

# RESERVE PLANNING: PRACTICAL APPLICATION (PART 4 OF 6)



by Jim Talaga, RS  
President  
Association Reserves – WA LLC

August 2014

[www.reservestudy.com](http://www.reservestudy.com)

In our [June newsletter](#) we looked at the decision points for which components are deemed appropriate within the reserve study versus those factored in the operating budget. We looked at guidance provided by [National Reserve Study Standards](#) and [Washington law](#).

At a recent association meeting, this question was posed “**Why would we ever want a reserve fund with more than \$1,000,000 in it!?**” To answer this question (you may sense a theme here), we will again look to National Reserve Study Standards and Washington law for guidance.

So how much should you have in reserves? There is no mandate in the State of Washington. **Reserve funding levels, if any, are at the discretion of the Board as they establish the budget and financial risk management policies of the association.** RCW 64.34.380 (1) “An association is **encouraged** to establish a reserve account with a financial institution to fund major maintenance, repair, and replacement of common elements, including limited common elements that will require major maintenance, repair, or replacement within thirty years. **If** the association establishes a reserve account, the account must be in the name of the association. The board of directors is responsible for administering the reserve account”. Reserve study providers are to make a recommendation for a reserve contribution rate and funding plan. Associations must disclose the reserve study to prospective buyers, and reserves cash flows of both the professional recommendation and *their* proposed budgeted rate to current owners within the budget process (see RCW 64.34.308). *Note: HOA’s have similar language in RCW 64.38.* See the funding plan tab in our [library](#). Be aware that some Declarations and the mortgage market have requirements for reserve accounts and funding levels. For example, Fannie Mae currently requires that associations budget a minimum of 10% of the total annual operating expenses for reserves, and some Declarations state the association **must** maintain “reasonable” or “adequate” reserves.

Now the specific question of **“Why would we ever want a reserve fund with more than \$1,000,000 in it!?”** My first thought might be they have an expense of \$1,000,000 or more to prepare for! Secondly, in the course of a funding plan to achieve a strong low-risk reserve funded status within 30 years (statutorily required study period), balances that high may be needed. And factoring inflation 30 years into the future \$1,000,000, although significant to be sure, won’t be worth what it is today. The key is to look at the reserve cash flow summary in the study (see below) to see the recommended income and expenses over the next 30 years.

