

CAPITAL RESERVE FUNDING AND UNDERSTANDING S2760/A4384

NJ Coalition of Lake Associations

David Chesky, P.R.A. R.S.
Executive V.P. – Civil Division
Dchesky@falconengineering.com

95 Mount Bethel Rd
Warren, NJ 07059

66 York Street, 4th Floor
Jersey City, NJ 07302

(908) 595-0050
www.thefalcongroup.us

Breaking Point:

EXAMINING AGING INFRASTRUCTURE
IN COMMUNITY ASSOCIATIONS

Historical Context -

FACING THE TRUTH ABOUT AGING INFRASTRUCTURES

“As buildings and their internal systems and physical components age, how can the community associations that own them best prepare to meet the unexpected—but necessary—financial demands.”

*Issued in 2020 prior to Surfside Collapse



Historical Context – Breaking Point Con.

80% surveyed felt it was critical that their association have adequate reserves in the event of a major construction need. Only 40% considered deteriorating infrastructure as a top-ranked concern. 70% indicated that maintaining property values was of primary importance of reserve funding. Half of respondents felt their communities reserve funds were inadequate.

Capital Reserve Fund Analysis – What is it?

- A process of identifying, quantifying, and financing the replacement and maintenance of a community's common elements.
 - Physical Analysis
 - Financial Analysis
- Three Levels
 - Level 1 – Full Study
 - Level 2 – Update with a Site Visit
 - Level 3 – Update without a Site Visit



Capital Reserve Fund Analysis – What's the Purpose?

■ The Purpose of Capital Reserve Analysis:

- To offer recommendations as to the amount of monies an Association or other form of ownership should fund on a yearly basis for the future replacement of commonly owned elements.
- The Analysis and Recommendations are important in that they help to avoid possible future special assessments of the individual unit owners.
- The Analysis should take into account the site specific existing conditions, their useful life, and the realistic replacement costs based upon actual material costs and the site specific individual item's method of reconstruction.



Capital Reserve Fund Analysis – Why Should we do it?

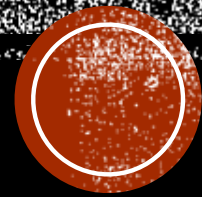
- Why should the Association perform a Capital Reserve Fund Analysis?
 - Because it meets **legal, fiduciary, and professional** requirements. A replacement fund may be required by:
 - Any secondary mortgage market and/or individual purchaser or lender.
 - State statutes, regulations, or court decisions
 - The community's governing documents
 - It provides for the **planned replacement** of major items that must, at some point in time, be replaced.
 - It **minimizes the need for special assessments**. Homeowners, especially those on fixed incomes, may have limited resources. They may be unable to afford the large special assessments necessary for major replacements.



Capital Reserve Fund Analysis – Why Should we do it?

- **Why should the Association perform a Capital Reserve Fund Analysis?**
 - A replacement fund **enhances resale values**. Lenders and real estate agents are aware of the ramifications for new buyers if the replacement reserves are inadequate. Many states require Associations to disclose the amounts in their reserve funds to prospective purchasers.
 - **Accounting standards require** that proper attention be paid to the replacement fund.
 - **Benefits to Boards/Managers** – because it maintains your community, it therefore reduces the frequency of dealing with angry homeowners and sub-standard construction as well as reducing meeting frequencies.





Who Needs It and Who Should Prepare It???

- Any planned real estate development with \$25,000 in assets or greater shall undertake and fund a capital reserve study.
- All capital reserve studies shall be prepared in conformance with the latest edition of the National Reserve Study Standards of the Community Associations Institute or similar standards by another recognized national organization (Association of Professional Reserve Analysts).
- A capital reserve study shall be performed or overseen by a reserve specialist who is credentialed through the Community Associations Institute/Association of Professional Reserve Analysts or an engineer or architect who is licensed by the State.

**Translation: have reserve analyses
prepared by professionals –
Studies shall not be prepared “in house”**



What Should the Report Include?

