Reserve Funding Strategies for Condos & HOAs

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Recap:

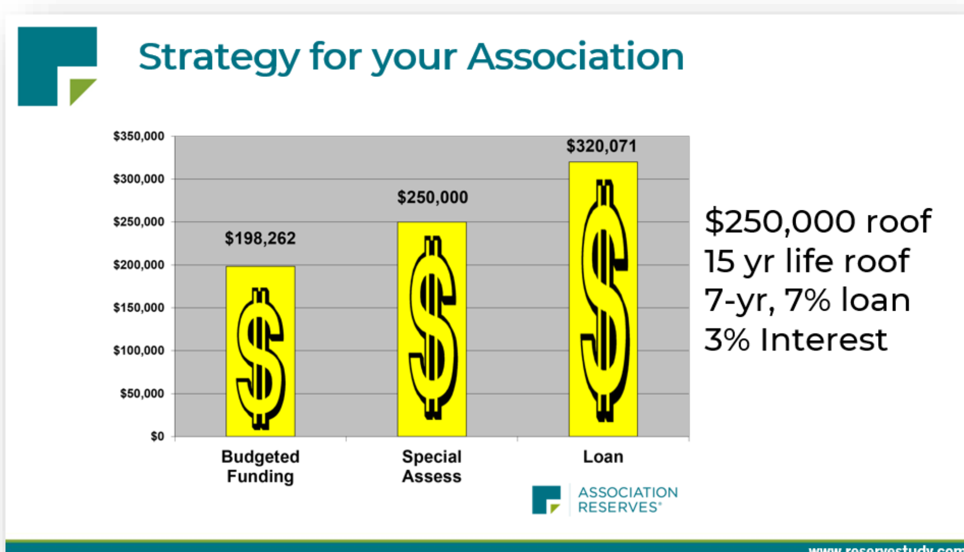
Operating and Reserve funding obligations are real. Both are current costs. Both are the board's job to fund, to sustain the association.

Since you can't make the Reserve costs go away (they are driven incessantly by Mother Nature and Father Time), you basically have three strategies/choices:

- Collect funds from the homeowners gradually, as the assets age
- Have the homeowners pay when it fails
- Borrow after it fails, and homeowners pay it off later with interest.

Summary:

The cost differences between these three strategies are real, and significant, as shown below.



This webinar addressed these three strategies, what they cost, a review of the various pros and cons, and added some additional information about economic factors and outside influences (Fannie Mae and Freddie Mac, State Laws, etc.) that affect a board's strategic choices. In addition, we addressed communication choices and strategies that accompany each choice. A plan is only as good as it can be implemented, after all.

We summarize with a reminder that there is no way to opt out of the costs. They are driven unmercifully by Mother Nature and Father Time. Owning and maintaining Real Estate is fundamentally expensive, and it starts when you purchase the home. Don't be so focused on state or lending minimum requirements that you miss the point… your job as a board member is to budget for the sustainability of the common areas, leading to rewarding home values and an absence of unsettling special assessments.

Bottom line, it is not fair to push the known cost of today's deterioration onto tomorrow's homeowners, which also significantly increases the cost. The choices you make to plan for known expenses can avoid problems like this recent news story of an association levying $26,000/home "emergency" special assessments… for deterioration that gradually occurred over 30 years.

The lessons to learn: Fund honestly, and avoid a crisis.

Want an experienced professional to prepare your next Reserve Study update, ensuring appropriate component selection, life estimates, pricing, and development of an appropriate Funding Plan *custom designed* for the needs of your association? Launch a free online proposal request by clicking here. See our network of regional offices across the country here, serving clients in all 50 states.

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Other Links:

"Understanding Reserves" book (**updated for 2025**). Order single copies on Amazon here, or download chapter one for free here.

Learn about uPlanIt, our free online Reserve calculator tool here

General Reserve Questions

Q: Is it appropriate for an HOA management company to charge a percentage-based project management fee?

