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Funding Reserves… And What Happens when you Don't!

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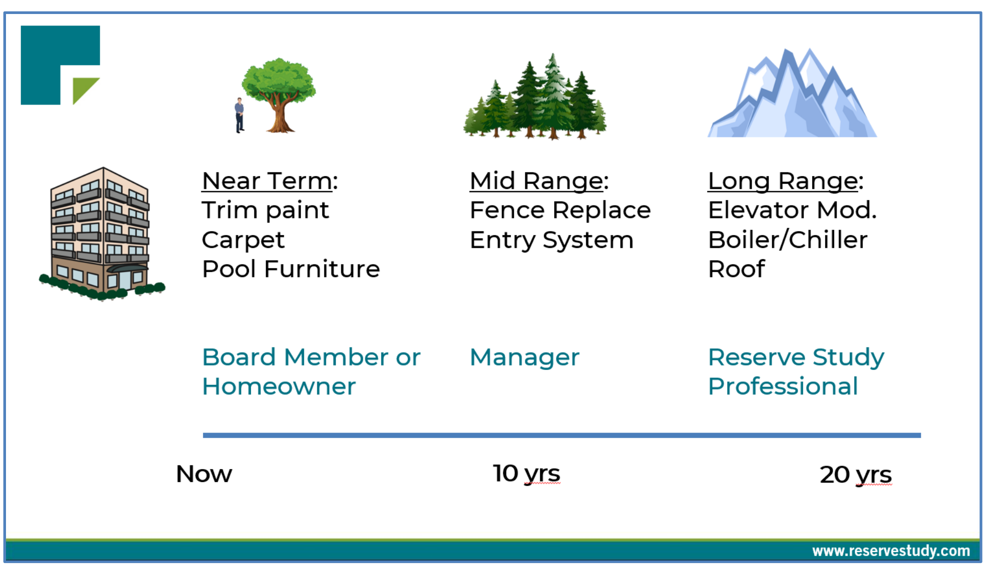
Miss the webinar? Watch it [here](#).

You can lead a horse to water but you can't make it drink. That reminds us that action doesn't happen until someone is properly motivated. For years managers, attorneys, accountants, and Reserve Study professionals have been telling boards to get a Reserve Study and make adequate Reserve contributions. But looking across the country, the majority of boards continue to nod their heads and say "we should do a better job of funding our Reserves", and then do nothing about it.

Boards make the decisions that create the future of the association. But I think we need to appreciate that no matter how much we counsel and coach and remind boards to make adequate Reserve contributions, nothing is going to change until they begin to feel the need. They need to feel thirsty. That's the purpose of this webinar.

First, we address the concept that everyone's perspective on the common area assets is different, based on their point of view and background of experience:



Then boards are minded that even though they might not be skilled at seeing ahead to Mid-Range or Long-Ronge projects, they have a responsibility to the owners and the association to provide for the care of all those assets.

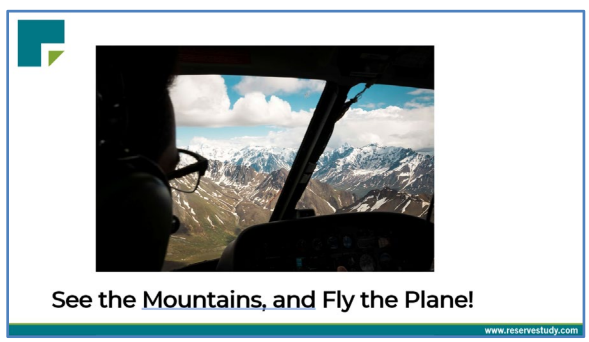
Fortunately, the board has help to “see ahead” – with management and experts like Reserve Study professionals acting like Air Traffic Control, guiding a speeding airplane on its journey over a mountain range from coast to coast.

And to emphasize that everything is happening fast, with no time to waste, watch this comedy sketch from the old I Love Lucy TV show about Lucy and Ethel in the Chocolate Factory Homework here.

We then address the question of “What happens if…” the board doesn’t prepare the association for these known upcoming expenses (deferred maintenance, special assessments, declining property values…), and the true cost of not preparing.

We then remind the audience that in all other areas of our life, we expect leadership to include the total cost of ownership (which includes maintenance and future replacements of major assets) into the “usage cost”. Think of health clubs, hotels, rental cars, etc.

In conclusion, we stress that board members are the flight crew, responsible for navigating their association successfully to the future. They are not passengers casually sitting back in seat 23A. Without their diligent hands on the controls, the association, and all its members, will suffer very undesirable, yet entirely preventable, unpleasant consequences. We stress “See the Mountains, and Fly the Plane!” And by seeing their responsibility clearly, and understanding that the expenses are known, they’ll start getting thirsty for change.



