MINISTRY OF MUNICIPAL AFFAIRS AND HOUSING

Non-Profit Housing–Capital Reserves

The Ministry of Municipal Affairs and Housing is responsible for administering the province's social housing programs, including the non-profit housing program. With the passing of the *Social Housing Funding Act, 1997,* and as part of the Local Services Realignment initiative, responsibility for funding the costs of social housing programs was transferred to municipalities effective January 1, 1998. Subject to legislative approval and the finalization of a new agreement on social housing with the federal government, responsibility for the administration of the programs is to be transferred to municipal organizations.

The key objectives of the Ministry's 1998/99 Business Plan with respect to social housing include:

- cost-effective administration of existing non-profit housing during the transition to municipal administration;
- reformed and simplified social housing programs to facilitate municipal administration; and
- establishment of a framework of provincial and federal standards and processes for municipal delivery.

Recommendations for reforming and simplifying the administration of the social housing program in preparation for its transfer to municipalities were issued by the Minister's Social Housing Committee in November 1998.

Until responsibility for program administration is transferred, the Ministry's Housing Operations Division, through its seven regional offices, continues to oversee the funding and operations of more than 1,100 cooperative, private and municipal non-profit housing providers (providers) and to bill municipalities for the subsidies and administrative costs. These providers receive subsidies totalling close to $800 million annually to operate some 2,200 properties containing almost 100,000 rental units for singles, seniors and families. Over 75% of these units were built between 1988 and 1994.

Under operating agreements with each provider, the Ministry requires a portion of the annual operating subsidy to be contributed to a separate capital reserve fund established by the provider and stipulates how these reserve funds may be invested and spent. However, from June 1992 until late 1997, a moratorium was placed on capital reserve funding, suspending the Ministry's annual contribution to the funds in order to constrain rising subsidy costs. Only project-specific payments to cover emergency repairs were made to providers during those years.

As part of the Local Services Realignment initiative, the current government decided to make a special lump-sum payment to restore the reserves. The Ministry paid $173 million to providers in late 1997 and, in the spring of 1998, the federal government paid a further $31 million to providers of cost-shared projects. The Ministry also restored its annual reserve contribution, which forms part of the annual operating subsidy to providers that is recovered from municipalities. For the 1998/99 fiscal year, the reserve contribution was over $42 million. By the end of 1998, providers held capital reserves estimated at $340 million.

As of March 31, 1999, the province's share of mortgage guarantees on non-profit housing properties totalled about $7.5 billion. These guarantees will remain once administrative responsibilities have been transferred to the municipalities. The province will therefore retain significant financial risks and will have an ongoing financial interest in the fiscal health of non-profit housing providers and the condition of their properties.

AUDIT OBJECTIVE AND SCOPE

Our audit objective was to assess whether the Ministry had satisfactory systems and procedures in place to ensure that capital reserve funds were managed prudently and in compliance with operating agreements and ministry requirements, including procedures to report on the effective use of funds to preserve the condition of non-profit housing assets.

Our assessment was based on audit criteria that ministry management agreed are appropriate for prudent and effective management of capital reserve funds. Principally, it is important for the Ministry to ensure that:

- funds are provided and spent based on a reliable assessment of need;
- funds are managed and invested wisely until they are needed;
- providers monitor and maintain the condition of their properties; and
- funding conditions are fully complied with.

Our audit was conducted in accordance with professional standards for assurance engagements, encompassing value for money and compliance, established by the Canadian Institute of Chartered Accountants, and accordingly included such tests and other procedures as we considered necessary in the circumstances. Specifically, our audit included visits to the Ministry's head office and to three ministry regional offices responsible for overseeing over half of all providers funded as well as site visits to a number of providers. Our work was conducted from September 1998 to February 1999 and focused primarily on activities occurring in 1998.

We reviewed related audit work recently completed by the Ministry's Audit Services Branch and used it to ensure that our audit avoided any duplication of effort. Also, to a limited extent, we relied on it in determining the nature and scope of our work. With respect to non-profit housing programs, the Branch's recent work had focused primarily on the costs incurred and procedures followed by the four largest municipal providers and by those providers identified as having significant problems.

