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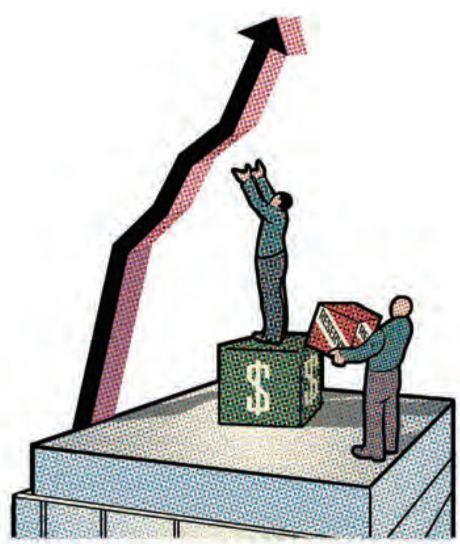
Reserve Fund Interest Rates

Who's Responsibility Are They and What Rates are Appropriate?

There has been much written over the last few years about Ontario condominium Reserve Fund Studies ("RFS") - what they are, which expenditures should and should not be included, how to define "adequate" funding of a reserve fund, which investment strategies to use and which funding options to implement. There has been less written on the dynamics of setting some of the assumptions which are used in the studies. This article focuses on two very important and inter-related assumptions – the interest rate and the inflation rate.

Taking a step backward, it may be helpful to very briefly review the major estimates required in a typical reserve fund study. These are described more precisely in Ontario Regulation 48/01, Part IV:

1) Identification of capital expenditure components which may need major repair or replacement over the next 30 years (30 is required, some consultants offer a much longer projection period to capture items with longer service lives)
2) Prediction of total service life and remaining service life for each component
3) Allocation of repairs or replacements to a specific future year
4) Estimation of a current cost for each of those repairs or replacements
5) Selection of an inflation rate to project the future cost of the repairs or replacements
6) Identification of the current reserve fund balance in the most recent audited financial statements
7) Estimation of an interest rate to apply to invested reserve fund assets over the cash flow period
8) Preparation of Cash Flow Tables using assumptions 1 to 7 to model funding options and indicate which of the Cash Flow models will produce positive reserve fund balances throughout the projection period. The Condominium Act requires positive balances in all periods.



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This process has significant elements of measurement uncertainty at almost every point - identification of the capital expenditure elements, estimates of remaining service lives, estimated repair and replacement costs, and future inflation and interest rates.

The genesis of interest in this subject was an observation that inflation and interest rates used in many recent RFS have been, to be frank, all over the map. Conversations with very experienced professionals in the condo management and reserve fund study consulting businesses produced quite different opinions on which rates should be used and who is responsible for selecting these rates. Conversations with condo board members produced an even greater sense of confusion over what was appropriate. This is surprising as one would presumably believe that rates used across the province would be relatively closely aligned. It seemed logical that, however uncertain predicting the future might be, construction or renovation costs for most condominiums should be subject to quite similar future inflation influences. In addition, all Ontario condominium corporations are legally governed by the same investment restrictions of the Condominium Act, sub-paragraphs 115 (5) and (6).

To provide more empirical evidence than initial hearsay observations, a survey questionnaire was designed to inquire about the inflation and interest rates which have been used in recent reserve fund study updates. Reserve fund study consultants, condo managers, condo corporation auditors and individual condo owners and Board members throughout Ontario were canvassed. The survey results, combined with a number of actual updated reserve fund studies examined, represented over 50 studies by fifteen different Ontario based RFS consulting companies.

When the survey results were tabulated, it was determined that over 50% of respondents reported inflation rates of 2% to 2.5%, while 30% reported rates of 3.0%. There were a scattering of higher or lower rates.

For interest rates, a much greater dispersion of selected rates were reported. Interest rates as low as 1.0% and as high as 7.1% were reported. The spread between the inflation and interest rates selected on individual studies ranged from a high of +4.1% (interest rate higher than inflation) to a low of -2.25% (interest rate lower than inflation). All but four of the RFS Updates used interest and inflation rates within plus or minus 2% of each other, roughly two thirds showing higher interest rates and one third showing higher inflation rates. Half of the RFS Updates used rates within plus or minus 1% of each other.

These inflation and interest rate assumptions can have a major impact on the funding plan for any reserve fund. As an example, in a recently examined reserve fund cash flow for a moderate sized condominium corporation, a reduction of interest rates from long term historical averages to rates based on the Board's future expectations reduced interest income (and increased required owner funding) by approximately $25,000 per unit (15% of per unit contributions) over the 30 year cash flow period.

