

# Scottish Parliamentary Working Group on Tenements: Sub Group Owners Entity

## Sinking Funds

In our previous paper we proposed that:

- Sinking Funds (SFs) should be introduced on a compulsory basis, even if at a minimal level or phased in by building age.
- SFs should be paid into specially established holding funds – Safe Deposits Scotland and Credit Unions provide potential models for this holding fund.

While the establishment of SFs goes hand in hand with the establishment of Owner’s Associations that are corporate entities, it would be possible to establish such funds through a specific holding fund on the Safe Deposits Scotland model which could hold, monitor and control funds on owners’ behalf.

We have now looked further at the potential working of these funds.

### Establishment and enforcement

#### Building up the Sinking Fund

The SF would comprise of the same number of shares as there are individual flats/units in a tenement / development.

Tenement		Sinking Fund	
Flat 7		SF Share 7	
Flat 5	Flat 6	SF Share 5	SF Share 6
Flat 3	Flat 4	SF Share 3	SF Share 4
Flat 1	Flat 2	SF Share 1	SF Share 2

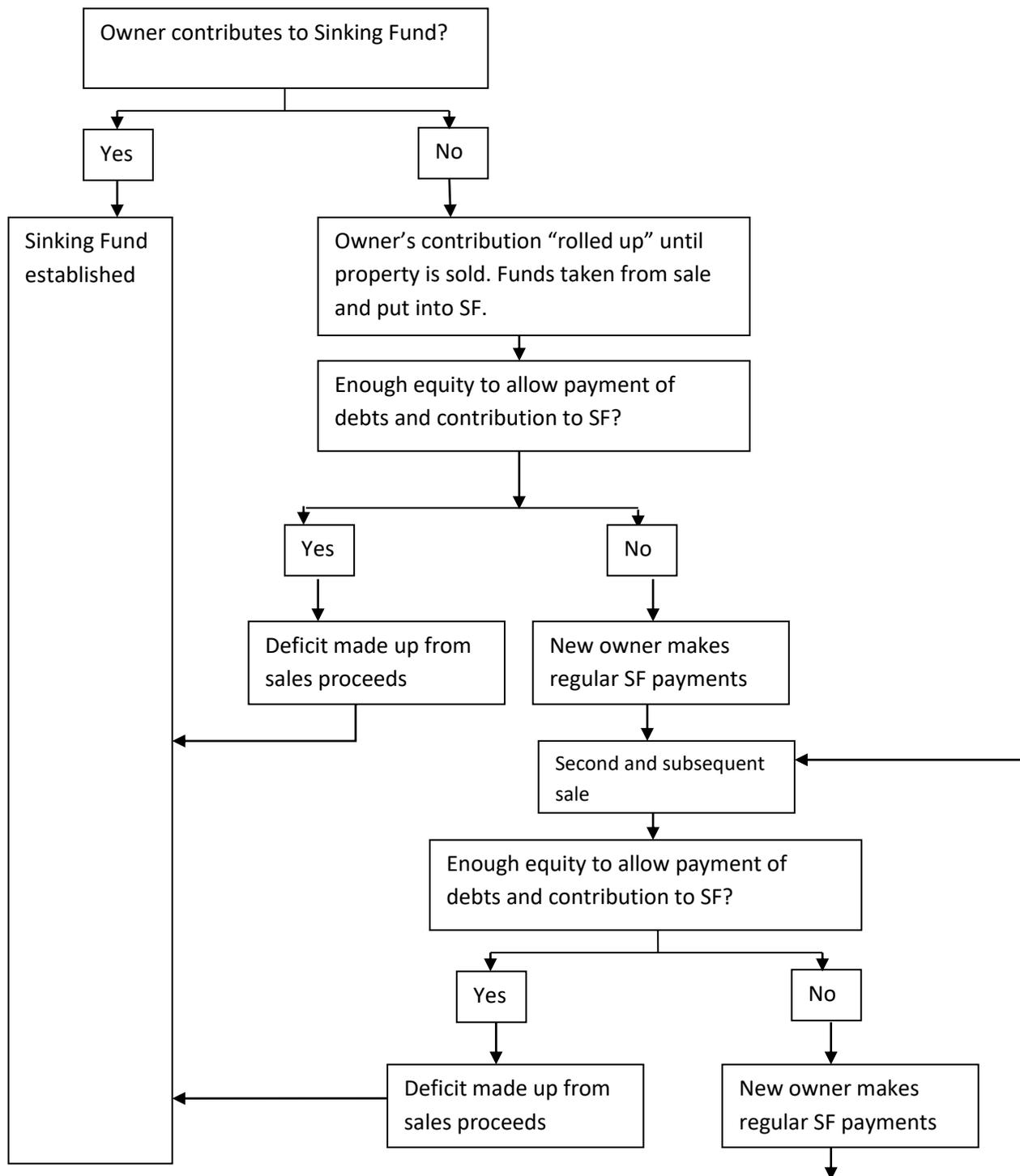
The collective SF would be managed by the same rules as apply to commissioning repairs in the tenement/development. So, if decisions about common repairs are to be made by a majority of owners, then decisions about the use of the SF would be made by the majority. The same rules of appeal as apply to making decisions about common repairs would apply to the use of the SF.

