ASSOCIATION RESERVES™

Planning For The Inevitable™

How Much Should an HOA Have in Reserve?

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

Choosing to live in an association-governed community, whether it's a highrise condominium or a gated community of single family homes, certainly has many perks. One major convenience is the maintenance of the property. As part of such a community, homeowners enjoy care-free living while the homeowners association or HOA is tasked with ensuring that all of the common areas of the property are well-maintained.

This includes having all the landscaping cared for on a weekly basis, keeping the pool (if there is one) cleaned and maintained, and making sure all other physical aspects of the property are in good working condition. Basically, physical assets that aren't affiliated with the individual unit or home in which you live is the responsibility of the HOA to repair and replace in a timely manner.

That's why you pay your HOA fees on a regular basis. A portion of these financial resources are allocated to the Operating budget, which covers the routine management, upkeep and maintenance of the shared areas of the property. From the pool, to the utilities, to the yard work, your association fees are being used to make sure these parts of the community are tended to on a regular basis and everything is in good working order.

If the Board of Directors is acting responsibly, a significant portion of these fees, typically 15-40%, are allocated towards the Reserve budget. The Reserve budget covers repair and replacement costs that will come about over time. Let's say the driveway needs to be resealed or the exterior of the buildings need to be repainted, your HOA fees will be used for those things, in addition to the various routine costs of managing the property.

Funding Your HOA Reserves

So how much should your HOA have on hand to address these inevitable repair and replacement costs? A good rule of thumb is for Reserves to be funded at 70% or higher of the property's calculated deterioration. A reserve fund at that level will, in most cases, satisfy the

National Reserve Study Standard definition of "reserve adequacy" as long as responsibly-sized contributions continue to be made.

To determine whether your HOA Reserve Fund is adequately funded, a metric called "Percent Funded" is used. This calculation measures the current strength of your HOA Reserve Fund. Percent Funded is defined in National Reserve Study Standards, where 100% funded means that enough cash is on hand to exactly match the deteriorated fraction of your Reserve components. However, in practical application, most Reserve experts agree that anything over 70% funded is considered a strong HOA Reserve Fund.

This means your HOA Reserve Fund is considered "underfunded" when it is less than 70% funded. An HOA Reserve Fund that is less than 30% funded is considered extremely weak. The lower your Percent Funded amount, the higher your risk of needing additional or outside funding sources to execute Reserve projects in a timely manner.

However, HOAs that start off with measurably "weak" reserve funds can also satisfy adequacy requirements. Despite being underfunded, reserve adequacy can be achieved by adopting an aggressive funding plan that avoids reliance on outside funding sources.

Percent Funded is an important measure, because the amount of cash required for a strong Reserve Fund is relative and depends on the common areas the association is responsible to maintain. For example, if your association is large or has numerous common area amenities such as a gym, sauna, pool, and tennis courts, it will need to have a higher Reserve Fund balance. If your association is simple with very few common areas, there will be less components needing repairs in the future. Therefore a lower amount of cash in Reserves could be adequate.

The following are considered good practices for making sure you have sufficient funds in your HOA Reserve Fund:

- Work with a Reserve Specialist to get a professional Reserve Study to ensure the funding calculations are accurate and the funding plan is adequate.

- Because ratios are always a more insightful and meaningful measure, focus on the Percent Funded calculation as a way to assess your reserve fund strength, rather than the amount of cash in reserves.
- Make sure your Percent Funded is calculated at the beginning of each fiscal year.
- Honesty and transparency is key. Disclose the Percent Funded and the amount of cash in Reserves to homeowners and provide regular updates.
- Conduct Reserve Study updates annually, with on-site updates every 3-5 years.
- Your HOA should be setting aside 15% to 40% of their assessments towards the Reserve Fund.

Why Your HOA Reserve Fund Matters

If your HOA doesn't have enough cash in reserve to cover the expenses of a major repair or replacement, you could be subject to a Special Assessment. This would mean all the homeowners will be expected to come up with their proportionate share of the project cost. Depending on the work that needs to be performed, you could be on the hook for thousands of dollars when you least expect.

Does this mean your Board of Directors is neglecting their duties? If the special assessment is for a predictable Reserve project that failed in plain sight, right on schedule, it would certainly appear that way!

Association-governed communities are known by different acronyms through the United States — Condos, Co-Ops, HOAs, POAs, or PUDs — and they come in all shapes and sizes. Most states have legislation related to reserve funding or reserve fund disclosures. Over 20 states legally require Reserve Studies, including California, Florida, Hawaii, Nevada, and Washington. Regardless, in every state a Board is responsible to protect property values by meeting the financial needs of the association.

How Reserve Studies Help

Let's consider those HOAs that do conduct regular Reserve Studies and work towards maintaining "adequate reserves". A long-time HOA trade organization called the Community Associations Institute (CAI) worked closely with a number of Reserve Study professionals to develop the definition of reserve adequacy and made it part of their National Reserve Study Standards. The definition contains two parts: Having enough cash to complete projects on time and not relying on outside funding sources like loans or Special Assessments.

A current Reserve Study is the only way to determine reserves adequacy. That's because a Reserve Study contains a funding plan designed as much as possible to avoid the need for additional or outside funding sources. Without a Reserve Study, it's just a guess as to how much you need!

The Reserve Study examines the basics of the HOA, things like age and condition of the building, as well as all of the features and common area amenities that the HOA is responsible to maintain.

The study is a forecast, estimating when certain components of the property would be due for repair or replacement and the expense associated with having this work performed. While the Reserve Study is a projection, it is based on projects that are both inevitable and predictable. The study provides Boards with reliable numbers to work with in attempting to fund reserves at the same pace as the property's deterioration and in time for repair or replacement costs.

HOME VALUES

A study conducted by Association Reserves showed that homes in condominium associations with strongly funded reserves sold for 12% more than comparable homes in underfunded associations. Whether or not the HOA takes action to ensure the money is available to complete repairs and replacements in a timely manner is a decision the Board will need to make. It is important for the owners of the various units of the property to have confidence that the Board is fulfilling their responsibility in this regard.

Plan Your HOA Reserve Fund with Peace of Mind

With more than 30 years of expert advice and competency, Association Reserves gives you security and confidence that you are working with the most trusted and experienced Reserve Planning partner. We comply with National Reserve Study Standards to assure a consistent, unbiased assessment of your property's financial health. Our goal is to make your present less stressful and your future more financially secure.