WHEN TO NOT MAXIMIZE RESERVE INTEREST?

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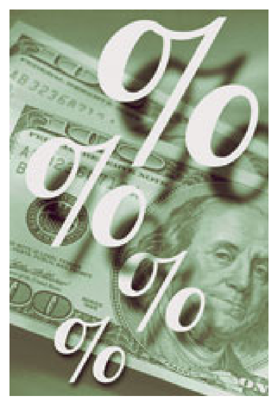
We have a hi-rise condominium client with four elevators, which have served them well for the past 25 years. With each annual Reserve Study update over the last three years, we've been recommending to the client that they replace their hallway carpeting and modernize their elevators, both large expenses. The Board of Directors of the Association authorized the replacement of the worn out carpeting in the elevator lobby areas, but decided to defer the hallway carpeting replacement and elevator modernization projects for a few more years. Fortunately their Reserve Fund is strong (i.e., it's kept pace with the ongoing years of carpet and elevator deterioration), so they have the cash necessary to accomplish these two necessary and anticipated projects.



In our last Reserve Study update, we were impressed with the amount of interest earning on their Reserve Fund. The Treasurer was proud to explain how the Association was maximizing reserve interest by committing their reserve funds to long-term (5-year) investment vehicles. Generally, maximized reserve interest is a good thing, but not in this case.

Their current Reserve Study anticipates $600,000 worth of expenses (hallway carpeting, elevators, and a few other small projects) in the next fiscal year. The Board figured they could continue to defer the hallway carpeting and elevator projects until the Reserve Funds (which were completely tied up for four more years) became available. It turned out to be a risky strategy, and they just got caught.

I received a call from the Treasurer when a prospective buyer of his neighbor's unit backed out of escrow "due to lousy hallway carpeting". The Treasurer also informed me that in the last week, two of the four elevators had gone down for expensive maintenance. The elevator service company informed the Board that it would be cheaper to do a full modernization than repair the existing elevators.

The Treasurer finally realized that our Reserve Study updates for the last three years had not been based on “pie in the sky” ideals, but the “real world” needs of the building. The Board is now confronted with penalties for early withdrawal of the Reserve Funds that they will need to accomplish these two necessary projects. Rather than benefit from the higher interest earnings, the Association is actually going to wind up losing some money in this transaction.

The moral of the story – before you lock up your Reserve money in a long-term investment vehicle to maximize your Reserve interest earnings, take a close look at your Reserve Study! Don’t gamble on making a long-term commitment of Reserve funds that you may need to spend for reserve projects in the near term. The result may be slightly less interest earnings, but the Association will avoid early withdrawal penalties and be in a position to accomplish critical Reserve projects in a timely manner.