UNDERFUNDING RESERVES: KEEP CALM & BE SMART!

by Robert M. Nordlund, PE, RS
CEO/Founder
Association Reserves, Inc.

October 2013

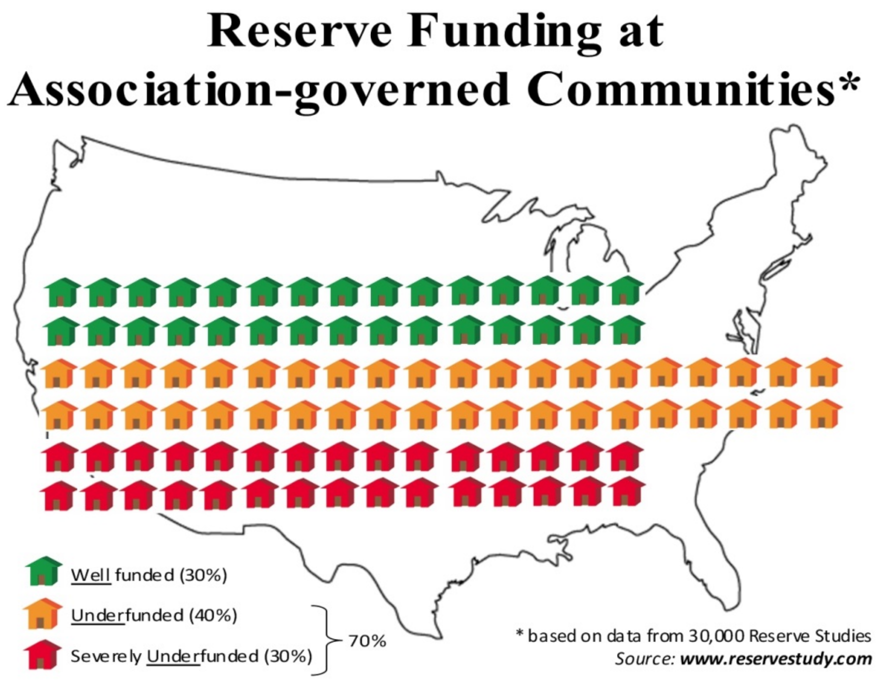
www.reservestudy.com

Society is replete with examples of intelligent people doing foolish things, especially regarding their homes and their money. Homeowners know that maintenance and repair expenses are unavoidable, that the cycle of deterioration begins the moment the last shingle is nailed in place, and that it starts afresh after each repair or replacement. They know it would be wise when buying a home to include the inevitable maintenance costs in their budget and to set aside funds to perform necessary repairs in a timely manner. Nevertheless, the reality is that even when intelligent people buy homes, the yearly costs of offsetting deterioration are often (foolishly) overlooked.

In this regard, individual homeowners typically bear the consequences of their own choices. Just as a fresh coat of exterior paint every 7-10 years serves to showcase a home in a neighborhood and put a smile on the face of immediate neighbors, failing to set aside money to replace a 20-year-old leaky roof may require the embarrassing inconvenience of a house filled with strategically placed pots and pans.

Owners of homes in Association-governed communities, however, bear collectively the burden of foolish financial decisions. If the homeowners have relied on the volunteer Board of Directors to establish a reasonable budget, they may be surprised to learn the Association is "underfunded" at a time when crucial repairs are needed.

As Association properties across the nation have aged, a growing number (70%) have insufficient reserve funds to adequately maintain their common area property. Because someone has to compensate for the prior owners unmet reserve funding obligations, new homeowners are particularly vulnerable to the consequences of an aging Association having not factored in the "true cost of home ownership" in their annual budget.



If underfunding reserves is foolish, why do so many Associations do it?

Here are three of the common reasons, followed by some tips for turning the situation around.

Difficulty of collecting current assessments

The tough economy has devastated many Associations. Whether due to pending foreclosures or ongoing delinquencies, some homeowners do not pay their dues. Delinquent owners have a ripple effect on the community, where homeowners who *can* afford to pay their monthly assessments may simply decide not to. The Association will end up with less than the projected assessment income, leading ultimately to an underfunded budget—and funding the operating budget always takes priority over "funding reserves".

Associations that operate with an assessment delinquency rate above the national average of 5-10% may be suffering from an ineffective collection procedure. There are some very creative ways to get delinquent owners to pony up the money they owe. Consult an attorney about collecting unpaid assessments directly from tenants or restricting certain owner privileges to "owners in good standing." Make it a priority to develop, adopt, publicize, and enforce a formal collection policy.

State of Denial

Remember how toddlers, when playing hide-and-seek, may try (unsuccessfully!) to hide by simply covering their eyes? In the same way, Common area deterioration doesn't stop just because it's ignored. Funds never magically appear in the reserve account when the time comes to repaint the ironwork fencing.

At some point, hopefully well before a major common area component (the big seven in Washington are Asphalt, Decks, Painting, Roofing, Siding, Windows, and Plumbing) is nearing the end of its useful life, the Board needs to take an honest look at the Association's current situation and figure out what to do about it. This exercise is called reserve planning, and it relies on the preparation of a formal Reserve Study by a qualified expert.