OVERALL AUDIT CONCLUSION

We concluded that actions taken had not been sufficient to ensure the prudent management of capital reserve funds and the preservation of non-profit housing assets. Swift action is required to ensure that the capital reserve funds provided are managed and spent prudently in accordance with requirements and that the assets are cost-effectively maintained. In particular the Ministry should:

- track progress in addressing common deficiencies such as providers with under-funded reserves, generally poor investment practices, lack of preventive maintenance plans and building condition inspections, and poor purchasing practices;
- require providers to prepare and follow long-term capital plans that detail the nature, timing and amount of future capital expenditures based on competent assessments of the condition of their assets; and
- require greater pooling of capital reserve funds and other investment strategies to improve by millions of dollars the income earned on reserve funds and to reduce the incidence of borrowing from reserve funds for operating purposes.

In its November 1998 report, the Social Housing Committee stated that "The appropriate management and investment of capital reserves is critical to the long-term viability of social housing." It made two recommendations aimed at ensuring that social housing is maintained in good condition and that capital reserve funds are appropriately invested and used. Aspects of their recommendations are consistent with some of the recommendations we have made.

DETAILED AUDIT OBSERVATIONS

MONITORING PROVIDER PERFORMANCE AND COMPLIANCE

As of June 1998, there were about 175 financial officers, housing administrators, and technical and support staff in the Ministry's regional offices who were primarily responsible for advising non-profit housing providers and monitoring their activities and financial condition. Monitoring involves the review and approval of annual budgets, audited financial statements and information returns filed by each provider, and the calculation of subsidy adjustments based on the information received. This information includes details of capital reserve funds and transactions.

From our visits to regional offices and an examination of a sample of their files, we noted inconsistencies in the extent to which information received from providers was reviewed. Some regional staff were more thorough than others. In April 1998, in order to improve the quality and consistency of reviews, the Ministry issued further guidance to regional offices on the financial review procedures to be completed. However, few regional staff were following the guidance at the time of our visits.

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Regional offices report to head office every two months on the status of information due to be received from providers as well as information received but not yet reviewed. The backlog of reports to be received and/or reviewed as at January 31, 1999 had been considerably reduced from prior years.

Regional staff also conduct on-site reviews of providers and the extent of their compliance with the operating agreement and ministry directives. Since our audit of the entire program in 1995, virtually all providers have been reviewed on site at least once. Following a special effort to complete the first cycle of reviews in 1997 and 1998, the most common deficiencies found were summarized, and a committee of regional office staff was formed to propose a consistent approach to the corrective actions to be taken. The status of providers found to be in difficulty was also regularly summarized and reported to head office for further action.

The results of our visits to a sample of providers in each region we visited were, in most cases, consistent with those of the operational reviews conducted by regional office staff. Regional offices generally relied on the external auditor appointed by each provider to determine whether the provider had complied with the terms of the operating agreement in the establishment and use of capital reserve funds. In particular, these auditors examined whether expenditures made from capital reserve funds were of a capital nature, as defined by the Ministry, and whether the funds were fully funded and their balances correct.

A review of management letters issued by external auditors suggested that these areas were being examined and reported on for provider board and ministry attention, although some were more comprehensive than others.

The Ministry has a non-profit housing information system that captures the financial information reported by all housing providers once the regional offices have reviewed and approved it. It also captures the status of information to be reported and reviewed. While the provider information cannot be captured quickly enough to facilitate timely monitoring of individual providers, the system could be used to track the success of actions taken over time by regional offices to address the problems identified by their reviews. However, head office was not using the system for this purpose at the time of our audit. Progress in addressing deficiencies such as those identified in the remainder of our report could be monitored and reported using the system.

Recommendation

To better ensure that non-profit housing providers are in sound financial condition and are complying with their operating agreements and related directives, the Ministry should use available information to track the progress of regional offices in addressing identified non-profit housing provider deficiencies.

