A Risk Management Approach to Reserve Fund Planning: How Much is Enough?

By Jeff Truman, PEng, PMP

THERE IS a fair amount of debate as to when a condominium corporation's reserve fund is adequately funded. Accountants like the inflation matched approach, which is often used by businesses to maximize their revenue stream. A "no deficit" approach is often too simplistic, as it aims only to ensure reserve balances meet planned expenditures on an annual basis. What happens when the boilers fail the fall after a summer wall restoration program has been completed? What is the right approach to funding? How can a corporation and their property manager reduce these risks?

Historical Effect

The *Condominium Act* of 1998 was put in place partly to address serious shortcomings in the financial health of condominiums. The condominium stock in Ontario, and particularly the GTA had reached a point where significant expenditures were being required for building repair projects. Special assessments were often required. This unfairly punished current owners, resulting in many having to give up their units or obtain additional financing.

The Act is really only a blunt instrument, in that it requires that the Board shall review (the reserve plan) and propose a plan for future funding... (that will ensure) the fund will be adequate for its intended purposes". The italics are intended to emphasize the non-specific nature of the requirement. Further, Corporations were given until 2004 to have such a plan fully in place. Because reserves are updated on a 3-year cycle, we have thus only had two full cycles of reserve fund studies since the Act was enforced.

Accordingly, many condominiums may still not be adequately funded, or exposed to risk of special assessment. Other recent factors, such as construction inflation and the HST, have also created concerns. So how can a corporation do better?

Risk Management: A Better Way

A risk-based approach to project planning seeks to identify the potential risks, their impact, and devises appropriate remedial measures that reduce or manage the impact of the risk event. The Project Management Body of Knowledge (PMBOK), the governing standard of project management processes, published by the Project Management Institute (PMI), defines Risk Management as one of the 12 primary project management processes.

The objective of risk planning is to "...increase the probability and impact of positive risk events, and decrease the probability and impact of negative risk events."

What Are The Risks?

The primary risk to a reserve fund plan is that expenditure requirements exceed the reserve fund amount in any given year. This can happen due to:

1. *Sudden, unforeseen expenditures:* e.g., boiler failure, storm damage, roof or garage membrane failure
2. *Regulatory changes:* e.g., fire safety enhancements, life safety changes (e.g., Window openings limited),
3. *Cost changes:* e.g., inflation, labour cost changes, tax changes (such as the HST!)
4. *Financial Market changes:* e.g., reduction in investment gains, losses.

Since the corporation cannot manage or affect these risk events, they must therefore somehow mitigate their effect via the Reserve Plan. One way is to set reserve contributions so high that the reserve fund can accommodate any event.

However, a large reserve fund does not translate directly into benefits for the unit owners, and higher contribution amounts can scare off potential buyers. A complete analysis and plan is required.

A Complete Plan: What Are The Critical Aspects?

The following aspects are critical in developing a complete reserve study.

Threshold: Many reserve planners use the *Condominium Act's* $500 limit regarding board-approved expenses as the threshold for repairs. However, this can unnecessarily inflate contribution requirements for items that are essentially operating expenses.

Contribution Amounts: They should be equalized over time to have minimal impact on individual owners' financial health. Spikes in planned expenditures drive contribution requirements, and reduce the positive impact of interest earnings. Current and future owners' interests are balanced, ensuring a fair allocation of contributions over the life of the building. In developing a funding plan, the following variables should be considered.

A fully vetted reserve plan should be created by testing different combinations of the variables to meet these and the board's stated objectives. Sensitivity analyses can be employed to highlight those variables with the biggest impact on the Reserve Plan and Contribution Amounts. Projects should be analyzed for time of recurrence and whether they could be phased in to minimize annual project expenditures. This analysis enables the Planner to determine the actual impact of longer-term versus nearer-term projects and ensure your funding goal is met, as well as earn significantly more interest over the term of the fund.

Planning horizon: Although the Act requires a 30-year analysis,

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certain scenarios increase the impact on contribution amounts. One example is that amounts to cover major repairs at the 5-year horizon typically cover any major repair beyond that time frame; major capital expenditures beyond the 5-year time frame will then have less impact on current contribution requirements. Inflated contribution rates and reserve amounts can result. Conversely, as for new buildings, replacement requirements beyond the 30-year horizon may need to be considered so contribution amounts can be set to earn more interest over time.