Year	Starting Reserve Balance	Fully Funded Balance	Percent Funded	Rating	Annual Reserve Contribs.	Loans or Special Assmts	Interest Income	Projected Reserve Expenses
2013	\$100,000	\$444,547	22.5%	Weak	\$72,360	\$0	\$845	\$104,100
2014	\$69,105	\$414,845	16.7%	Weak	\$74,531	\$0	\$1,069	\$0
2015	\$144,705	\$524,979	27.6%	Weak	\$76,767	\$0	\$1,350	\$97,497
2016	\$125,324	\$495,130	25.3%	Weak	\$79,070	\$0	\$1,255	\$79,769
2017	\$125,880	\$484,290	26.0%	Weak	\$81,442	\$0	\$1,567	\$21,216
2018	\$187,673	\$535,129	35.1%	Fair	\$83,885	\$0	\$2,236	\$14,085
2019	\$259,709	\$596,583	43.5%	Fair	\$86,402	\$0	\$2,586	\$90,987
2020	\$257,710	\$582,468	44.2%	Fair	\$88,994	\$0	\$2,644	\$78,035
2021	\$271,312	\$583,121	46.5%	Fair	\$91,663	\$0	\$3,071	\$22,865
2022	\$343,182	\$642,526	53.4%	Fair	\$94,413	\$0	\$3,832	\$17,875
2023	\$423,552	\$710,816	59.6%	Fair	\$97,246	\$0	\$4,091	\$129,890
2024	\$394,999	\$667,803	59.1%	Fair	\$100,163	\$0	\$4,471	\$0
2025	\$499,633	\$759,370	65.8%	Fair	\$103,168	\$0	\$5,362	\$35,002
2026	\$573,161	\$819,777	69.9%	Fair	\$106,263	\$0	\$6,111	\$35,906
2027	\$649,630	\$883,276	73.5%	Strong	\$109,451	\$0	\$6,576	\$99,604
2028	\$666,052	\$885,347	75.2%	Strong	\$112,735	\$0	\$6,297	\$191,163
2029	\$593,921	\$795,521	74.7%	Strong	\$116,117	\$0	\$6,508	\$8,264
2030	\$708,282	\$893,800	79.2%	Strong	\$119,600	\$0	\$7,579	\$27,355
2031	\$808,106	\$977,852	82.6%	Strong	\$123,188	\$0	\$8,120	\$122,745
2032	\$816,669	\$968,735	84.3%	Strong	\$126,884	\$0	\$8,721	\$24,023
2033	\$928,251	\$1,063,669	87.3%	Strong	\$130,690	\$0	\$9,651	\$65,742
2034	\$1,002,850	\$1,121,198	89.4%	Strong	\$134,611	\$0	\$10,751	\$0
2035	\$1,148,211	\$1,250,967	91.8%	Strong	\$138,649	\$0	\$11,950	\$55,950
2036	\$1,242,861	\$1,329,885	93.5%	Strong	\$142,809	\$0	\$13,203	\$0
2037	\$1,398,872	\$1,471,770	95.0%	Strong	\$147,093	\$0	\$14,510	\$56,207
2038	\$1,504,268	\$1,563,078	96.2%	Strong	\$151,506	\$0	\$15,745	\$25,439
2039	\$1,646,080	\$1,691,966	97.3%	Strong	\$156,051	\$0	\$17,054	\$53,052
2040	\$1,766,132	\$1,799,527	98.1%	Strong	\$160,732	\$0	\$17,522	\$204,692
2041	\$1,739,695	\$1,757,469	99.0%	Strong	\$165,554	\$0	\$16,489	\$362,293
2042	\$1,559,444	\$1,555,263	100.3%	Strong	\$170,521	\$0	\$11,764	\$947,339

In this example you can see significant expenses to prepare for in the far right column.

**And what happens to the association if the proposed budgeted rate differs from what is recommended in your reserve study?** Along with no funding level mandate, Washington law does not provide for penalty – the association must simply disclose the recommended rate and funding plan by the professional along with the cash flow from the proposed contribution rate. See RCW 64.34.308 (condo’s) and 64.38.025 (HOA’s).

With reserve studies being required for most associations in Washington, one can quickly and easily compare the relative financial strength by looking at the Percent Funded (reserve health snapshot at time of report), reserves disclosure (reflects current board policy of future financial direction) and in an Association Reserves study, the per unit deficit or surplus (see below - difference between reserve starting balance and Fully Funded Balance divided by number of units).

<b>Projected Starting Reserve Balance:</b> .....	<b>\$100,000</b>
<b>Fully Funded Reserve Balance:</b> .....	<b>\$444,547</b>
<b>Average Reserve Deficit (Surplus) Per Unit:</b> .....	<b>\$6,891</b>
<b>Percent Funded:</b> .....	<b>22.5%</b>
<b>100% Full Funding 2013 Monthly Reserve Contribution</b> .....	<b>\$6,030</b>
<b>70% Threshold Monthly Reserve Contribution</b> .....	<b>\$5,280</b>
<b>Baseline Contribution (min to maintain reserves above \$0)</b> .....	<b>\$3,800</b>

This approach views the reserves as equity and allows the associations to establish the financial risk management policies as they see fit. The market then determines any adjustment in unit sales price based upon comparison of any variance in funded status and/or policies of different associations.

The 100%, 70% and Baseline contribution rates shown above are those computed to reach different long term funding objectives in light of the association’s current status of 22.5% funded. In this example, to get from 22.5% to 100% by the end of the 30 year plan, the association should budget monthly reserve contributions of \$6,030. To reach 70% \$5,280, and to maintain a reserve balance above \$0 in any of the 30 years, \$3,800. Washington law requires reserve studies to provide the 100% target (low risk – reserve cash equals accrued deterioration of components) and Baseline rate (high risk – reserve minimums). **Again, you choose!**