The Reserve Study Explained

1. Capital Reserve Fund Purpose, Limitations, and Components

Capital Reserve Funds are tax-exempt savings, often substantial, that can only be used for replacements and repairs that extend the life of a property, the capital investment. They are standard in real estate, including “common interest” residential properties such as a condominiums and coops. Their purpose is to preserve the value of assets.

An example of an asset is the asphalt in a parking lot. It is an essential part of the property and contributes to its value. By rejuvenating the asphalt every 5 or so years, it will, in theory, never have to be replaced. Thus, the cost of rejuvenation every 5 years is also a Capital Reserve component.

Because interest earnings on capital reserve funds are tax exempt in certain Instances, it may be beneficial to include as many components as possible.

Having healthy Capital Reserve Funds means current residents pay for the replacement of elements, like roofs, that they are using today but future residents will have to replace. Replacing a roof will cost hundreds of thousands of dollars. Since a roof lasts ~50 years, saving for 50 years ensures that funds will be available for its replacement.

Maintenance items cannot be included in a Capital Reserve Fund. The distinction between maintenance and a repair that extends the life of an asset is more an art than a science and is ultimately determined by the IRS. The IRS is particularly sensitive to any item called "painting," which it considers maintenance. In general, maintenance items are repairs done on a regular, short-term schedule like landscaping. Replacing trees, however, would be a reserve study item because it only occurs every 20 or so years and contributes to the value of assets.

2. Cash Flow Projection Method vs. Component Method

The purpose of the Capital Reserve Study is to determine how much money a community needs to save to protect its capital investment in the property. There are two methods of doing this. One is to value each component of the property and deposit that amount into savings. As soon as each component is fully funded, the reserve contributions are reduced until that component is replaced. Some Reserve Specialists do not recommend this method because it would require immediately making a large contribution, like $400,000. that would sit in the bank for 20-50 years.

The Cash Flow Projection Method, on the other hand, uses the same measures cost and lifetime to determine how much money will be required in any given year and recommends an even savings rate that will ensure funds are available when they are needed and not before. These calculations begin with the original cost of each item, prorate the cost by expected life, adjust for inflation, and calculate the expected interest earned on savings. This allows regular deposits each year and provides a cushion in case of premature failure of major systems..

3. Inflation Rate vs Construction Inflation Rate

One key figure in the Reserve Study is the inflation rate. This rate is not the general economic inflation rate that in recent years has been about 3%. This is the inflation rate of construction costs — materials and labor. It is calculated by the Construction Specifications Institute (CSI) and for 2006 was 8.6%. It was expected to be slightly lower in 2007 but then not expected to drop significantly after that.

This rate is adjusted regionally as it is specific to geographic area.

4. Updates of the Capital Reserve Study

An annual review and recalculation is recommended to determine if replacements, additions, significant improvements, etc. done during the year; and changes in projected interest or inflation rates will require an adjustments in deposits. It does not require a site visit.

A full study is recommended every 3-5 years.

5. Combining Capital Reserve Funds and Maintenance Reserve Funds

Capital Reserve Funds and Maintenance Reserve Funds cannot be combined in savings accounts as they have different tax requirements. Maintenance expenses usually recur every 2-5 years, much more frequently than capital expenses and may have different construction inflation rates. They can most easily be conducted a the same time, by the same company.

6. Correcting Under-Funding

If current funding levels are not sufficient to meet future needs, there are several ways to remedy this. One is to increase deposits each year for an extended period, 10% each year for 20 years for example. This would mean significantly higher contributions in ten years, however, that many residents might not be able to afford.

A second method is to increase contributions immediately or make lump sum deposit in order to allow these funds to begin earning interest and avoid large future increases. Reserve Study Specialists can project results on each of these methods to determine which would work best.

Another method is to require a transfer fee on sales to fund the Reserve Study deficit. The sellers have benefited from that under funding, but their buyers and the remaining residents will bear the burden. It is reasonable to ask sellers to make a lump sum payment to cover the short fall. Assuming there are future sales, this could add lump sums, earning interest, avoid large future increases.

7. Rationale for 50- vs. 20-Year Projections

The rationale for the shorter period is that most real estate projects, hotels for example, do major replacements every 20 years and do not budget for longer periods.

Residential buildings, condominiums and coops, maintain their property for as long as possible, with no projection for tearing them down. Thus all components should be included in the study. Some studies project replacements over 100 years.

8. The Advantages of Having a Healthy Reserve Fund

a. **Preserves affordability.** Residents with limited income cannot generally afford special assessments.

b. **Protects the investment** of all residents because buildings that have healthy reserve funds are better maintained than those who don’t. (See reserveadvisors.com)

c. **Ensures solid sales.** A wise purchaser will look at the reserve funds before purchasing.

d. **Projects expenses accurately** for current and future residents.

e. **Encourages wise planning** to preserve value over extended periods rather than making short term decisions.

f. **Ensures financial security.**