revenue policy says that when CMHC reviews your replacement reserve, it will see what effect any transfers of net operating revenue have had on the reserve. One possible effect could be that you will need to put less money in your replacement reserve in the future. (Or, your need for funds may have gone up. If so, you may need to keep paying in the same amount.)

Section 5: exceeding the replacement reserve requirements

Section 5 says this. If the review of your replacement reserve shows that you have more money in the reserve than you need, CMHC will tell you to do one or both of these things:

- reduce the annual allocation to the reserve
- apply the interest earned on the fund to your operating budget.

These measures will allow you to keep housing charges lower than they would otherwise need to be. That can mean that

- less Income-tested Assistance is needed; or
- the effect of a shortage of Income-tested Assistance is reduced.

That will be a great help to the families in your co-op that need subsidy. And your non-subsidized members will gain too, from a more affordable housing charge.

But bear this in mind. Experience suggests that very few co-ops will find themselves with too much money in their replacement reserves.

What happens if your co-op loses money in the future

Section 6: operating at a loss

Section 6 is a very important part of the policy. It makes it possible for co-ops that earn net operating revenue to use it to meet losses in the future. It works like this. If

- your co-op earns net operating revenue, and
- adds the net operating revenue to the replacement reserve or to a special reserve, and
- the result is that you have put more money into the reserve in a year than the reserve fund plan calls for

then you have made a "supplementary contribution to the reserve." If that happens at your co-op and you

- lose money in the future and
- don't have an accumulated surplus to offset the loss,

you can use the supplementary contribution—or contributions—to cover the loss. You do this by lowering the amount you transfer to the replacement reserves by the lesser of

- the amount of the loss or
- the total of any prior supplementary contributions,

If you have not made supplementary contributions in the past, or you have but they are not enough to cover an operating loss, you will have to try to make the loss up from future revenues, when you can. That will mean budgeting to each net operating revenue, by setting your housing charges higher than is needed to cover your operating costs. For more on operating losses and accumulated deficits see the side panel on this page.

More about operating losses and accumulated deficits…

Like any business, a co-op needs to earn revenues at least equal to its expenses. But sometimes that's not possible. If a co-op spends more on its operations than it earns in a year it has an operating loss. But it may not have an accumulated operating deficit as a result.

That's because an operating loss can be absorbed if the co-op had a large enough accumulated operating surplus at the beginning of the year.

A co-op has an accumulated surplus if, over all the years of its operations, its total revenues have been greater than its total expenses.

If the amount of the accumulated surplus is as much as or more than the amount of an operating loss, the loss can be absorbed. If not, then the co-op will have an accumulated deficit. This is the opposite of an accumulated surplus. An accumulated deficit means that over all the years of its operations, a co-op's total revenues have been less than its expenses.

CMHC's new policy says, in effect, that a co-op with an operating loss must cover the loss from its accumulated surplus if it has one. It can only use supplementary replacement reserve contributions to cover an operating loss if there is no accumulated surplus to absorb the loss—and, of course, if it has made supplementary replacement reserve contributions in the first place.

If your co-op is losing money it can't seem to make up, call us at CHF Canada. We can help you analyze the problem and look for solutions.

If you need more background on net operating revenues and what CMHC's policy means for your co-op, get in touch with us at CHF Canada. We're just a phone call or an e-mail away. Here's how to find us.

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And if you have more money than you need...

Section 7: continuing net operating revenues

This part of the policy is really talking about co-ops earning more money than they need. The policy says that if a co-op has all the money it is going to need in its

- subsidy surplus fund
- special reserve (if any)
- replacement reserve

and it is still earning net operating revenue each year, CMHC will look at whether the co-op needs all the subsidy it is receiving. CMHC's point is that a co-op in this position probably has housing charges that are higher than necessary. That means it might be using more subsidy than it needs to.

In fact any co-op in this position will probably reduce its housing charges anyway. Why charge members more than they need to pay? But we think that very few co-ops, if any, will ever find themselves in this position. For most co-ops the challenge is finding enough money to pay expenses and fund reserves, not having too much.

Section 8: how long the policy lasts

Section 8 says that this new policy on net operating revenue will last for a trial period of three years. At that time, CMHC wants to look at how it is working and to see if co-ops have been putting replacement reserve plans in place. As we said earlier, replacement reserve planning is the key to getting the most out of the new policy. CMHC is anxious to see these plans in place for the same reason as CHF Canada: without them it is difficult to plan for the future upkeep of our co-op homes.

Last word

At CHF Canada we think that the new CMHC policy on net operating revenue is a good deal for Section 95 co-ops. That's because net operating revenues stay with the co-ops that earn them and can be used in a number of ways, depending on where the need is most urgent. We want to help our members get the most from the policy—that's why we've prepared this guide. If you have more questions on how to make the policy work for your co-op, don't hesitate to get in touch with us.