A: It can be, but the important issue is transparency. If management is taking on responsibilities beyond its normal contract (coordinating contractors, overseeing a major project, managing schedules and invoices) additional compensation may be appropriate.

But the board should understand exactly what services are being provided and how the fee is calculated. A percentage-based fee can create an incentive for costs to rise, so our recommendation is for a fixed fee or hourly arrangement to ensure you're receiving appropriate value. Get a proposal that documents the specific projects to be accomplished, and the cost of performing that work, so nobody is confused.

Q: How should Reserve Specialists advise boards that repeatedly reject recommended dues increases?

A: Our job is to clearly identify the present physical and financial situation, and recommend a multi-yr Funding Plan that provides sufficient cash to sustain the common areas. If the funding plan says the association needs to be funding $300,000/yr and the board decides to fund only $200,000/yr, there will be a problem. Costs don't go down when Reserve Funding goes down. Mother Nature and Father Time, who drive Reserve costs, are undefeated since the beginning of time, and they don't negotiate with associations with "tight budgets".

The looming problem only gets bigger the longer boards underfund Reserves, forcing the Reserve Study professional to recommend higher and higher budgeted Reserve transfers, until only a special assessment will solve the problem. A board has a fiduciary responsibility to act in the best interests of the association. When a subject matter expert has made a clear recommendation about the path forward and the board willfully chooses a different strategy, that then becomes their own problem. And that never ends well for the association, the owners, or the board. So fund honestly, and avoid a crisis.

Q: What is the difference between a Reserve Study and a Transition Study?

A: They're answering different questions.

A Reserve Study asks, "What is the current physical and financial status of association, and how much should we be setting aside to offset ongoing deterioration?"

A Transition Study is generally associated with the transition from developer control to homeowner control and focuses on identifying construction completeness or quality issues that remain unresolved, confirming what the association is actually receiving.

Both are valuable, but one shouldn't be mistaken for the other.

Q: Are there state requirements governing the quality of Reserve Studies?

A: No. Reserve Study quality is driven by professional standards, either CAI's National Reserve Study Standards, or the Standards held by the Association of Professional Reserve Analysts. States generally dictate what type of Reserve Study needs to be performed, when, by whom, or some minimum funding levels or goals.

As with any other professional service, look for someone with credentials in the field (a RS or PRA), examine their work-product, and seek references and recommendations.

Q: What would you recommend saying to a board or owners who want to put off Reserve funding or Reserve projects because they do not believe they will benefit, as the roof may not need to be replaced in their time as an owner. I would like to do anything possible to help them understand they should not "kick the can down the road".

A: Two things. **First**, never describe Reserve funding as "contributions". That makes Reserve funding sound voluntary, or as if it is "charity" for future owners. Call them "budgeted Reserve obligations" or "Reserve transfers". Reserve funding is a bill as real as any other bill in the Operating budget. **Second**, Reserve Funding offsets the ongoing cost of deterioration. Reserve funding is not for a future event, it is a "usage fee" to offset the slow, predictable deterioration that occurs day after day while owners are members of the association. Collecting those funds over time ensures there will be cash in Reserves when needed.

Q: What is the average percentage fee for major reconstruction oversight?

A: There really isn't one percentage. Project oversight fees depend on the project's size, complexity, location, and the scope of services.

Rather than asking only, "What percentage are they charging?" ask, "What do we want accomplished (specifications, and oversight ensuring work is done to contract)?" Get competing proposals and compare scope as well as price.

Reserve Component Questions

Q: We're about 40% Funded. How should we prioritize our most urgent deferred projects?

A: Start with condition and consequence, not simply the order of projects in the Reserve Study.

Life-safety issues come first. Then address projects where delay could cause additional damage or dramatically increase the eventual cost. Cosmetic projects generally come later.

Your Reserve Study is a planning tool, not a command to replace something simply because a particular year appears on the expenditure table. Discuss priorities with your Reserve Study professional to "read between the lines". Note that if conditions change, update the plan.

