

## Reserve Fund – What Is It And Why Is It Important?

### Guidance

Always consult the bond covenants or loan agreement to determine the specific definition and requirements for a Reserve Fund. If a Reserve Fund is required, this may involve consultations with your Financial Advisor and or bond counsel.

### Overview

A Reserve Fund is permanent savings set aside as long-term savings for the life of the bond or loan. Normally, a reserve fund cannot be used for any purpose other than to pay off the final year of indebtedness.

In amount, a minimum requirement for a Reserve Fund approximates one year of debt service. In some instances, a Reserve Fund is fully funded at closing. Some Reserve Funds have an amount predefined in the covenants and no supporting calculation is needed. In all other instances where a Reserve Fund is required, the amount necessary is based on a calculation derived from the covenants.

If the Reserve Fund is not fully funded upon closing or does not have a predefined amount, the most prescribed calculation involves the Average Annual Debt Service (AADS).

AADS is simply the total of any remaining unpaid principal and interest, divided by the remaining number of years.

Once determined, the amount of AADS is divided by 60, producing the minimum monthly amount to deposit into the Reserve Fund account. Over five years (60 months), the Reserve Fund becomes fully funded.

Because a Reserve Fund is set aside for the life of the loan, withdrawals from the Reserve Fund should rarely if ever be made other than to pay the final year of principal and interest requirements.

### Caution:

- Withdrawals from the Reserve Fund should be avoided if possible other than for final payment of debt service. Before withdrawing Reserve Funds, contact your Financial Advisor, bond counsel, and or Financial Compliance promptly.
- If for any reason a withdrawal of Reserve Funds is made, this may trigger a requirement to file public notice of the withdrawal. This is the “Continuing Disclosure” requirement contained in most bond covenants and involves posting a public disclosure notice on a website (EMMA) maintained by the Municipal Securities Rulemaking Board (MSRB).
- Premature disbursement of Reserve Funds may be indicative of financial hardship.

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- The AADS calculation may change slightly each year (depending on the amortization schedule), and this may require an annual “true up” calculation of the Reserve Fund requirement. Therefore, the Reserve Fund balance should be checked for adequacy not later than the fourth quarter of the fiscal year to allow full compliance by fiscal year end.
- Noncompliance with Reserve Fund requirements (or any bond covenant compliance) can adversely affect the ability of a borrower to obtain new financing.

### Best practices

Periodically evaluate compliance status – Annually (at a minimum), it is helpful to review all bond covenant requirements, typically in the fourth quarter of the year. Corrective action, if needed, can be taken to assure covenant compliance occurs by fiscal year end.

Report on compliance status in the Annual Financial Report (AFR) - The audited financial statements should report each year on the status of compliance with covenant requirements, including whether the Reserve Fund is funded at a level to provide covenant compliance.

- Suggested comment in footnotes of AFR – “Management believes it (is/is not) generally compliant with all applicable requirements of bond covenants.”

Disclose balances of actual and required Reserve Fund balances - Footnote disclosure in the Annual Financial Report (AFR) ideally should include enough level of detail to determine if bond compliance exists regarding funding of Reserve Fund requirements for each bond series. Proper disclosure makes compliance status very clear.

Separate and apart - If bond covenants require a Reserve Fund to be “separate and apart from all other funds and accounts,” this is generally interpreted to mean separate bank accounts as well as a separate account in the general ledger for transactions within this fund.

### Questions?

Consult with your Financial Advisor for guidance on how to calculate your Reserve Fund. For legal questions, always consult your legal counsel. Your Certified Public Accountant may also be helpful. You may contact Financial Compliance for further assistance.

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### Example Illustration of Reserve Fund Footnote Disclosure:

Reserve Funds - Requirements and Actual Balances at FYE xx/xx/xxxx						
	Series 2014	Series 2015	Series 2016	Series 2017	Totals	Reference to Financial Statements
Actual Balance	\$25,500	\$45,500	\$25,500	\$60,500	\$157,000	Debt Service Fund, AFR page 23
Required Balance	\$25,000	\$45,000	\$25,000	\$60,000	\$155,000	
Balance in Excess (Short) of Minimum Requirements	\$500	\$500	\$500	\$500	\$2,000	

Management believes it is currently compliant with applicable requirements of bond covenants that require Reserve Funds.

Calculation of Average Annual Debt Service		
Year of Maturity (payoff)		2041
Current Year		2021
Remaining Number of Years		<u>20</u>
Remaining Principal Payments		\$20,000,000
Remaining Interest Payments		\$2,500,000
Total Remaining Debt Service		<u>\$22,500,000</u>
Total Remaining Debt Service		\$22,500,000
Remaining Number of Years	=	<u>20</u>
<b>Average Annual Debt Service</b>	=	<u><u>\$1,125,000</u></u>

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Calculation of Reserve Fund			
Assumption: Closing and funding requirements begin on January 1, 2021 of the fiscal year. (Reserve Fund requirements will begin based on guidance from the bond covenants.)			
Average Annual Debt Service (AADS) =			\$1,125,000
Months Allowed To Fund the Reserve Fund			60
Minimum Monthly Deposit to Reserve Fund			\$18,750
First Year Deposits Would Look Like This:			
Month and Year	Monthly Minimum Deposit	Cumulative Reserve Fund Balance At Month End	Month # of 60
January, Year 2021	\$18,750	\$18,750	1
February	\$18,750	\$37,500	2
March	\$18,750	\$56,250	3
April	\$18,750	\$75,000	4
May	\$18,750	\$93,750	5
June	\$18,750	\$112,500	6
July	\$18,750	\$131,250	7
August	\$18,750	\$150,000	8
September	\$18,750	\$168,750	9
October	\$18,750	\$187,500	10
November	\$18,750	\$206,250	11
December	\$18,750	\$225,000	12
December, Year 2022		\$450,000	24
December, Year 2023		\$675,000	36
December, Year 2024		\$900,000	48
December, Year 2025		\$1,125,000	60