



Coronavirus Disease (COVID-19) Impact on Solvency of Strata Corporations

Discussion Paper



Executive Summary

- It is anticipated that a surge in unemployment and financial distress throughout the community will cause a significant number of owners within **Strata Corporations** (bodies corporate and owners corporations) - mostly apartment buildings - to default on their strata contributions.
- **Strata Corporations** operate as Not for Profit entities. They raise funds necessary for a building's day to day operations. Any spike in owner contribution defaults can have an adverse impact on the solvency of a **Strata Corporation**.
- The day to day operations of a **Strata Corporation** cover essential services critical to the safe habitation of a building (such as building insurance, fire safety, waste management and sanitisation).
- The economic activity generated from the regular activity of **Strata Corporations** is \$6 Billion per annum.
- Many **Strata Corporations** will have funds set aside for capital repairs, however access to those funds is restricted by statute in most states. In Some states, there is no requirement for reserve funds thus making the situation more untenable.
- A rise in the number of individual lot owners defaulting on levies payments will have a broad collective impact, even for those who are less directly affected by the economic fallout of Covid-19. The obligations of the strata building falls to the **Strata Corporation**. Any failure to fulfil an obligation falls to the collective, and not the individual.
- In the event that a **Strata Corporation** becomes insolvent, the health and safety of all residents may be undermined if fewer funds are contributed towards repairs and upgrades.
- The impact on increased demands of the essential services of residential buildings due to self-isolation, forced isolation, restricted travel and unemployment needs to be considered.
- It is assumed that the hours in residence will dramatically increase and therefore the demands on the facilities within strata buildings will be increased accordingly. Increased demand on services cannot converge with a decrease in funding of these services.
- It is necessary to consider a broad range of solutions to alleviate the pressure on **Strata Corporations**, including Government funding assistance, key stakeholder participation and regulation relief.

Introduction

Strata Community Association (SCA) is the peak industry body for Body Corporate and Community Title Management (also referred to as Strata Management, Strata Title or Owners Corporation Management) in Australia and New Zealand.

Our 5,000 individual and corporate members include strata managers, owners corporation managers and, body corporate managers (*'managers'*), support staff, owners' representatives and suppliers of products and services to the industry. SCA proudly fulfils the dual roles of a professional institute and consumer advocate.

In light of the unfolding economic fallout caused by Covid-19, our members are concerned about the likelihood of a solvency crisis emerging among significant numbers of bodies corporate and owners corporations (**'Strata Corporations'**). The strata community sector seeks to bring all stakeholders to the table in a proactive way in order to get ahead of this issue, in advance of a potential market failure among **Strata Corporations**.

The technical features of strata buildings have become increasingly complex, requiring a high degree of specialist knowledge among all the many and varied trades and services that operate within the broader property services industry. The difference between common and private property, and the decision-making processes of **Strata Corporation** committees, add a degree of complexity to trade and service delivery.

As self-isolation requirements continue, there will be a corresponding increase in pressure on essential services such as utilities and waste management and the costs associated with same.

The main purpose of this discussion paper is to identify the issues and consider a range of options that will provide relief to the problem. This paper is not intended to be exhaustive and the author acknowledges that a multitude of variations or alternatives may provide an equal or greater benefit to those suggested herewith.

We trust this discussion paper will provide a basis for the advancement of this important issue.

Strata Market

This relentless growth in the size of the market has seen an increasing number of Australians living within strata buildings. Based on the 2016 Census, more than 2.2 million people live in flats and apartments, the vast majority being strata titled. This figure does not include all forms of strata title such as townhouses and community titled developments which are very common. Nor does it include businesses operating in strata titled commercial buildings.

A 2018 survey of state and territory land title records¹ showed there were 316,227 strata schemes in Australia comprising 2,587,397 individual lots, so with an average household size of 2.6 this brings the residents in strata schemes to an approximate 6.7 million. Their combined property replacement value exceeds \$1.2 trillion.