The amount paid into each individual share of the SF could be either:

- a flat rate decided by Scottish Parliament
- proportional to the amount each flat/unit is due to pay as its share of common repairs and maintenance.

The first would be easiest to legislate for.

## Establishment (and enforcement) of compulsory Sinking Funds (SFs)



Local Authorities should also be given powers to require individual tenements to subscribe a higher amount into a SF in the same way that they can currently impose Maintenance Plans under the Housing (Scotland) Act 2006. The intention here is that LAs would use these powers where they have previously supported owners to carry out common repairs and are seeking to maintain the levels of maintenance that have subsequently been achieved.

Local Authorities and registered social landlords (RSL) would not be required to pay into the SF, but, when a LA or RSL sells a flat/unit it should be required to “pay up” its share in full.

Individual owners remain responsible for paying their share of common repair costs regardless of the level of saving in “their” share of the SF. So a failure to pay into the SF would not absolve the individual of any responsibility for repair costs, they would simply have to find other ways to fund the repair. (See flow diagram)

### **Enforcement**

In establishing SFs, affordability for existing owners must be considered. For long standing owners, financial circumstances may have changed since they purchased. Enforcement therefore needs to consider how issues of affordability for existing owners is dealt with whilst also ensuring that those who can pay are incentivised to do so and are not penalised by the fact that other owners do not contribute to the SF.

Owners should be required to establish a SF and start paying into it by a specified commencement date<sup>1</sup>.

Enforcement of payment of shares into the SF should be tied into the house sales process in the same way that a charge against a property is paid off when a property is sold, any underpayment in the SF share attributable to an individual flat/unit would be paid when a property is sold. In this way, existing owners who have not yet contributed to the SF for whatever reason will not be caught up in the enforcement process until they come to sell (at which point the vast majority of owners will have available equity to make up their contribution.)

Any owner who does not pay into the fund should be required to pay a penalty or surcharge, at the time of sale or at any previous time of their choosing, the amount of which should relate to a multiple of the interest that would have been earned had payment been duly made. So if the multiplier was five, and the amount paid into the fund would have earned £100 in interest, the penalty would be £500. The penalty should be paid into the fund and distributed pro rata to the amount in the individual shares.

To illustrate:

*Flats 1 -6: each owner pays in the required contribution of, say £1000 per annum. After 3 years, their share of the Sinking Fund amounts to £3000.*

*Flat 7 and 8: the owners pay nothing. After 3 years, the owner of Flat 8 sells their property. They are due to pay £3000 into the SF, plus the penalty. This amount is taken from the proceeds of the sale and paid into the SF.*

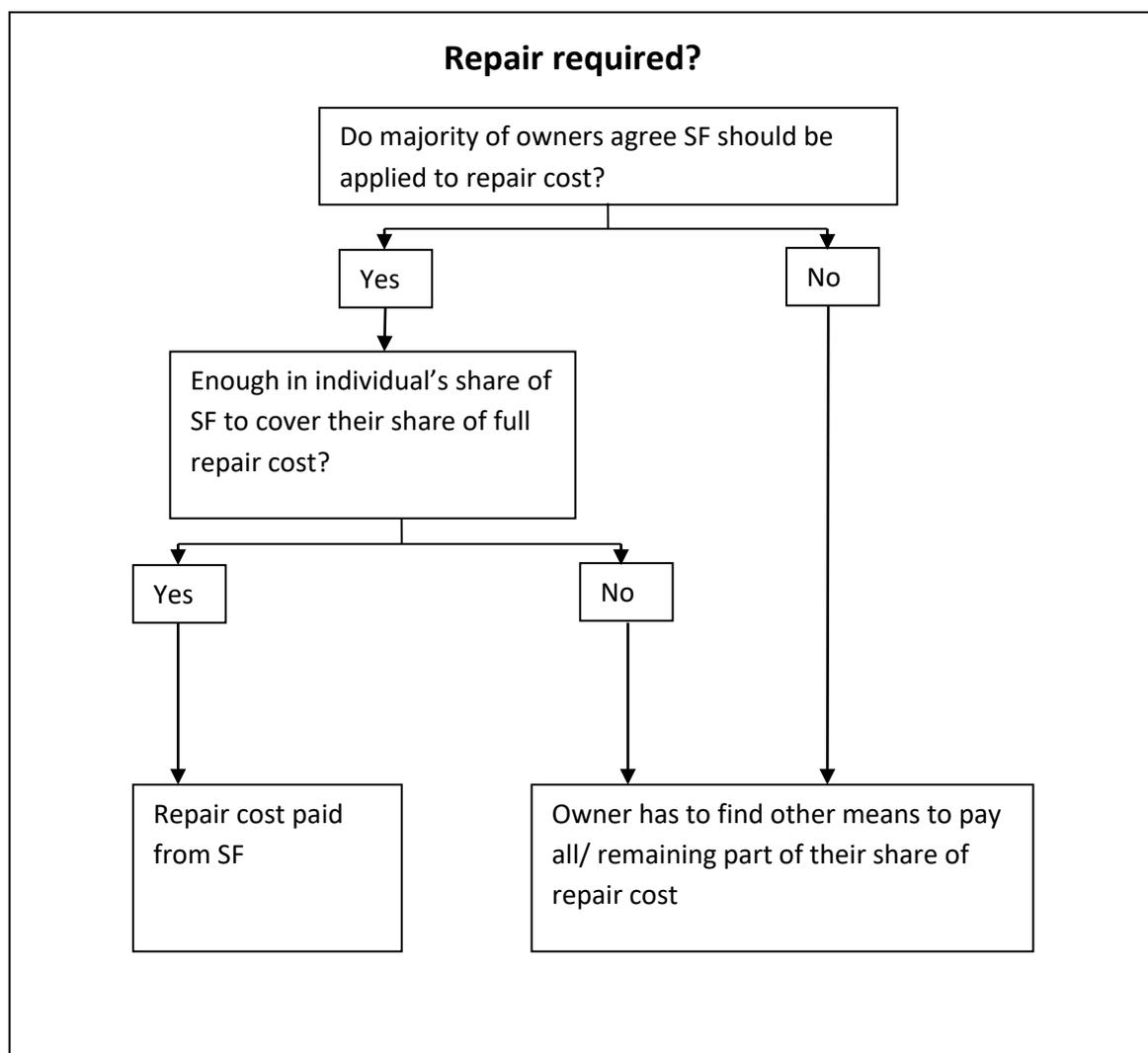
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<sup>1</sup> Even if a Development Management Scheme is established, this would be a separate requirement as it is **not** currently compulsory to establish a SF in a DMS