The reserve study shall include, but be not limited to the following:

- The association's capital reserve fund balances.
- The association anticipated income and expenses.
- An analysis of the physical status and of the common area components of the buildings and other common areas that the association is obligated to maintain.
- The anticipated cost associated with the building maintenance, as well as the anticipated cost of repair or replacement of common area building components, that the association is obligated to maintain.
- A reasonable estimate of the cost of
 - Future reserve studies/Updates
 - Periodic structural inspections that may be required for "Covered Buildings"
- A reasonable estimate of the cost associated with implementing any corrective maintenance deemed necessary pursuant to Structural Inspections for "Covered Buildings"
- A proposed 30-year fund plan that establishes the adequate proposed capital reserve funding over a 30-year time period. This is where the funding methodologies are presented and include Full Funding (Component Method), and Baseline Funding, Threshold Funding Methodologies (Cash Flow Methods)
- Any other information necessary to perform an analysis of the adequacy of the association's capital reserve fund relative to maintaining the structural integrity of buildings and common areas which the association is obligated to maintain.

New Stuff

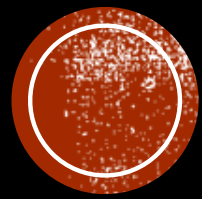


When Should We Do It?

- Associations are now required to update their Reserve Studies at least once every five (5) years (Although industry standard and our recommendation is to update every three (3) years).
- Some Associations that have had recent studies prepared may benefit from having a Level 3 study (Administrative/Paper Update) conducted at this time as it will correct for any deficiency/shortfall in funding as well as bring the study into compliance with the current study requirements.

SENATE BILL 2760 - TIMING FOR RESERVE STUDIES	
Last Reserve Study Completed	Update Reserve Study By:
Never had a Reserve Study	Need a Full Study (Level 1) by January 8, 2025
Prior to January 8, 2019	Level 1 or Level 2 study by January 8, 2025
Associations Formed after January 8, 2024	As soon as possible after election of an executive board and no more than two (2) years following election of the Board - Level 1
After January 8, 2019	No more than every five (5) years, recommended every three (3) years





RESERVE FUNDING AND EXPENDITURES




Can We Assess or Take Out a Loan for Projects?



- Associations shall obtain a reserve study including a 30-year funding plan in order to ensure that the association has adequate reserve funds available to repair or replace the capital assets and facilities that the association is obligated to maintain without need to create a special assessment or loan obligation.
- In cases where a capital asset reaches the end of its established useful life earlier than predicted by the reserve study, nothing in the legislation is intended to prevent the Board from imposing a special assessment or obtaining a loan.
- Translation – you cannot base your reserve study on the assumption of scheduled “special assessments” or taking out a loan. Special assessments and loans are for when things have gone awry unexpectedly.



- These reserve funds shall be used for the repair or replacement of components that have reached the end of their established useful life as set forth in the most recent reserve study.
- When an expenditure of the reserve funds is required to repair or replace a component, the association shall use only the amount of reserve funds allocated by the reserve study to make that repair or replacement. The Association may “borrow” monies from the reserve fund only if the following two conditions are met:
 - The use of such additional funds from the reserve fund is not reasonably anticipated to prevent or interfere with the ability of the association to undertake additional repairs or replacements in the five (5) years subsequent to the additional expenditure.
 - The association’s executive board adopts a written resolution requiring that the expenditure of these additional funds shall be recovered within the following five (5) fiscal years.



**This is why you
shouldn't go
light on
cost estimates.**



**This is why
you should
not be baseline
funding.**



How Do We Make Up Deficits in Funding?

- If an association does not have an adequate reserve fund and the increase in the association's budget line item for reserve funding to render it adequate as set forth in the reserve study would require an increase of more than 10% of the previous year's common expense assessment, the deficiency shall be made adequate within the earlier of the following ten (10) fiscal years, or the projected date predicted by the reserve study which absent increased funding, the balance in the association's reserve account would fall below zero. In either case, the annual increase in reserve funding during the required period of time shall be an equal annual line-item increase in the reserve fund until the reserve fund is made adequate, notwithstanding causing an increase of more than 10% in the annual common expense assessment.
- If an association does not have an adequate reserve fund and the increase in the association's budget line-item for reserve funding to render it in conformity with the reserve study would require an increase of less than 10% of the previous year's common expense assessment, the deficiency shall be made adequate within the following two (2) fiscal years



**FOR YOUR CONSIDERATION:
THE HYPOTHETICAL
ASSOCIATION**

Happy Valley Lake Association

- Happy Valley Lake Association had a Reserve Study prepared in 2022.
- The 2022 Reserve Study recommended an annual contribution of \$250,000 beginning in fiscal year 2022.
- Happy Valley Lake Association Board decided that they were going to ignore the study and contribute only \$50,000 to the reserve fund.
- This creates a deficit of \$200,000 in reserve funding annually.