The annual economic activity generated by the strata sector includes close to \$6 Billion in "call out" jobs (trades people) and \$1 Billion in "professional services" (lawyers, accountants and consultants). The strata market represents a significant sector of the economy.

¹ Australian National Strata Data 2018, UNSW City Futures Research Centre

Insolvency Predictions

During the height of the GFC, forty-five percent of community managers in the USA said their client associations faced "serious" problems as a result of the housing and economic downturn, while 9 percent describe the impact as "severe."²

ABS reported that two thirds of Australian businesses reported that their turnover or cash flow had reduced as a result of COVID-19 resulting in reducing staff hours, renegotiating their lease and rental arrangements, and a quarter deferring loan repayments.³

It is generally accepted that the economic crises we face today is at least equal to the conditions of the GFC, if not more severe. Therefore, it is sensible to refer to those times as a reference point of what we might expect to see in the weeks and months ahead.

Assuming a best-case scenario of 10% of levy payment defaults, and a worst case of 40%, we can model that in either case many **Strata Corporations** will run into serious solvency problems.

Obviously, it is difficult to assign specific risk to specific Strata Schemes, due to differences in age of buildings, quality of buildings, demographics of location, scale and size of buildings, and other factors.

By their very nature, **Strata Corporations** tend to be made up of lot owners and investors from all walks of life, including pensioners and self funded retirees. Regardless of the location or age of a building, it is likely that at least a proportion of owners within a typical building will experience the economic impact of the unfolding crisis in some form, consequently creating funding constraints for **Strata Corporations**. Many of those relying upon rental income are equally affected by unemployment and will struggle to pay levies this quarter.

By way of example we can identify a sample of obvious owner groups who will experience a direct and immediate financial impact;

Investors

A typical **Strata Corporation** will be composed of somewhere in the order of 50% of investors (give or take 10%) who lease their properties to tenants. The majority of these owners are middle class 'Mum and Dad' investors, who cannot carry the property holding costs of these assets without the income generated through rental payments. Compounding this exposure is the fact that renters often occupy a lower rung of the economic ladder. These individuals are more likely to be employed in industries which are adversely impacted, such as hospitality and retail.

Commercial Units

In the last two decades there has been a greater concentration of 'mixed use' developments with a combination of strata lots designed for retail and food use existing alongside residential lots. It is typical for these lots to make up between 5% – 15% of the aggregate levy contributions of a **Strata Corporation**. Many of the businesses underpinning these lots will be under extreme financial stress.

² Community Association Institute (2010). CAI Survey: Associations Hit Hard by Housing, Economic Slump. www.caionline.org/PressReleases/Pages/HitHardbyHousing.aspx

³ Australian Bureau of Statistics (7 April 2020). COVID-19 impacts business cash flow and turnover, <https://www.abs.gov.au/ausstats/abs%40.nsf/mediareleasesbyCatalogue/49F8475B31112582CA25853600764041?OpenDocument>

Self-Funded Retirees

It is well established that strata buildings are a natural lifestyle progression for downsizers in later stages of life. Obviously, it follows that many of these downsizers are likely to be self-funded retirees. Many of these owners will have already experienced a direct impact in their financial circumstances as a result of share market losses and earnings downgrades affecting dividend payments.

First Home Owners

Strata properties have long been regarded as an entry point to property ownership. Consequently, many owners within **Strata Corporations** are first home buyers and new families. These owners tend to be very budget sensitive and will have a difficult time withstanding major economic turbulence, particularly if their employment is in question.

Potential Consequences of Insolvency

The impact of an insolvency event within a **Strata Corporation** will have extremely adverse impacts for all stakeholders within the sector. Similar to the macro economy of the community, a **Strata Corporation** has a number of micro economic factors that are interdependent beyond the simple function of paying for services.

Examples of this interconnection may be broad and varied. Below are but a few illustrative examples;

Health and Sanitisation

The residents and commercial users of a strata building rely on the **Strata Corporation** facilitating cleaning and waste management. In many cases the **Strata Corporation** has a commercial waste collection arrangement for all occupants, and in other cases the **Strata Corporation** assists with waste to facilitate collection by council. In either case, this is an essential amenity which impacts the health and wellbeing of all stakeholders.