This wide distribution of results should be surprising given how similar reserve fund investment portfolios are, and how all corporations should, in theory, face roughly the same inflationary pressures. The answers to why such diversity exists became more evident as responses to the more qualitative questions asked in the survey were analyzed. Those questions are listed below with a discussion of some of the answers provided by a broad cross section of leading condominium corporation service providers.

1) Who do you believe has the responsibility for selecting the Interest Rate assumption used for reserve fund assets in RFS cash flow tables?

Many consultants who perform reserve fund studies believe that the selection of the interest rate is their responsibility. Others ask that Management provide an interest rate in the questionnaire circulated at the beginning of an RFS project. In some cases the consultant will perform a reasonableness test on a Management-provided interest rate and push back if the rate is not plausible.

A Condominium Board is required by the Condominium Act to establish its own Investment Policy based on Act imposed restrictions, and Management must implement this investment policy. Given this legislative directive, it is hard to understand why Boards and Management are not more often involved in the selection of the interest rate assumption.

2) How is the Interest Rate selected?

The most common answer for how the interest rate is selected, even for those consultants who believe that they have the responsibility to select the rate, was "based upon the condominium corporation's current investment policy and portfolio yield, modified based upon an outlook of how yields will change over the coming 30 years". What was interesting was how much variation there was in how that future outlook was interpreted. A few consultants believed that 30 year historical yields were an appropriate benchmark to use and others suggested that a spread of 1% to 2% above the selected inflation rate was appropriate. One innovative approach was to vary the rate depending upon how far in the future the critical year emerged in the cash flow. If it is in the near term, a lower interest rate was selected to reflect current reality, and if further out, a higher rate to reflect historic norms and the size of the balance, assuming that larger balances can earn higher yields than lower balances by accessing longer-term investments.

Those consultants and Boards who are hoping that yields will return to the 7% + range of ten years ago should consider the fact that governments have become much more active in controlling interest rates in recent years. Any significant increase in rates will have major negative implications for government deficits, the housing market and many indebted Canadians, a situation which governments will work hard to prevent happening.

3) Is it appropriate to use a combination of short term and long term interest rates in the RFS cash flow tables (e.g. 2.0% for years 1 through 5 followed by 4% for years 6 through 30)?

Most respondents to the survey believed that this approach could be acceptable, though relatively few apply it. The advantage of this approach is that it allows the current reality of very low yields to be modeled while also allowing for a modest degree of optimism to be incorporated into the cash flows, assuming that historical yields and spreads on inflation will return in the future. One major consultant uses a standard approach in all of their studies, applying fairly closely matched variable rates for both interest and inflation for the 2nd to 4th years, 5th to 7th years and 8th and beyond years, based on historical average rates of five year GICs over different time periods.

4) Who do you believe sets the Inflation Rate assumption used for RFS cash flow tables?

Many respondents stated that the RFS consultant should select this rate, but several made specific reference to the Province setting the rate. They used as their reference for this assertion the provisions of sub-sections 93(6) of the Ontario Condo Act which refers to "expected repair and replacement costs" being required in a reserve fund study.

5) Which is the relevant inflation assumption to use in an RFS cash flow table?

A few respondents stated that the Consumer Price Index (CPI) should be used. The majority, however, suggested a Construction Cost Index. Some acknowledged that new construction inflation can be quite different from repair and replacement inflation, which is not reliably modeled by the Bank of Canada or anyone else. Some added that the construction index should be adjusted based upon experience and expected future changes in the rate.

Conclusions

Given the wide variance in interest and inflation rate assumptions used in recent reserve fund studies, Condo Boards and Management would be well advised to become more engaged in the setting and / or approval of the rates used. Using artificially high interest rates in cash flow tables can have the effect of masking a need for significant future increases in reserve funding. The significant reduction in yields on government guaranteed investments since the beginning of the 2008 financial crisis has added urgency to this need for vigilance. While the assumed interest rate is important, equally significant is the relationship between the interest rate and the inflation rate. A gap of more than 2% between the two rates should be challenged to ensure that there is a logical basis for the gap. Condo Boards should ask themselves, and then ask their RFS consultant, the following questions:

1) Given the corporation's investment policy, is it reasonable to estimate that reserve funds will earn the yield assumed in the cash flow tables?

2) Is the Board happy with the relationship and spread between the interest and inflation rate assumptions?

3) Do the interest and inflation assumptions make sense in the short term (given upcoming fund balances) and in the longer term (given historic interest/inflation spreads and the predicted fund balance)?

If the interest and / or inflation rate assumptions are provided by condominium management or boards to the RFS consultant, then quality control mechanisms should be in place within the consulting organization to apply a reasonableness test to those assumptions, and challenge the rate if it is considered overly optimistic. CV