Q&A

Questions and Answers on Secondary Financing

What is secondary financing?

Secondary financing refers to any mortgage loan your co-operative takes out before its primary financing is fully repaid. For most co-ops, primary financing refers to the mortgage loan that brought them into being. Secondary financing is used to meet later needs.

Why would we want secondary financing?

Like any other property owner, your co-op will have to borrow new money if your buildings need more work than you have funds on hand to pay for.

How would we decide if we need to borrow?

First, you need to decide how much work your property needs. A building-condition assessment (BCA) by an engineer will help with this. A BCA will tell you what you need to do, how soon it should be done and what it may cost. Estimates are often conservative, meaning they are set high to avoid surprises. Soft costs, such as the architect's or engineer's fees, legal costs and project-management fees, are not usually included. So, for a large job, you will need to add these to the estimate.

The next step is to decide how much of the work you can fund through your capital replacement reserve and how much you will need to borrow. The best way to do this is to develop a capital plan (also called a reserve-fund study). The plan will show, year by year, what you will need to pay for, what your reserve can cover and when your reserve funds will fall short. At that point you can look at different options, including taking out a new loan.

Your relationship manager can tell you how to get a BCA and a capital plan done. They can also explain how to project your co-op's cash flows into the future, assuming different allocations to your reserve, amounts borrowed and yearly housing-charge increases. See the Co-operative Housing Federation of Canada's guide and the Agency's Q&A for more on capital planning.

Can't we save the bother of a BCA and borrow just enough to fix one thing, such as our windows?

That depends. You may be able to get a loan for a single project if you can show that your co-op can pay it back over just a few years. However, lenders and CMHC may hesitate to approve such a loan, knowing that several high-cost buildings components often need replacement at about the same time. If you want a longer term loan—say, more than five years—you will have to show your lender that you know what other work your property might need before the loan is paid back and how you will pay for it. A BCA and capital plan will answer these questions.

When we borrow more money, how does the new loan work with the mortgage we already have?

Secondary financing can take two forms. Some co-ops take out a second mortgage on top of the first one. The co-op continues to make payments on the first mortgage until its scheduled end, while also paying off the second mortgage, which may end on a different date.

Other co-ops take out a new, larger loan that replaces the original mortgage and provides new funds for work to the property. The new loan ends some years later than the one it replaced. This approach is often called "blend and extend."

What is mortgage insurance and will we need it?

Mortgage insurance is a guarantee to the lender that it will get its money back if the co-op is unable to repay the loan. CMHC is the only source of mortgage insurance for multiple-unit properties.

Some lenders are happy to make an uninsured loan at an attractive rate. But, if the loan looks riskier, they may ask for CMHC insurance. This is available through National Housing Act (NHA)-approved lenders. (Virtually all credit unions and all the major banks are approved lenders.) Mortgage insurance will give your lender confidence, allowing your co-op to borrow more money or pay a lower interest rate. But bear in mind that you will have to pay CMHC a per-unit application fee and a mortgage-insurance premium. You'll need to check to see whether getting the insurance will save your co-op money over the long run. If you decide that it will, you can borrow the mortgage-insurance premium as part of your loan.

If you can't find a private lender, you may be able to borrow directly from CMHC. However, CMHC direct loans are only available as a last resort, and then only for S61- and S95-Program co-operatives.

How will a lender decide whether to give us a loan?

A lender has three questions, and the answer to all of them must be "yes." The first is "If we lend you money, can you pay it back?" Before you talk to a lender, your board needs to make sure the answer is "Yes, we can." (Before you answer, take care to allow for unexpected expenses, like surprise increases in taxes and utility and repair costs.)

If you are losing money, you are not a good candidate for a loan. Lenders look for what they call "positive debt coverage." They want to see money left over after all operating costs and the mortgage have been paid and funds set aside in the capital replacement reserve. In short, a lender's preferred customer shows a surplus every year. (Instead of recording a surplus, a co-op will add this extra money to its reserve.) You may need to raise your housing charges to meet this expectation.

The second question is "Do you have an asset you can put up as security for our loan?" The lender will want to know that you are looking to borrow quite a bit less than the value of your property, taking into account any other loans you have. (How much less depends on whether the loan will be CMHC-insured or not.) Lenders refer to this as the "loan-to-value ratio." You may not be able to answer this question without getting a professional appraisal done to find out the value of your property in today's market. While your property tax assessment may give you an initial idea of its current worth, most lenders will ask for an appraisal unless the loan you want is quite small.