A similar argument can be made in relation to common area cleaning and sanitisation (especially important in light of current events), as well as specialist services such as servicing grease arrestors for commercial food retailers, and pest control for common areas.

Protection of Life and Safety

All modern buildings are equipped with life preservation equipment such as fire suppression and detection, and early warning systems for residents. This infrastructure has an ongoing service and testing requirement and is critical to the safety of all residents and users.

Examples of other critical systems include Co2 monitors in basements, CCTV surveillance systems, vertical transports of high-rise buildings, water plant testing and asbestos monitoring and reporting.

At a micro level, the current people movement controls, instituted for absolutely genuine reasons, engenders the very real security risk created by the huge rise in home delivery of food. Strangers delivering food, medications and other essentials immediately challenges a **Strata Corporation's** costly security arrangements.

Fitness for Occupancy

A considerable effort has gone into policies to forbid landlords evicting tenants, and in turn to forbid banks from foreclosing on mortgages during the current economic conditions. The states and governments are to be commended for these initiatives. However, it must be acknowledged that the ability for a resident to occupy a building relies not only on the generosity of a mortgager or landlord, but also on the premises itself being fit and compliant for occupation.

A **Strata Corporation** is required to attend to critical maintenance of buildings, much of which is a statutory requirement (such as is the case with fire compliance). If the **Strata Corporation** fails to meet these obligations, the relevant authority can deem the entire building unfit to occupy and therefore all residents will be forced to vacate, regardless of any leniency arrangements with their landlords or banks.

Strata Corporations have strict liability for statutory duties to maintain their common property and can also be liable to lot owners and third parties for failure to properly discharge this duty. Therefore, some **Strata Corporations** will not have any discretion around certain types of expenses, which simply must be met. They can only obtain those funds from the lot owners via levies or by borrowing (which the lot owners have to pay back). Without government funding or subsidies for these essential items of maintenance. The health and safety of entire communities will be significantly adversely affected.

Unlike the 'flexible' arrangements that have been mandated with banks and landlords, it is not practical to devise similar arrangements to enable leniency for **Strata Corporations** who do not attend to critical maintenance, as the result will undermine the safety of occupants in these buildings.

It is beyond argument that this work must continue, and as this work is conducted in the main by small and medium businesses, the cost of attending to this critical work must be met by **Strata Corporations**.

Continuity of Insurance

Across all states and territories, the obligation for **Strata Corporations** to maintain insurance for building replacement and public injury is universal. This is a statutory requirement for obvious reasons.

As stated earlier in this submission the bricks and mortar replacement value of the strata sector is at least \$1.2 trillion, and likely considerably higher when adjusted to include townhouses, commercial strata property, and strata properties that have been constructed since 2016.

This problem is compounded by the fact that most strata insurance policies require payment of premiums annually in advance (an issue that is discussed later in this submission).

Given the size of the underwritten insurance risk across the sector, the possibility of an insolvency event affecting **Strata Corporations** presents a risk to the broad economy, which is further explained below.

Bearing in mind that properties within the strata sector will not transact if potential buyers cannot be assured of adequate building insurance, the consequences of being uninsured flow through beyond the fate of the owners of each respective **Strata Corporation**.

We have seen parallels to this exact issue play out in relation to the ongoing issue of combustible cladding on buildings. This issue has precipitated pockets of buildings having difficulty in securing insurance terms, which has in turn created relatively significant ripples within the property market. It is therefore not difficult to understand just how problematic a whole of sector insurance failure would be to the broader property market, and by extension the broader economy.

It must be acknowledged that a widespread failure of the strata insurance market due to insolvency represents an unacceptable risk for reasons of safety, economic security, and statutory compliance.