Ministry Response

Due to other priorities such as devolution to municipalities and Year 2000 compliance efforts, no information system improvements are recommended at this time. However, to the extent that the necessary information can be easily extracted, the Ministry will use it to track progress. As well, the Ministry will:

- ***continue to monitor serious problems with providers through the Projects in Difficulty tracking process and ongoing operational reviews; and***
- ***establish policies and procedures for default management and recommend a process for dealing with projects with serious problems in the interim and in a post-devolution environment.***

ESTABLISHING CAPITAL PLANS AND PRIORITIES

In order to preserve the condition of housing properties and to extend their useful lives, it is important to periodically inspect their condition and to establish priorities for needed repairs. Since capital repairs often result in major expenditures, it is good practice to establish long-term plans and budgets for the nature, amount and timing of future capital expenditures. Capital expenditures, as defined by the Ministry, include:

- improvements that significantly increase the capacity, quality, efficiency or useful life of an existing capital asset beyond that expected when originally purchased;
- the purchase of new assets; and
- the replacement of existing capital assets or major building components.

The operating agreements with providers who own and operate properties built after 1985 did not require the preparation of capital plans or ministry approval for individual capital expenditures. In contrast, operating agreements under an earlier federal-provincial program stipulated that Canada Mortgage and Housing Corporation (CMHC) would not require approval of individual capital expenditures if the expenditures were included in the three-year capital plan previously approved by the CMHC and the provider's board. However, this program covered only about 10% of all non-profit housing units.

We found that less than 10% of the providers we visited had capital plans in place and only a further 10% were developing plans. Regional offices surveyed indicated that capital plans were not widely used by the providers they were overseeing.

One housing provider we visited had not yet established a capital plan even though one of its buildings was 14 years old. The provider had received over $900,000 from the Ministry for its capital needs in late 1997 and had reserves totalling $1.7 million as of October 1998. In recent years this provider had spent $150,000 to replace 14-year-old windows, $112,000 to replace 11-year-old appliances and $120,000 to replace 8-year-old carpeting. None of these expenditures was supported by a business case to justify their necessity and priority to the board. In the absence of capital plans and business cases, the provider could not adequately

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demonstrate that these expenditures were necessary at the time. As well, all of these replacements were made earlier than the Ministry's guidelines for their expected useful lives.

More than two thirds of the properties operated by non-profit housing providers were less than 10 years old and, therefore, relatively few had required significant capital repairs to date. However, capital expenditures can be expected to rise significantly in the not too distant future. While accurate current data were not available, we estimated that capital expenditures by providers increased from about $5 million in 1997 to nearly $18 million in 1998. Some of this increase was likely due to a backlog of work that arose during the moratorium on reserve funding.

The Ministry's allocation of the lump-sum payments to providers' capital reserve funds was based on a capital expenditure forecasting model developed by engineering consultants that considered the type, age and location of housing properties. That model was being used to determine ongoing annual contributions as well. Although the model provided a reasonable and expedient method of restoring the replacement reserve funding withheld in prior years, its adequacy for preserving the condition of non-profit housing stock can only be assessed once reliable condition assessments have been completed and appropriate capital plans prepared.

In that regard, although the Ministry was planning to conduct technical audits of non-profit housing properties, none had been scheduled at the time of our audit. As well, the Social Housing Committee recommended that technical audits be conducted to determine the condition of all social housing stock in Ontario to establish a basis for determining the appropriate level of funding for capital reserves.

Another important reason for having capital plans is to be in a position to estimate the timing of significant future cash requirements. Proper forecasting of cash flows would permit effective investment strategies to be employed for the significant amount of funds providers have recently received.

Recommendation

To ensure that capital reserve funds meet priority needs and are spent prudently, the Ministry should:

- **require non-profit housing providers to prepare multi-year capital plans based on reliable assessments of the condition of their properties; and**
- **provide clear direction to non-profit housing providers on good practices for establishing capital expenditure priorities and for preparing business cases to justify major capital expenditures.**

Ministry Response

Current operating agreements do not contain such requirements, and so the Ministry's ability to ensure compliance with such directions is unclear. The Ministry fully supports this approach and agrees that multi-year capital planning, prioritization and business cases are good practices.