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<u>Webinar Questions Asked By 2021 Attendees</u>

Q: How can reserves be invested to increase the balance?

A: Reserves can and should be separated from normal Operating Account funds. Reserves should be invested under the philosophy "Protection of Principal" (meaning investments only such that the principal balance can never go down). Note that maximizing interest returns are a good idea, but maximized returns should never have a higher priority than protecting the integrity of funds on-deposit.

Q: Please explain how calculating Reserve contributions using the "Pooled" (Cash Flow) method can result in lower contributions than the "Straight Line" (Component) method.

A: With exactly the same expenses to fund, that's a great question. Over the long term, there is no difference. But in the first few years, there can be a huge difference, as we show here.

Q: What is a good method of catching up, if underfunded, without raising monthly fees too much?

A: Incremental annual increases. We call it the "$10 Solution". Read more about it here.

Q: How do you itemize that $10 extra per month in your reserve study?

A: It's just $10 higher Reserve contributions. For instance, that means your $350/mo homeowner assessments rise to $360/mo, in order to accommodate your $35/mo Reserve contributions rising to $45/mo.

Q: Our reserves are extremely underfunded (10-12%). Moving overnight to a fully funded or close-to position is unthinkable. What ways can you suggest to gradually improve our position? I have heard of special contributions to reserves from Owners when they sell or alternatively special contribution to reserves of New owners. What do you think?

A: As stated above, implement the "$10 Solution" plan. That is something you can control. Please check with your association's legal counsel before launching any new fees. And please be reminded that you can't control that income stream… it is dependent on sales transactions that are notoriously unpredictable through the years (strong in some years, weak or absent in other years).

Q: **Our waterfront association is in the process of replacing our bulkhead and will need to make an assessment. The replacement was not included in our original reserve study (years ago) because we knew the replacement was near and it would have greatly skewed the study. Is it OK to "borrow" money from the Reserve Account to help fund the replacement if we reimburse the fund once assessment money is received?**

A: No need to call it borrowing. If the asset is a Reserve Component as defined by the National Reserve Study Standards (NRSS) four-part test, it is a legitimate Reserve expense. A Reserve expense is not defined by appearing on your Reserve Component List (or not). That only dictates your contribution calculations! Spend the funds from Reserves, update your Reserve Study, and expect a considerably adjusted Funding Plan.

Q: **How do you calculate Fully Funded Balance?**

A: Please see here and here (p3). For additional information, watch our "Reserve Studies 102" webinar (or read the webinar outline) which you can find here.

Q: **How many real estate agents really use Percent Funded number during a sale of a condo?**

A: Very few. Even so, Percent Funded is a wonderfully useful metric, right up there with % owner-occupied (who lives there) and % 60-day delinquencies (how good is the board doing managing cash flow from the owners). We are busy training boards and owners, so they know which documents to request and what questions to ask!

Q: **This is probably a Reserve Studies 101 question, but could you review how to calculate a minimum threshold amount; is it 1-3% of the annual income of assessments?**

A: Yes, that is covered in both our Reserve Study Basics and Reserve Studies 101 webinar curriculum. You can find the written outlines and recorded webinar here. For all but very small or very large associations, that minimum threshold of significance (above which a trivial periodic project should more appropriately be budgeted through Reserves) is in the range of .5% to 1% of the association's annual budget, or the board or manager's "signature authority" for expenditures. That means for a $500,000 annual budget, a starting point for considering your Reserve threshold is in the range of $2500 - $5000.

Q: **If reserves are funded below a certain percent (i.e. <20%) is the ability for homeowners in the HOA to get a mortgage or refinance their home impacted? Are there other legal consequences to be aware of as they plan to boost their reserve fund?**

A: Let's be careful. Major lenders look for Reserve contributions to be at or above 10% of total budget (if your total budget is $500,000/yr, they want to see $50,000/yr going to Reserves). Yet it is likely *far more influential* that they know the actual strength of the Reserve Fund, reported in Percent Funded. But they're generally not asking that question. Reserve contributions and Reserve fund strength should be considered when talking about Reserve adequacy, as you can read here. One is cash going to Reserves, one is cash in Reserves (available to sustain the common area assets).

Q: **Why don't more reserve studies capture the maintenance and costs expended on reserve items in the past? Also, there is often yearly maintenance items, such as elevator inspections and service, that impact longevity. Where is this captured?**

A: Many Reserve Study companies capture this information and report it in their component detail information. Reserve Study companies continue to find a balance between capturing an overwhelming amount of background or related information, and the "bare bones" of key information.