Of course, this risk deals with the constraints of properties transacting and the flow on economic impacts that naturally arise. It does not consider the dire impact of a total loss (say in the event of a fire) would have to an uninsured building. Indeed, insurance exists because it is an accepted fact of life that events resulting in losses occur. This reality will not cease to be true simply due to the constraints of the economy.

Compliance with Mortgages

Following on from the above issue relating to insurance, it is undoubtedly a critical term in every mortgage that the property remains insured at all times. For the reasons set out above, if a **Strata Corporation** becomes insolvent, it will follow that all lots within a Strata Scheme may well be in breach of their mortgage.

It is worth revisiting the nature of a **Strata Corporation** for a moment, in the context of this issue. In most cases the building insurance is taken out as a group policy across the whole building. The cost of insurance will usually be the single largest expense of the **Strata Corporation**, often representing 40 – 60% of the annual budget, and usually due in a single payment within the budget cycle. Even in cases where the majority of owners continue to pay their levies, while a relatively small proportion of owners do not or cannot pay, the **Strata Corporation** will be at great risk of falling short of the funds required to meet their insurance obligations.

In real terms it is not difficult to imagine **Strata Corporations** with a small number of owners unable to pay due to the challenging economic times causing the corporation to be unable to pay their insurance obligations, and thereby creating the entire group of owners to be at risk of defaulting in their mortgage obligations. The few will very likely impact the many, even those who have been insulated from the economic downturn because they have kept their jobs or income.

Special consideration needs to be given to the interconnected nature of owners in **Strata Corporations**.

Potential Opportunities for Relief

It is unlikely that there will be any one panacea to address the issues that are likely to play out. Instead, a more realistic approach will be to identify a range of key areas to focus on and proactively consider initiatives that will ease the burden of **Strata Corporations**, lot owners, and partners within the Strata Sector.

Key stakeholders must be prepared to collaborate with **Managers** and lot owner advocacy groups (such as the OCN) to achieve a cross industry solution.

We have considered a range of potential solutions below, and we welcome an opportunity to advance round table discussions to further advance these or other options. These proposed solutions are not intended to be exhaustive, but rather a starting point for further engagement.

We identify the key stakeholders to be;

- State and Federal Governments
- Financial Institutions Active in the Strata Sector (in particular Macquarie Bank and Bank of Queensland)
- Insurance Companies
- Strata Service Providers (in particular large institutional organisations)
- **Managers** (Strata, Body Corporate, Owners Corporation)
- **Strata Corporation** Committee's
- Lot Owners

Each of these stakeholders will play a role in successfully navigating the way forward.

State and Federal Government – Funding

Australian governments at every level are to be congratulated for the decisive action that has been taken to control the health emergency, and to respond in kind to the economic consequences of these actions. The strategy clearly appears to be in favour of artificially shutting down large parts of the economy to facilitate social distancing, while also enabling those who have been impacted to ‘hibernate’ in large part funded by government assistance.

The Strata Community calls on all governments to consider expanding the principles of this strategy to **Strata Corporations** by way of direct funding grants.

As many property owners, businesses, tenants and workers in the economy are provided with the basic financial support to weather the coming storm, many of those groups will unfortunately place the payment of their strata levies at a low priority, due simply to the nature of how **Strata Corporations** operate. Unlike other essential services, the direct consequence of not paying a strata levy are fairly forgiving. It takes a considerable amount of time before any genuine jeopardy is faced by recalcitrant levy payers, and even at the most extreme stage of enforcement, the courts are fairly lenient towards long term payment arrangements.

This reality is not in itself a problem during ordinary times. However, we are not facing ordinary times, and it is our expectation that many owners will chose not to pay their strata levies, and others will simply be forced into a situation where they don’t pay because they are simply unable to.

The usual last stage of debt recovery is to force the owner of a lot into liquidation and pursue the equity in their assets as a creditor. However, recent urgent changes to insolvency laws (in response to the Covid-19 crisis) will also mean that this option is also not available to **Strata Corporations**, therefore eliminating the final remedy available.