The Ministry will:

- ***examine current approaches/best practices of some experienced social housing providers (including those in other jurisdictions) which could be passed along to others;***
- ***devise an appropriate plan to communicate both the value of, and tools for, developing such plans to non-profit providers; and***
- ***link this recommendation to the proposed program reforms currently being assessed/analyzed by the Ministry.***

INVESTMENT OF CAPITAL RESERVE FUNDS

The operating agreements between the Ministry and each housing provider together with the Ministry's accounting and administrative requirements for providers stipulate the nature of the bank accounts and investment vehicles providers are permitted to use. The agreements also give the Ministry the right to require providers to pool their capital reserve funds with those of other providers and to approve any other investments providers wish to make.

We assessed the overall average rate of return on capital reserve funds held by housing providers over the three-year period from 1995 through 1997. As the following table illustrates, housing providers are, on average, earning far less on their capital reserve funds than even the average rates of return on the conservative investments permitted by the Ministry.

Investment Performance by Housing Providers

	For the Year		
	1995 %	**1996 %**	**1997** %**
Range of rates for authorized investments per ministry guidelines*	7.0 to 7.3	4.3 to 5.7	3.5 to 4.7
Average rate of return earned on capital reserve funds by housing providers	5.7	4.1	4.0

Source: Office of the Provincial Auditor

* *The rates for comparison purposes came from Bank of Canada statistics. All rates are the average for conservative investments ranging from one-month banker's acceptances to five-year guaranteed investment certificates offered by trust companies.*

** *The average rate of return earned by housing providers in 1997 was determined from the 70% of providers that had filed audited financial statements that had been reviewed and approved by the Ministry at the time of our audit.*

Our visits to providers found that at least 60% of them could have improved their investment returns if they had established more prudent investment strategies. In one case, the provider's own external auditor had reported that $200,000 had been left in a non-interest-bearing bank account for an extended period.

The first 10 years of a building's life present the best opportunity to maximize investment returns and increase reserve funds. Capital expenditures are infrequent and early compounding of investment returns has a large impact on the amount of funds ultimately available to meet future capital replacement needs. About 65% of all non-profit housing properties are less than 10 years old. In testing a sample of providers with properties under 10 years old, we found that, on average, they earned even less than the average for all providers over the last three years.

One way to improve the rates of return on reserve funds is to pool them among providers so that professional fund management becomes economical. However, we found that pooling of funds was not a common practice. A few municipal providers pool their funds with the municipality or other local providers to improve returns. However, even some providers that have pooled funds or otherwise have significant funds to invest have tended to invest in lower yielding short-term securities despite little short-term requirement for the funds.

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One large municipal provider had pooled its funds with those of other local providers and the regional municipality. The funds became part of the municipality's pooled investments. The rate of return for this provider in 1997 was over 7.3%, or almost $2 million, compared with average returns on the highest ministry-authorized investments of 4.7% in 1997.

Another municipal provider had pooled funds and had received ministry approval to establish a less conservative portfolio of investments made up of 1/3 equity investments and 2/3 fixed income securities. Its board also met periodically with the fund manager to review and approve investment strategy. At 9.6%, its investment returns were over 5.6% better than the average earned by all providers in 1997. For perspective, each 1% improvement in investment returns yields over $3 million annually of additional income based on estimated fund balances at December 31, 1998. A 5.6% improvement would therefore yield about $17 million more revenue, not to mention the compounding effects in future years.

As can be seen in the following table, pooled fund returns have over the last three years consistently and often significantly exceeded the returns on investments endorsed by the Ministry.

Investment Performance by Large Municipal Providers

	For the Budget Year		
	1995 %	1996 %	1997 %
Range of rates for authorized investments per ministry guidelines	7.0 to 7.3	4.3 to 5.7	3.5 to 4.7
Average rate of earned by large municipal providers that pooled funds*	8.2 to 8.4	8.5 to 12.0	7.2 to 9.6

Source: Office of the Provincial Auditor

* *The average rate of return earned by large municipal housing providers was determined from the audited financial statements for those years.*

Pooling is not exclusive to municipal non-profit providers. In another region, a property management firm had received agreement from 13 smaller non-profit providers to pool their funds and, at the time of our audit, was negotiating with a major financial institution to have the funds managed.