Building Renewal: The long-term value of the building is determined by the condition of its physical assets. Maximizing asset value should contemplate component renewal to achieve a complete facility renewal over about 20-25 years, or as the corporation requires.

"Least Required" Reserve: A balanced approach avoids unnecessarily inflating the reserve, providing adequate amounts for required repairs while minimizing each Owner's current obligations. Inflated reserve balances can often result in unnecessary repair programs recommended by overzealous consultants. It is this consideration which factors most significantly into the risk analysis.

What Should Be Our Funding Goal?

The Funding Goal varies for each corporation, depending on the corporation's age and condition of its assets. When significant projects are anticipated in the near term, these tend to drive the required contribution rate to achieve the goal of being fully funded more so than longer-term projects. Special assessments are often required to "ramp-up" to near-term projects if a stable contribution rate is desired over the long term. Corporations with older assets are typical of this scenario. For corporations with newer assets, longer-term significant projects tend to drive the required contribution rate.

Meeting the requirement of the Act only requires a corporation to have sufficient funds to meet the planned expenditures. If expenditures occur earlier than planned, or the economic climate deteriorates, this level of funding exposes the corporation to the risk of Special Assessments or deferred maintenance, which increases the future cost.

What About Replacement Costs?

The most reliable cost estimates are based on actual repairs. The corporation's and property manager's own experience is therefore critical. Maintenance vendors canprovide service history, projections and other information specific to the component in question. Long-serving board members are well aware of historical successes and failures.

In the absence of "actual" costs, the planner should apply their experience with similar components in similar projects/properties. Reserve planners with experience performing actual repairs are an invaluable asset. Building restoration consultants are aware of the specific issues that might affect costs, such as access, type of construction, and inflationary pressures.

In the absence of all other data, planners can rely on industry-standard cost guides. However, these cost guides are typically taken from large sample sizes, and will not reflect the positive or negative impact of the either the contractor's or consultant's expertise.

It is also important to set replacement cycles so that "spikes" in the year-to-year planned expenditure amounts are limited. When standard replacement cycles (5, 10, 15 years) are used, planned expenditures can "spike" in one of those years, say year 20 or 30. This spike then determines the contribution requirements, which often end up being higher than if that spike was spread over several years.

Phasing large projects, such as roof or window replacement, is a simple way to avoid those larger spikes. Smoothed expenditures and contributions are the best way to take advantage of the time value of money, and earn more interest for the reserve over time.

How Much Reserves Are Enough? How Do You Know?

In terms of quality management, project success is defined by client satisfaction, which typically takes the form of time, cost and quality. In that sense, the truest measure of how much reserves are enough is whether the reserves meet the needs of the corporation. So how can you define what a corporation needs?

Corporations are required by the Act to be "fully funded", where the annual reserve balance is adequate to fund that year's anticipated expenditures. This requirement actually presents a minimum condition, as corporations are free to choose the replacement life on many building components, impacting the building renewal period. For example, the board may elect to renew items such as finishes on a more frequent basis to maintain building value.

As pointed out earlier, the minimum conditions present a risk in the event of sudden required expenditures. The alternative, to grossly inflate the reserve balance, is not fiscally prudent. So what is the answer?

Annual Funded Ratio (AFR)

A measure we use to assess the health of the Reserve is the "Annual Funded Ratio (AFR)" – the 3-year moving average of the reserve starting balance to the planned expenditures.

Many industries typically utilize three and seven – year moving averages when forecasting trends. We use a three-year period, as it matches the Reserve Study update period as defined by the Act. Using a 3-year moving average allows the AFR to look forward to the future health of the Reserve Fund, and acts as a barometer on the relative health of the reserve.

Close

Like any financial plan, a well crafted RFS is an asset to the corporation and enhances the value of each owner's unit. It includes an assessment of the risk appetite of the client, which requires input from the board, the property manager, and parties most familiar with the building, including service trades. This also requires a thorough understanding of risk events, their probability and potential outcomes associated with those events. A planned approach that incorporates these aspects reduces the financial risk for the corporation.

Jeff Truman, PEng, PMP, of Truman Services Inc. can be reached at 416-4 TRUMAN or by email at jeff@truman.ca.