**FOR YOUR CONSIDERATION:
THE HYPOTHETICAL
ASSOCIATION**

Happy Valley Lake Association has two (2) options:

Option 1 -

- In order to comply with the new law, the Association can (and should) conduct a level 2 reserve update which will re-calculate the annual contribution requirements incorporating updated life cycle information, updated cost information, historical replacement information, etc.
- This recalculation of the recommended annual contribution will factor in any deficit from lack of funding from prior years.
- The Association is required to increase its annual funding to one of the provided/recommended funding methodologies in the updated study.



FOR YOUR CONSIDERATION: THE HYPOTHETICAL ASSOCIATION

Happy Valley Lake Association has two (2) options:

Option 2 – the Association does not need to update the study until 2027 based upon the legislation

- If the Association decides to not update the study now, in order to comply with the new law, the Association is required to increase its annual funding to \$250,000 for the 2025 fiscal year.
- In addition, the Association is required to make up the deficit in funding from prior years. This deficit makeup is calculated as follows:
 - Since the Association only funded \$50,000 of the required \$250,000 annually, the deficit is \$200,000 per year.
 - The Association has been funding at this level without increases since the last study was prepared in 2022. That amounts to three (3) years (2022, 2023 and 2024) of inadequate funding or \$200,000 x 3 years for a total of \$600,000.
 - The Association will need to compare the total deficit of \$600,000 against its previous years common expense assessment. If the \$600,000 is more than the previous years common expense assessment, then the Association has 10 years to make up the deficit equally spread over the 10 years or the projected date predicted by the reserve study which absent increased funding, the balance in the association's reserve account would fall below zero.



FOR YOUR CONSIDERATION: THE HYPOTHETICAL ASSOCIATION

Happy Valley Lake Association has two (2) options:

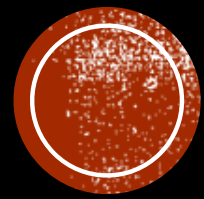
Option 2 – the Association does not need to update the study until 2027 based upon the legislation – continued...

- The Association will need to compare the total deficit of \$600,000 against its previous years common expense assessment.
 - If the \$600,000 is more than the previous years common expense assessment, then the Association has 10 years to make up the deficit equally spread over the 10 years or the projected date predicted by the reserve study which absent increased funding, the balance in the association's reserve account would fall below zero. Hypothetically, this would result in an additional \$60,000 per year added to the \$250,000 contribution for a total of \$310,000 for ten (10) years.
 - If the \$600,000 is less than the previous years common expense assessment, then the Association has two (2) years to make up the deficit. Hypothetically, this would result in an additional \$300,000 per year added to the \$250,000 contribution for a total of \$550,000 each year for two (2) years.

The make up funding scenario presented above would only apply until a new reserve study is conducted at which time the reserve study should re-calculate the funding incorporating any funding deficits from prior years.

*** The above scenarios are for explanatory purposes only***





BOARD LOAN AND SPECIAL ASSESSMENT POWERS



Some More on Assessments and Loans

- Notwithstanding the terms of governing documents of an association, the Board may, without the consent of the owners or approval of a developer selling units in the planned real estate development, adopt an assessment payable by the owners over one or more fiscal years or obtain a loan on such terms as the board determines are reasonable, whenever necessary to fund the cost of corrective maintenance of the primary load bearing system of the planned real estate development
- Prior to adopting an assessment or obtaining a loan, the Board shall make a determination that the assessment or loan is necessary to maintain structural integrity of the building and shall obtain a written report from an engineer or architect licensed by the State that states that the failure to undertake corrective maintenance of the primary load bearing system will:
 - Constitute an imminent or reasonably foreseeable hazard to health or safety.
 - Constitute a violation of section 3 of the Legislation.
 - Will result in a material increase in the cost of such corrective maintenance if delayed.