Recommendation

To improve investment returns on capital funds and thereby reduce the need for additional future government funding for capital improvements to non-profit housing stock, the Ministry should, as soon as possible:

- **require non-profit housing providers not already doing so to pool their capital reserve funds and to have them professionally managed; and**
- **encourage non-profit housing providers to use capital plans for cash flow projections of future capital outlays to help optimize the mix of investments and maturity available to them.**

Ministry Response

The Ministry agrees that not all providers are realizing the maximum return on investment possible and that the pooling and professional management of capital reserve funds could increase this rate of return.

The Ministry is actively reviewing the pooling of replacement reserves in response to both the Provincial Auditor's comments and a similar recommendation offered by the Social Housing Committee.

The non-profit sector organizations are expected to bring forward a proposal for ministry approval in the near future. The Ministry will review this proposal for pooling as it is developed and will frame its response in the context of devolution and the interests of the municipalities.

Pooling and the use of professionally managed funds will put a greater onus on the provider to have a capital plan and cash flow projections. The Ministry will consider these needs and its ability to impose these requirements when reviewing the proposal from the sector organizations.

UNAUTHORIZED USE OF CAPITAL RESERVES

Under the Ministry's operating agreements with housing providers, capital reserve funds must be maintained separately from other funds. The funds and any income from them are to be used solely for future capital expenditures.

Our analysis of information available at the time of our audit suggested that as many as 30% of providers might have borrowed from their capital reserves in 1997. A similar proportion of providers had also reported less cash and investments on hand than the amounts required to be in their capital reserve funds in 1995 and 1996.

To determine the extent to which providers had contravened their agreements and borrowed from their capital reserves, we tested a sample of providers reporting under-funded reserves from three regions. In about 60% of these cases, the providers had borrowed funds from reserves for one to three years. Some providers had increased their borrowings over the period. Because the borrowed funds were not earning investment income, investment returns for these providers have under-performed even conservative investments.

For example, one provider we examined had increased its borrowing from capital reserve funds from $47,000 in 1996 to $100,000 in 1997 to $139,000 in 1998. The regional office did not request the provider to prepare and submit a restoration plan until June 1998. The plan was finally received in November 1998. We understand that meetings were being scheduled for 1999 because the regional office was not satisfied with the plan.

A provider in another region had borrowed $260,000 from capital reserves as of September 1995. The regional office requested a fund restoration plan from the provider in June 1996, in February 1997 and again in April 1998 but the capital reserve fund was still under-funded by $139,000 in September 1998. In 1999 the regional office again asked the provider to submit a plan.

At least half of the providers with under-funded capital reserves, including the two above, have properties over 10 years old and are therefore more likely to require capital outlays soon. Regional staff have tried to address the problem by requiring providers to establish and submit restoration plans but we found that their efforts have had only limited success.

One of the regional offices we visited had adopted a more proactive approach with such providers. Experienced staff more thoroughly assessed the provider's practices and circumstances and worked with the provider to develop a workable action plan with timeframes and targets for progress. Staff at that office believed that such an approach was needed because some housing providers and boards lacked the necessary management and financial skills to effectively address their underlying problems. Such early intervention would help prevent the provider from experiencing even more serious financial difficulties.

We also understand that new procedures introduced by the Ministry in late January 1999 allow housing providers to apply for advances on their subsidies in cases of emergency. The new procedures require providers to demonstrate the need for funds and the options they have considered. Cases will then be reviewed by the regional office and subsequently submitted to the Assistant Deputy Minister for approval. The new procedures will help the Ministry to identify and assess providers experiencing financial difficulties and may help to reduce the incidence of borrowing from capital reserves.

