

HOW MUCH SHOULD WE FUND OUR RESERVES?



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There once was a man with one foot in a bucket of scalding hot water and one foot in a bucket of ice water. When asked how he felt, he said, “On the average, I feel just fine!” Keep that warning about averages in mind as we ask: how much should your association budget to fund Reserves?

Sufficient Reserve Funding

Typically (that is a dangerous word), most associations should be setting aside 15–40% of their assessments towards Reserves. Interestingly, this ratio is consistent among condo associations, townhome-style associations, and single-family home associations. That’s because associations with more common area amenities tend to have both higher budgets and proportionally higher Reserve funding requirements.

Obviously, every association has its own unique list of common area assets it is responsible to maintain. Some have longer lists (pool, elevator, tennis court, balconies, wood siding, etc.) that drive up both the budget and the Reserve needs; others have shorter lists of amenities or more cost-efficient exterior finishes.

Factors that Affect Reserve Funding Obligations

In addition to these physical factors, there are three other important influences to your Reserve contributions.

- Economic assumptions for interest and inflation. Inflation has its effect on the entire replacement cost, while interest is only earned on the much smaller amount of Reserves actually on deposit. This means interest earnings will never offset inflation, even in the rare case the two rates are the same. Because of this, inflation has a very powerful influence on Reserve contributions. On average, every percent increase in inflation requires a 13% increase in the size of your Reserve requirements!

- Your current “starting point”. Reserve Fund status is measured in terms of “Percent Funded”, where 100% Funded means you have cash on hand equal to the deteriorated value of your Reserve projects. If your association is new and has very little deterioration, it doesn’t take much Reserve cash to be 100% Funded. But “seasoned” associations have more common area deterioration, so they need significantly more cash to be “well funded.” When deterioration has significantly outpaced Reserve funding (Reserves in the 0–30% Funded range), the association will need to play “catch up” to avoid running out of money for soon-upcoming Reserve projects. Because of this “catch up” effect, associations with a weak Percent Funded will need higher Reserve transfers than associations in a strong position (over 70% Funded).
- Your Funding Goal. The most common Reserve Funding Goals are Full Funding, where the association’s goal is to become 100% Funded, and Baseline Funding, where the association’s goal is simply to not run out of money in light of projected Reserve expenses. Due to lack of “margin” for events that don’t occur exactly as planned, special assessments are common among associations pursuing a Baseline Funding Goal. Full Funding is a higher objective, so associations Fully Funding their Reserves have higher Reserve contributions (coincidentally by about 13%) than those pursuing a Baseline Funding Goal.

Given this background, what is the bottom line for your association? The “sweet spot” for most associations is to budget somewhere around 25% of assessments towards Reserves. So if your monthly condo assessments are \$400, about \$100 of that should be set aside towards Reserves. If your single-family-home HOA annual assessments are \$1,000, about \$250 of that should be set aside towards Reserves.

But don’t rely on averages to fund adequately for an upcoming major roof, paint, asphalt, or elevator project. Rely on the specific guidance you’ll get for your association in a Reserve Study prepared by a local, independent, credentialed (RS® or PRA®) Reserve Study professional. In most cases, that number will be in the range of 15–40% of your assessments. Owning and maintaining real estate is expensive, but at least it’s predictable. So fund honestly, and avoid a crisis at your association.