Q: **How do we motivate uninvolved owners?**

A: Communicate regularly and in multiple ways (mail, email, newsletter, signs, community forums, Memorial Day or 4th of July gatherings… etc.). Build the reputation of the community and remind them of all that is going on to run the business of their association (landscape choices, janitorial choices, new pool-side furniture coming in June, etc.).

Q: **How to make sure homeowners understand what boards need to be doing? They only seem to look at what the monthly cost is and don't understand this whole process.**

A: See above. Communicate regularly and in multiple ways. Establish committees, where time involvement is minor, and they can feel like they are contributing to creating a great future for their association, protecting their investment and keeping it a nice place to live.

Q: Boards generally feel uneasy having more than $100k of funds in the bank. They start to splurge and spend it on the wrong items. How can they be reined in?

A: Remind them of their Percent Funded… the ratio of cash in the bank to cash needs of the association. That $100k might look mighty tempting ("look at how much money we have!") until you realize the Reserve needs of the association are now $457,922 (because of upcoming asphalt and roofing and boiler replacement projects). Then that $100k looks mighty small!

Q: Your comparison of costs for the roof - reserves vs special assessment vs loan was eye-opening. Is an increase in costs of 1/3 unusual?

A: Not unusual. In rough numbers expect it anywhere from ¼ to 1/3 more expensive to have your owners pay for a project through a loan instead of ongoing contributions. If you truly wish to keep Reserve contributions low, you'll set them appropriately through ongoing contributions, so all Reserve deterioration is offset on an ongoing basis.

Q: Can Reserves be used for renovations in a HOA owned unit used by a caretaker?

A: Yes, if the projects pass the NRSS four-part test. That is likely the case, if it is a HOA unit, and you wish to schedule kitchen renovation or bathroom renovation or new carpet or paint every x years. Very reasonable.

Q: How do you define a "strong" reserve?

A: See here. Generally it is [70% Funded or above]. And remember that you'll need the ongoing Reserve contributions to keep it there! See more in our Reserve Studies 102 webinar (outline and recording can be found [here]).

Q: How do you compel homeowners to get the Board to do a reserve study or to put all components in the reserve (beyond the few specific items in regulations)?

A: It's the board's job to lead the association forward. If they are short-sighted, that is unfortunate. There are likely to be special assessments and lagging home values. The board needs to appreciate that they serve like the flight crew of a commercial airliner, not passengers sitting casually looking out the window in seat 23A.

Q: Have you seen owners compel a board to budget for reserves?

A: Not to my knowledge. I've seen managers threaten to abandon the account if the association doesn't have a Reserve Study and budget responsibly (because otherwise the association will become a nightmare account), and I've seen attorneys state in writing that the board has significant liability exposure if they continue to move forward without a Reserve Study or Reserve funding or both. But owners do have a say. It is those motivated owners who then run for open Board positions and implement sound financial practices.

Q: What interest rate did you use in the loan slide?

A: 7% interest over 7 years, plus 1.25% loan origination fees.

Q: The useful life of some of our HVAC has reached their end of the Remaining Useful Life. It is still working with significant corrosion and dirt. Our Property Manager suggests to the Board that we don't leave any useful life in the table. We had a Mechanical Audit Reserve Study done and it estimates the HVAC still has 2 years of remaining useful life. Isn't that risky relying on an estimate of useful life?

A: Good for you to have a Mechanical Audit done to update your estimate on the Remaining Useful Life for your major mechanical equipment. Please be reminded that all Remaining Useful Life estimates are just that… estimates. Different components "fail" differently, and implications of "failure" are also different depending on the component. See here. From what you've said, it seems reasonable to move forward another year without performing the project. Consult with your Reserve Study professional, and have your HVAC systems technician review it again. Failure during the summer would be something you'd want to avoid, so there is some reason to replace "early". Another reason to replace "early" is if you can replace with a new energy-efficient unit that will begin to "pay for itself" in energy savings.

Q: What percentage of the recommended reserve fund is typically funded by HOAs?

A: We don't specifically track the "compliance" factor, comparing what our clients actually budget for Reserve contributions compared to what is recommended. In some informal feedback (webinar audience polls), we believe the literal compliance is about ¼ to 1/3. Because so many associations are feeling budget pressure to not follow the recommended Reserve contribution, we developed uPlanIt, our online Reserve Study calculator tool. uPlanIt allows the user to test various "what-if" scenarios, to make sure any adjustment they make is not going to cause future problems.

Q: **For associations who do not wish to fund the reserve at 100%, what is a typical goal? 60-70%? This is assuming homeowners are okay with some kind of assessment every 6-10 years for milestone projects.**

A: Please see here to consider your risk factors. The statistics seem to support the idea that if you wish to keep your special assessment risk down at or below the 10% level, you need to keep your association above 50% Funded.