Recommendation

To reduce the incidence of borrowing from capital reserve funds which will jeopardize the ability of non-profit housing providers to pay for future capital repairs, the Ministry should:

- **more thoroughly assess the underlying reasons why non-profit housing providers have borrowed from and not restored their capital reserve funds; and**
- **ensure that non-profit housing providers that have borrowed from their capital reserves develop and implement appropriate plans for restoring the reserve funds as quickly as possible.**

Ministry Response

The Ministry agrees with the recommendation and the goal of developing a strategy for more proactive tracking and management of projects with deficits that could lead to borrowing from reserve funds.

The Ministry will implement a new tracking procedure and guidelines to assist regions in managing projects with deficits by October 15, 1999.

PREVENTIVE MAINTENANCE AND INSPECTION

The benefits of a good preventive maintenance program include an increased service life for the facility, early identification and correction of deficiencies, and lower operating costs over the facility's life cycle. Accordingly, the Ministry's operating agreements with providers requires them to establish such a program.

The extent to which providers had formal preventive maintenance plans in place for each of their properties was assessed as part of the over 770 reviews of providers conducted by all regional offices in 1997 and 1998. These plans would normally detail the frequency of maintenance work required for various properties. Their results revealed that between 20% and 50% of the providers in the three regions we visited did not have preventive maintenance plans in place.

Our own visits revealed that almost half of the providers we visited lacked a preventive maintenance plan and several lacked routine inspection procedures to spot problems early and to ensure compliance with *Ontario Fire Code* and other requirements. During some of our visits to properties, we noted certain *Fire Code* violations which we reported to the provider and the regional office for follow-up. Preventive maintenance for health and safety is obligatory.

Our site visits indicated that preventive roof maintenance had been consistently neglected. Many providers we visited had failed to conduct and document roof inspections, and several had undertaken premature roof replacements or major roof repairs. One large provider we visited lacked a formal roof inspection process or checklist but had recently hired roofing consultants to perform roof condition assessments on five of its buildings. The consultants reported the need for major capital work on two roofs at a cost of about $600,000. An additional $300,000 of capital repairs was also identified but would have to be delayed. While roofs are expected to last 20 years according to ministry guidelines, the roofs replaced were only 11 and 15 years old. Early and regular inspection and maintenance might have prevented the premature replacements or identified construction deficiencies that should have been addressed by the builder.

A comprehensive roof maintenance checklist developed by the Ontario Housing Corporation could easily be shared with providers to help them conduct and record the results of roof inspections and to know what to expect from roofing consultants.

Windows are also being replaced earlier than expected at a few sites. One provider reviewed by a regional office in 1997 had replaced all the windows of a building in 1997 after only nine years at a cost exceeding $160,000. A consultant had reported over a year earlier that the window caulking, joints and wood surfaces were in very poor condition. Ministry technical staff also noted that regular inspections would have identified these problems earlier and that timely maintenance might have prevented the need for early replacement. The report issued to the provider by the regional office in November 1997 noted that the provider lacked a preventive maintenance plan.

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Recommendation

To better ensure that non-profit housing providers properly maintain the condition of their properties and avoid costly, premature, major repairs or replacements, the Ministry should:

- **re-emphasize the expectations under the operating agreement for non-profit housing providers to institute standards and practices that preserve their properties, including preventive maintenance programs;**
- **provide further guidance to non-profit housing providers on best practices such as the checklist for roof inspection and maintenance developed by the Ontario Housing Corporation; and**
- **ensure that any technical audits conducted on non-profit housing providers assess and report on compliance with the *Ontario Fire Code*.**

Ministry Response

The Ministry agrees with the need to promote preventive maintenance and provide support for this endeavour.

Although technical audits were not conducted as part of the operational reviews, housing providers are given tools (for example, the Fire Log Book and Fire Safety Plan and Information Sheets from the Office of the Fire Marshal) to keep track of their obligation for checking equipment and maintaining fire standards.

The Ministry will:

- ***reiterate to groups the need for preventive maintenance programs through regular operational reviews. This would also be included as part of the communications strategy developed to deal with the need for capital planning identified earlier; and***
- ***continue to direct providers to available resources on preventive maintenance. These include Ontario Housing Corporation maintenance manuals and sector association training materials.***