Of course, in the current climate the best and most practical option will be for **Strata Corporations** to work with owners to assist them through their individual circumstances. However, due to the composition of **Strata Corporations**, the vast majority of individuals who make up the owners are fairly unengaged and do not have a good appreciation of the impact they have as individuals to the common wellbeing of the group. For the most part they see themselves as individuals.

The structure of the legal entity of **Strata Corporations** also diffuses the agility to make quick decisions. It is not possible to simply raise additional funds to cover a shortfall, as it is necessary to follow fairly slow statutory requirements for holding meetings and consulting with broader groups of owners. Even when following the required steps, there is no promise that a meeting will agree to raise additional funds, also due to the inherent individualism that exists within **Strata Corporations**.

The above comments are not a critique of the individuals that populate Strata schemes, but rather a meditation on the unique nature and composition of these entities. There is no barrier to entry to own a unit in a **Strata Corporation**. Many have a limited understanding and exposure to the fundamental principles of strata, and the legal structure does not require them to engage beyond a bare minimum of awareness. For the most part, this is sufficient, although it does not engender a strong appreciation of their collective obligations to all owners beyond their own interests.

For this reason, the SCA is advocating for generous direct government funding to **Strata Corporations** across all states and territories. It is believed that this is the only way to ensure that any potential stimulus is guaranteed to make its way to the accounts of individual **Strata Corporations**, which will in turn go towards the cost of essential day to day operations of buildings.

What the modelling shows:

Based on some very rudimentary modelling within SCA, it is estimated that the average annual levy contribution for general operations of **Strata Corporations** is in the order of \$2,500 - \$4,000 per annum. Therefore, in line with similar economic stimulus packages spanning the next 6 months, we suggest that a direct payment to each registered **Strata Corporation** of between \$1,250 - \$2,000 per lot would provide the confidence that all costs could be funded for the next 6 months without interruption.

The total cost of such a stimulus would be significant, likely in the range of between \$2.75 Billion and \$4.4 Billion. If such an option was to be legitimately contemplated, SCA would suggest further engagement with UNSW who have previously conducted research into the broader Strata Sector. Furthermore, if a direct subsidy was to be considered by Australian Governments, SCA could assist in understanding the most efficient delivery mechanism, which we would assume would include a process of application driven by the **Managers** on behalf of individual **Strata Corporations**.

Naturally it will be necessary to consider the extent by which such a stimulus would represent a disproportionate level of assistance to one group of the population over another. This is indeed a challenge. However, it could be overcome in a range of different ways;

1. The Funds could be granted as a direct offset against owner's levies, thereby having the effect of directly benefiting individuals within the economy, while also ensuring that those funds were directed to payment of strata levies to ensure **Strata Corporations** remained solvent. SCA members could assist in designing this process alongside government;
2. If 1. is not desirable, the funds could be offered by way of an interest free (or very low interest) loan directly to **Strata Corporations**, in a manner that bypasses the existing regulatory barriers for **Strata Corporations** to take loans (each state has different requirements regarding the approval to take out loans).
3. A mandate could be established to ensure that the funds were spent within a period of time, say the next 6 months, or else returned.

It is worth acknowledging that a **Strata Corporation** operates on a not for profit basis. Therefore, any government funding for operating expenses will be returned to the economy in a direct manner. These funds will be spent on things such as insurance, tradespeople, cleaning, fire maintenance and the like. It is a very different proposition to providing a relief package to a public company who may consider paying dividends to shareholders or bonuses to CEO's. A **Strata Corporation** is essentially a 'Money in, Money out' proposition.

State/Territory Policy Relief

Every state and territory have different policies regarding how a **Strata Corporation** must operate, including various requirements for making decisions and spending money.

In ordinary circumstances these requirements all make a great deal of sense. For example, a committee for a Strata scheme cannot simply raise levies without calling for a meeting of all owners. However, the requirements for calling such a meeting will have certain time constraints, and then require quorums and mandatory notice periods for reduced quorums, etc.

Other examples of sensible constraints include a prohibition on the Committee spending money from the Capital Works Fund (maintenance and sinking fund) for day to day operational expenses.

