MyFiduciary
Governance & Investment Support

# BODY CORPORATE ASSET-LIABILITY MANAGEMENT

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## EXECUTIVE SUMMARY

This note briefly outlines the advantages of an arms-length professional investment approach to management of New Zealand body corporate funds. We believe that relative to the status-quo such an approach would likely:

- Better prepare body corporates for the expected long-term costs (or liability streams) of maintaining a building, and its associated facilities, to a desired standard
- Substantially reduce the annual costs of funding this liability stream for body corporate members
- Enhance the longer-term value of the individual unit titles that the body corporate represents
- Improve the governance of body corporate funds and the potential personal liability risks for body corporate committee members
- Get ahead of potential legislative changes that enforce more discipline on management of body corporate funds

## ASSET –LIABILITY MANAGEMENT IN BRIEF

Section 30 of the Unit Titles Regulations (2011) requires a body corporate to formulate a long-term property maintenance plan. The plan must include the coverage of the plan, the period of coverage, estimated costs, and in the case of a long-term maintenance fund, the amount of funding required each year. There is also a requirement to review the plan at least once every 3 years (see Annex 1 at the end of this note for full details).

Having a plan, and potentially a long-term maintenance fund, to meet the liability stream from maintaining a property is conceptually no different than an individual, corporate, trust, or government formulating and implementing a fund to meet their various liability streams or investment purposes.

For example, individuals of working age may engage a financial advisor to develop a savings plan and implement an accumulation fund to meet their expected long-term retirement needs. Community trusts and foundations throughout New Zealand engage advisors, fund managers, and other experts to assist them in formulating a contribution plan, a fund, and a distribution plan from the fund that it enables them to sustainably distribute money to the causes that they support.

The New Zealand Superannuation Fund and Accident Compensation Corporation Fund are examples of arms-length government-owned funds that have been set up to meet the liability streams the government faces from New Zealand Superannuation and accidents and injuries respectively.

The key features of these funds and their management are that:

1. An investment plan has been written outlining the purpose of the fund, the asset allocation and investment approach that will be taken to meet the purpose, fund governance and decision making, and reporting and review obligations.

2. The level of contributions and asset allocations have been selected to maximise the chances of meeting the liability stream or investment purpose of the funds, subject to the risk tolerances of fund owners. For any long-term liability stream this in practice means there will be some allocation to risky assets (such as government and corporate bonds or equities). This increases the return of a fund, which in turn ***reduces the contributions required*** to meet its liability stream or investment purpose.

3. Various experts in the field have been engaged to assist in formulating, implementing, monitoring and reviewing of the funds. For example, ACC Funds Management engage arms-length external actuarial and medical experts to estimate the liability streams that are created from accidents and injuries. These are separate to the investment experts it engages to provide investment management or asset custodial services.

4. There is, in general, regulatory oversight of the experts and the firms that are engaged in the process.

## BETTER PRACTICE MANAGEMENT OF BODY CORPORATE FUNDS

At present, our understanding is that many body corporates in New Zealand do not have an established fund to help meet their long-term liability needs, and even for those that do, funds are typically held in a lawyer or property management firms' cash account, rather than professionally managed through a credible fund manager. This means that unit title holders are at risk that their liability streams are not as well identified or managed as well as they could be. The *potential* effects of this could be to:

- Place personal liability risk on body corporate committee members because there are inadequate funds to cover repairs and maintenance; or because funds are seen as not well managed.

- Place business risk on the legal and property management firms who have taken on "de facto" fund management roles by having body corporate funds in cash accounts.

- Reduce the re-sale value of unit titles because potential buyers assess that a building does not have a well-managed and funded maintenance plan.

- Raise the contribution rate to the fund (for body corporates that have one) above what is required to meet the long term liability streams.

  For illustrative purposes, the table below provides results from a simulation that assumes that there is a $10 million dollar one off maintenance and replacement cost that is expected to fall due in 20 years' time, and an annual contribution is solved for such that there is a 95% chance of meeting this bill. We see that the annual contribution required falls by $9,000 per annum as we move from a portfolio of 100% cash to a portfolio that contains 25% fixed income exposures, and this reduces annual portfolio risk levels (because cash and bonds are not perfectly correlated). Much more substantive contribution reductions, at over $50,000 per annum, are implied for moderately higher risk portfolios that still have a very high chance (95%) of meeting the $10 million dollar requirement.

**Table 1** Illustration of the impact of asset allocations on funding requirements

| Portfolio asset allocation | Portfolio expected return (net of fees) | risk (annual volatility) | annual contribution required |
|---|---|---|---|
| 100% NZ cash | 3.75% | 2.5% | 280,000 |
| 75% cash, 25% fixed income | 4.25% | 2.25% | 271,000 |
| Defensive fund – 90% fixed income, 10% equities | 5.1% | 2.6% | 225,000 |
| Conservative Fund - 80% fixed income, 20% equities | 6.2% | 3.2% | 230,000 |

Through the lens of the way many other liability streams are managed in New Zealand we suggest a better approach would involve:

1. Engaging credible property management and risk expertise (for body corporates who have not done so) to estimate short and long-term maintenance and replacement costs, including those costs that can be covered by insurance.
2. Engaging credible financial planning and asset consulting expertise to help develop a plan to meet these liability streams. This would include taking a body corporate committee through different asset allocation options and how these impact on annual funding requirements from unit title holders.
3. Engaging credible arms-length funds management expertise to execute and manage the funding plan. Note that (2) and (3) may be done within a single firm who have the required competencies.
4. As per the Unit Titles Regulation, build into the plan regular reviews and triggers should conditions materially change (e.g. if there is a large change to seismic risk assessments or materials deteriorate significantly more quickly than expected).

While these steps are not currently required by regulators, we note that it is a growing concern given the sums involved, and the most logical outcome of any review would be to bring body corporate funds regulation under the umbrella of how the industry is regulated in other contexts.

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## ANNEX 1: UNIT TITLES REGUALTIONS 2011

30 Long-term maintenance plans

(1)A long-term maintenance plan must—

(a)cover—

(i)the common property, building elements, and infrastructure of the unit title development; and

(ii)any additional items that the body corporate has decided by ordinary resolution to include in the plan; and

(b)identify those items that the body corporate may decide by ordinary resolution not to maintain for any period during the lifetime of the plan; and

(c)state the period covered by the plan; and

(d)state the estimated age and life expectancy of each item covered by the plan; and

(e)state the estimated cost of maintenance and replacement of each item covered by the plan; and

(f)state whether there is a long-term maintenance fund; and

(g)if there is a long-term maintenance fund, state the amount determined by the body corporate to be applied to maintain the fund each year; and

(h)state who has prepared the plan.

(2)A body corporate must carry out a review of its plan at least once every 3 years.

(3)Subject to subclause (2), a body corporate may carry out a review of its plan as frequently as it considers necessary.