The third question is "If we lend you money, will you pay it back?" This speaks to your co-op's track record and whether your past actions show that you keep your word and pay your bills on time. A lender will also want to know that your members regularly approve housing charges that are high enough to pay all the bills.

What if we're not sure we'll qualify?

In that case, your board first needs to ask itself some questions.

1. Can we raise our housing charges enough to meet the payments on the new loan while still putting money aside in our capital-replacement reserve?
2. Are we keeping all of our units occupied?
3. Are we collecting everything our members owe us, in full and on time?
4. Do we use a collection agency or take other action if someone moves out owing money? Could we avoid such losses by increasing our member loan, share or deposit requirement?
5. If we have paid member parking, can we raise our rates?

6. Can we charge more for cable TV or laundry?

You may have some work to do before talking to a lender. Your relationship manager can help with this.

If we can borrow to pay for major repairs, can we stop putting money into our reserve?

No. With a healthy reserve you can make repairs when you need to, rather than putting them off. Your lender will want this protection, and you should too. Besides, it costs more to borrow than to use your own funds. And you can't count on interest rates staying affordable forever. You may not be able to get a new loan when you need one.

How long can we take to pay back the loan?

You and your lender will decide this together, based on your financial capacity. The longer you take to repay the loan, the smaller the monthly payments. On the other hand, the longer you take, the more interest you will pay and the less flexibility you'll have to meet the unexpected. You also run the risk of a facing a higher interest rate when the loan is renewed (typically every five years). Like Goldilocks, you want the repayment period that is just right for you.

If you try to pay back the loan too fast, you may have trouble meeting the payments. If you repay it too slowly, you may find yourself in debt for another new roof before the last one is fully paid for. It's like borrowing to buy a car. You don't want to be saddled with loan payments when your maintenance costs start soaring. Above all, you don't want to make loan payments long after you stop driving the car.

Again, a BCA and a capital plan can help you—and your lender—make the right decision.

We think we need to borrow. What happens next?

CHF Canada and CHF BC both have programs in place to assist their members with their secondary financing needs. You can also discuss your needs with your Agency relationship manager.

How long will it take?

This is a hard question to answer. Much will depend on how quickly your co-op can answer the lender's questions and produce the information it needs. Every day counts. Check your by-laws or rules to see what the board can approve and what must go before a members' meeting. Schedule meetings well in advance and make timely decisions. Once the loan is approved, get the paperwork to your lender and lawyer without delay. (And ask how quickly it can be processed.) Getting your loan could take a year or as little as six months.

Where does the Agency fit in?

The Agency acts on behalf of CMHC, but we also help your co-operative. We can give you advice on how much to borrow and how quickly to pay it back. We will review your capital plan and give it our stamp of approval, which will help with your new financing. When the paperwork is ready, we make the recommendation to CMHC for approval to put another mortgage, or an extended mortgage, on your property.

What is CMHC's approval based on?

Like your lender, CMHC will want to ensure that you can pay back the new loan. Its staff will look at your finances and seek assurance that you understand the condition of your property and the work you need to do. They will check to see that you have been making your current mortgage payments on time. And they will ask whether your housing charges are high enough to let you meet all of your other obligations and repay the loan.

Can't we just go to a lender and borrow money? Why would we need CMHC approval first?

As long as you have an operating agreement with CMHC, you need its permission before putting a mortgage on your property.

Once your board has decided on what is best for your co-op, the Agency will work with you to get CMHC approval for the new loan, provided we agree that the loan will improve the property and your co-op can handle the debt.

Are there any grants available to help our co-op get the work done?

Probably not. Grants are not available from either CMHC or the Agency for work on a co-op's property. The Homeowner Protection Office (HPO), which helped B.C. co-ops with premature building envelope failure (leaky co-ops), is not making new commitments. Grants or other financial assistance may be available in some areas for energy- or water-saving retrofits or for adapting housing for persons with disabilities. Check with your relationship manager or your local federation for more information about any offers that your co-operative could benefit from.

Some municipalities may have special programs that could help. It is worth asking a friendly local councillor about any possibilities, such as small grants for heritage properties that need work. Every little bit helps.

Is there anything else we need to know?

If you do borrow, you will sign a mortgage with your lender and perhaps a loan agreement. Your obligations go beyond paying back the loan. They include things like giving your lender regular financial reports, keeping up your property and not taking out new loans without your lender's permission. While you can find general information on the Internet, your co-op's lawyer is the best person to help you understand the documents you will have to sign.

March 2014