Suppose the £3000 contributed by each paying owner has earned £90 in interest. The fine is 5 times that - £450 - and is credited to the shares attributable to Flats 1- 6 equally. The share attributable to Flat 7 is not credited with any part of the fine as the owner of Flat 7 has not paid into the fund.

In practice, it may be that the purchaser is required to bring the SF share up to the required level and recover the cost from the seller. The purchaser is also required to pay the annual contribution to the SF from the date of the purchase. Any subsequent default would again be recovered when the property is sold.

Co-owners should have a right to know the status of the SF. This right should also extend to their registered property factor. It would also be very useful for owners and factors to know which of their co-owners have the ability to deal with upcoming major repairs so that they can plan accordingly. As the law stands, if an owner does not pay their share of common repairs then the debt will have to be met by the other owners who would have to pursue that owner by court action. There may be conflicts here with privacy issues which need to be discussed. In any case, the level of SF contribution made by any owner needs to be explicitly stated in the Home Report. A question has arisen over the ranking of the SF against other debts – any outstanding mortgage, charge or other secured debt. The SF is a commitment not a debt, it should therefore rank after actual debts. Where there is insufficient equity from a sale to cover all debts, or where a property is repossessed, this may mean that any underpayment in a SF share is carried forward to a subsequent sale.



### **What if a repair costs more than the amount in the SF?**

Using the example above, suppose a repair is required in Year 2. The cost of the repair is £20,000 and each owner's share of the repair cost is £2,500. The owners make a majority agreement that the repair cost should be paid from the SF. The owners of Flats 1-6 each have £2,000 in the SF which they put to the cost of the repair but each has to find an additional £500. The owners of Flats 7 and 8 have to find their full share of the repair cost (£2,500) from elsewhere.

### **Fiscal Management of SFs**

It is important that SFs are securely managed to protect owners' funds. We draw parallels with the management of Pension Funds. There needs to be some regulation and consideration should be given to how many of these funds the market can sustain. However, it is important that managers should have the ability to invest funds in order to grow them in line with increasing repair costs and to provide a return to owners beyond what they could achieve by keeping money in the bank. Part of the growth in funds could be used to provide services to owners such as arbitration and mediation. There is also the potential for future payments due to the fund to be used to secure loans to owners to enable them to carry out repairs which the SF is currently unable to cover. This could be a useful incentive to owners to establish and contribute to funds.

There must be a degree of transparency and openness built into the SF – it must be possible for co-owners, the registered property factor and local authorities to be able to see the fund details. The details must also be made available to potential purchasers.

### **Implications of establishing Sinking Funds on property valuation**

At present, the value of any property reflects many factors of which repair condition is a much lesser consideration compared to others. For many years after the passing of any legislation requiring the establishment of sinking funds, the level of such funds is unlikely have any significance compared to the property value. In the absence of other information it will also be difficult for owners to assess the comparative value of a flat with a high sinking fund but requiring considerable maintenance against a flat which has a low sinking fund but is in comparatively good repair. This does provide an additional incentive to include some indicative costing of repair works identified in the quinquennial survey and referred to in the Home Report.