All of these constraints make sense. However, in these exceptional times we would encourage the states to work with the Strata Community to consider what temporary relaxations of these laws would be appropriate in the circumstances and where the management firm is to make some of these decisions, to indemnify them from spurious legal action by disaffected or disgruntled lot owners once the pandemic has been remedied and life returns to normal.

Financial Institutions in the Strata Sector

There are a limited number of financial institutions with a genuine stake in the Strata Sector, including Macquarie Bank, Bank of Queensland, Lannock, and Strata Loans.

SCA thinks that the banking sector could play a role in underwriting the solvency of a **Strata Corporation** by potentially providing a pre-approved line of credit to the schemes with a bank account. This could perhaps work on a dollar amount per lot and could be administered in conjunction with the State and Federal Governments.

Alternatively, lines of credit could simply be pre-approved with the application of the banks standard commercial rate for the risk profile of **Strata Corporations**.

It is likely that the major banks in this sector are best placed as the delivery mechanism for funding, considering the banks already have the majority of information about the **Strata Corporations** (such as ABN and TFN necessary to open an account), and they have active operational accounts for the majority of the professionally managed **Strata Corporations** across Australia.

Insurance Companies

There is a long-standing convention within the strata community that insurance premiums are paid annually, in advance. It is unclear if this is simply a convention, or if there is a legitimate technical, contractual, or financial reason that such a convention is necessary. It will be helpful if the insurance industry would consider incremental payment terms, such as quarterly in advance, to ensure that a collapse of solvency does not occur in the coming months.

Strata Service Providers

The strata sector is serviced by a range of providers, the majority of which are small to medium sized businesses. It is not fair or practical to ask these businesses to extend their credit terms.

However, there are a number of very large institutional service providers who may be better placed to offer more generous payment terms.

For example, most lifts in a strata building will likely be serviced by a large institutional organisation, such as Schindler or Otis or Kone. These organisations may well have the ability to extend their credit terms from 14 days to upwards of 60 – 90 days, in an effort to assist cashflow constraints in the immediate term.

Other institutional service providers that regularly feature in the strata sector include CHUBB and Wormald Fire.

A strategic agreement with these kinds of service providers on extended payment terms could provide short term relief and should be explored.

Strata Managers, Committees & Lot Owners

The levers available to the front line of **Managers**, Committees and Lot Owners is somewhat limited.

Committees are often constrained by legislation and may require some relief in order to make decisions that ordinarily would require all owners to consider.

In the immediate term, and subject to the regulations of each jurisdiction, the committee could work with the **Manager** to provide a moratorium on levy interest and penalties where owners have genuine cases of hardship. However, Committees and **Strata Corporations** must act reasonably in making decisions. Therefore, they must weigh up all relevant factors, including the financial responsibilities of the Strata Scheme holistically. Some schemes will simply not be in a financial position to refrain from recovering levies from all lot owners.

Within the state of Victoria where a large proportion of the smaller strata title schemes do not have committees and rely in non-quorum interim resolutions, the management firm can be appointed by VCAT. This assigns all the powers of an Owners Corporation to the Manager as 'Administrator'. This includes appropriate indemnities to protect the management firm for acting in the best interests of owners, protecting them from spurious legal action by disaffected lot owners.

Anecdotally we have already had many reports from our members whereby committees and owners are considering reducing their annual budgets. At first glance this may be appealing, however on closer inspection it may be counterproductive, as reduced budgets means that those who can still pay will pay less, and those who cannot pay wont. The result being a further constraint on cashflow rather than an improvement.

Conclusion

A collaborative and proactive discussion needs to commence, across industry and stakeholder groups, to ensure that we are ahead of the potential issues faced by the strata sector.

We hope that our discussion paper on these matters will be considered in this light and that clarification can be made.



**Suite 101, Level 1, 845 Pacific Highway
Chatswood NSW 2067
Ph: 02 9492 8250
E: admin@strata.community
W: www.strata.community**