Q: **Your thoughts about a bank loan to fund a project today?**

A: As I stated in the webinar, it is an alternative to an unpalatable special assessment, but it is a very expensive way to fund predictable Reserve projects.

Q: **Are there any ways to finance new roofs for an HOA that has not put away enough to pay for them en masse (special assessment)?**

A: Some banks serving the community association industry have loan programs (which are an expensive way to pay for a project, as mentioned in the webinar), and some service providers may have payment terms.

Q: **Are those transactions fees allowed by law?**

A: Yes. Bank fees have existed since the beginning of banks.

Q: **What would the ideal time of year be to request a reserve study? Maybe after 4th quarter numbers come in or is it not dependent on the financials, so to speak?**

A: A Reserve Study is fundamentally a budget preparation tool. A good schedule is to begin considering Reserve Study proposals six months in advance of your Fiscal Year End, in order to get the Reserve Study started four months in advance of Fiscal Year End, in order to have it in your hands two months before Fiscal Year End (when you should be busy updating your budget for the following year!).

Q: **Is there a general rule of thumb to know what Percent Funded your reserves should be every year?**

A: A strong Reserve Fund, where the association has low risk of unsettling cash flow events, is 70% Funded or higher. It is good for an association to stay in this range, adjusting their Reserve contributions so their Reserve contributions offset ongoing deterioration, and the funds exist on-deposit to perform your Reserve projects in a timely manner.

Q: Do we really need to have 100% funded reserves?

A: No. Measurable absence of special assessments begins when the association is above 70% Funded, which you can see here. Being 100% Funded remains a responsible target, because it is the center of the bulls eye. When surprising events occur to an association that is "Fully Funded", their Reserves are usually strong enough to handle that expense without a special assessment that might be necessary in a similar association with a weaker starting point. And remember Reserve adequacy requires a combination of a strong Reserve fund and strong enough ongoing Reserve contributions to keep that Reserve fund strong.

Q: How does a Board project funding for water and sewer repairs, upgrades and replacement? Roads are easier since road paving contractors can assess timing of repairs and full resurfacing. Who can assess something they can't see underground?

A: You may wish to enlist the services of a specialist – someone with remote camera technology. Please understand that not everything is predictable, so you may have to get comfortable with some unknowns and some levels of uncertainty. The point of Reserve planning is to <u>minimize</u> the number of surprises in an association's future, not completely <u>eliminate</u> surprises.

Q: Is there any FL law that relates to adequate reserves?

A: Legal questions should be directed to your local legal counsel, but my understanding is that FL law relates to minimum Reserve Study <u>preparation</u> standards (a minimum list of components that should appear in the Reserve Study…), not Reserve <u>adequacy</u>.

Q: Is there a minimum percentage you recommend for monthly reserve contributions as a percentage of the monthly dues taken in?

A: Most associations need to set aside 15-40% of their total annual income towards Reserves, with the most common amount being in the 25% range. Every association is unique, and they find that % in their Reserve Study. See here.

Q: **Any best practices on how to update or manage your reserve reporting as components are repaired? I find it challenging to manage the planning and budgeting part of it as things change each year with their contributions and what components were completed.**

A: Keep a file or a log for the expenditures. The annual budget and your annual financial statement should be a good enough record documenting the actual funds (compared to budget) that were set aside. And we recommend tracking the Reserve Fund as a whole (the Cash Flow method), not tracking individual Reserve Fund "accounts". See more here.

Q: **How are the repair and replacement costs estimated or calculated? Often, we get a reserve study that has numbers nowhere near the actual cost. For example, we got a roof repair estimated at 35k when in reality it was closer to 250k due to the type of roof (rock) and the need to remove the rocks/logistics and sq. ft.**

A: Your experience is unfortunate. Some providers reference a standardized "cost estimating" resources. Those are generally reliable. Our firm takes it up a notch by comparing to actual costs experienced by similar associations in your area, and your own association's expenditure history (we have some clients we've been assisting for over 30 years). We find most cost estimates that are significantly low to be from one of three factors: they are many years old, they were identified/scoped incorrectly, or they have unique property factors (poor access, etc.).

Q: **What is required of a BOD to use reserve funds when their reserve contributions were calculated using the pooled (Cash Flow) method?**

A: The same as when their Reserve contributions were calculated from the Component (Straight Line) method. Make sure the expense meets the NRSS four-part test and aim for the amount budgeted in the Reserve Study.

Q: **Any special information relating to the big freeze?**

A: We are finding that the "big freeze" in TX affected some paint processing plants that make a particular ingredient found in many paint types. This has affected the cost and availability of a large number of paint brands and types throughout the country, so your paint projects might be a bit more expensive this year.