Ignoring Logic and letting Emotions Rule

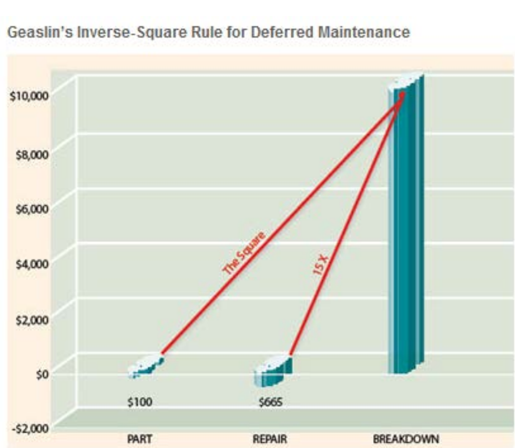
One of the most difficult choices the Board needs to make when preparing the Association's annual budget is whether or not to increase assessments to fund the Association's reserve account. Like raising taxes, increasing assessments is never a popular move. The Board may fear that homeowners will not support an increase, but choose instead the easy, popular, and short-sighted alternative to keep assessments low by delaying funding the reserve account to "some other time" or "some other board".

The desire to set aside logic and avoid an un-popular decision has a very strong emotional pull for Board volunteers. A quick review of the Association's governing documents may be helpful to remind Boardmembers of their responsibilities. Boards should also be well-versed in the Business Judgment Rule (BJR), because it's intended to protect corporate directors from decision-making liability. Every day, good, intelligent Boardmembers step outside the protection of the BJR by making decisions "without reasonable inquiry", leaving them needlessly exposed to the risk of personal liability.

What are the consequences of Under-reserving?

It is a myth that failing to set aside reserve funds is a way to "save" money. In truth, Associations who fail to offset the ongoing deterioration of the common area will pay in one of three other ways—and each alternative will prove far more expensive than properly funding reserves along the way with budgeted contributions.

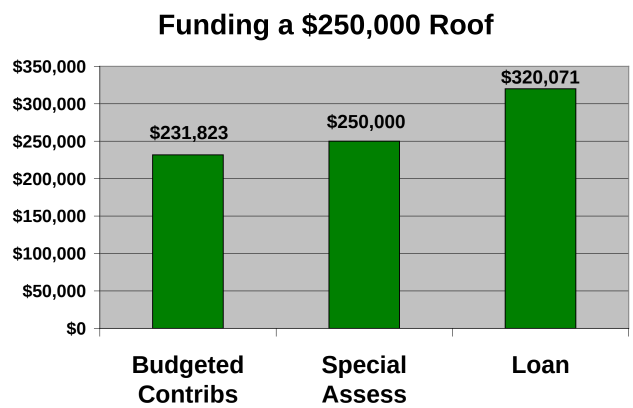
Deferred Maintenance



An obvious consequence of not being able to make repairs & replacements in a timely manner is deferred maintenance. Manifestations of deferred maintenance, like a cracked asphalt driveway or peeling paint, may be readily apparent to homeowners (or to prospective homeowners). Other symptoms may remain hidden for a while, like a roof on the verge of leaking or a hot water heater on its last legs. Projects that are put on hold, repairs that are neglected, and preventive maintenance that is ignored only become more costly and complex. Deferring maintenance almost always means that the cost of making the repair is ultimately more expensive than the cost of having properly funded reserves.

Need for a Special Assessment or Loan

The need to compensate for underfunding by generating a large amount of cash in a relatively short period of time leaves Associations with two options: Special Assess the homeowners, or take on an outside loan. Because of the positive effects of compounding interest on the Reserve fund over time and the negative affect of paying interest on borrowed funds, budgeted contributions will always be the least expensive option, as shown.

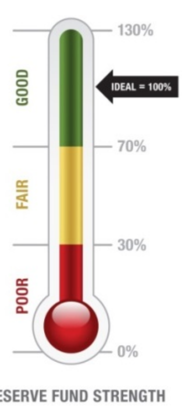


Lower property values

Deferred maintenance, a history of special assessments, an Association that is saddled with loans, and the homeowner dissatisfaction that accompanies this type of financial track record will ultimately impact the value and marketability of the units within the Association. The new scrutiny on reserve funding levels, which could render homes ineligible for federal loan programs like Freddie Mac & Fannie Mae, will only make matters worse.

How can we know if our Association is financially healthy?

The only way to determine the financial health of an Association is through a Reserve Study. A study that complies with [National Reserve Study Standards]() will contain three important results: The Component List, a calculation of Reserve Fund Strength, and a Funding Plan.



- The Component List serves as the foundation of the study by detailing the scope and schedule of all required repairs and replacements.
- Once the Component List has been established, a calculation can be made of Reserve Fund Strength by comparing the

RESERVE FUNDING PRINCIPALS

Reserve Funds on hand to the value of the component deterioration.

- The final step is crafting a Funding Plan that allows for the timely repair of all reserve items listed on the Component List. To comply with National Reserve Study Standard's four Reserve Funding Principals, there must be an emphasis on avoiding Special Assessments and Loans whenever possible.

The importance of properly funding Reserves

While many states do not legally require Associations to properly fund reserves, failing to fund reserves is never a wise decision for a Board to make. The financial health of the Association is at stake, and the negative consequences of failing to fund reserves are too great (and too expensive) to be ignored.

Boardmembers should take reserve planning seriously and, if they have a current (credible!) Reserve Study, they should adhere to its recommended Funding Plan. Likewise, Boards without a Reserve Study should "bite the bullet" and get one done by a credentialed Reserve Specialist. If the Board discovers the Association is well-funded, by all means spread the good news among the homeowners and the local real estate agents. If the Board learns their Association-governed community is underfunded, they would be wise to take steps to start reversing the process!