Q: How much flexibility in Reserve funding is there to include reconstruction oversight, or components that don't exist yet?

A: There is flexibility, but there needs to be a sound basis for what goes into the Reserve Study.

Costs directly associated with completing a reserve project (engineering, design, permits, staging, construction management, disposal, etc.) should be part of the budgeted Reserve component cost, funded through Reserves.

A proposed new amenity is different. Reserve Studies and Reserve funds are to sustain the common areas. It is inappropriate to use cash already identified for existing Reserve projects to create something new at the association. Use funds other than Reserves to create something new. Then at your next opportunity, update your Reserve Study to now include funding for the care of that new asset.

Q: Can or should costs from California's Civil Code §5551 (Exterior Elevated Element inspections and repairs) be funded from Reserves?

A: Yes. Although you can have expectation for higher accuracy with a "Full" or "With-Site-Visit" update (when we are onsite to confirm the inspector's evaluation) than in a "No-Site-Visit" update year, expect that such §5551 inspection and remediation expenses can and should appear as Reserve projects, appropriate for Reserve funding. The costs that appear in the Reserve Study will come from the expert's completed report.

Reserve Funding Questions

Q: Is it fair to ask elderly owners to contribute toward a roof they may never see replaced?

A: Yes, but that is not the point. Reserve funding is like a "usage fee" that offsets the steady, gradual ongoing deterioration that occurs while you own a home in the association. Reserve funding is all about everyone paying their fair share, independent of when project actually occurs. If everyone pays their fair share over time, there will be funds available when needed to accomplish the project without unfairly making owners <u>during the project</u> pay a disproportionately higher share of the cost.

Q: If California caps assessment increases (per pending legislation), how can an association catch up on underfunded reserves?

A: First, distinguish between what a board would *like* to contribute and what the law and governing documents actually allow it to assess. If the difference is significant, there will not be a painless solution.

If assessment increases are capped, the expectation is that California will turn into a "special assessment" state, with a significant portion of its Operating and Reserve budget being funded via special assessments. Assessment limitations unfortunately have no power to limit costs. The solution is more special assessments.

Q: What is the Cash-Flow-based (pooled) method of reserve funding?

A: Think of it as one reservoir of money serving all your reserve projects, instead of separating your Reserve fund into different accounts (figuratively or literally) where $50,000 belongs to the roof and $30,000 belongs to asphalt resurfacing and $3,500 belongs to the entry signage. When using the Cash Flow methodology, the association maintains one reservoir of Reserves for all the anticipated projects at the association. It relies on a Funding Plan that keeps the Reserve balance above a target level (pursuing a Full Funding, Threshold Funding, or Baseline Funding Goal).

Using exactly the same Component List (expectation for upcoming expenses), the Cash Flow Method uses your precious cash more efficiently than when using the "straight line" (Component) methodology, since cash is not tied up in small pockets inaccessible for use on other projects. The Cash Flow method is always preferable.

Q: What's your take on pooled (Cash Flow) method versus straight line (Component) method reserve funding?

A: Both are legitimate funding approaches. But because your Reserve cash is used more efficiently and effectively when your Reserve fund isn't tucked away into multiple separate pockets of money, <u>the Cash Flow method will always</u> provide your best and most flexible funding solution. It is the first choice of Reserve Study professionals nationwide.

Q: If an association transfers more than 15% of its budget to reserves but has a very weak reserve balance, can that still create lending problems?

A: Absolutely. This illustrates two things: first, that reserve funding <u>rate</u> and reserve fund <u>strength</u> are two different things, and second that lenders are free to set higher standards than the Fannie/Freddie minimums. Setting aside 15% of budget towards Reserves is a very simple metric for lenders to evaluate, not even requiring them to ask for or look at a Reserve Study. So it very quickly divides the loan applications into two piles… those who are prioritizing minimizing Reserve funding (below x% of budget), and all others. And of course some, or many, lenders who care about the sustainability of the physical association and protecting the new buyer from upcoming special assessments may look more closely at Reserve balance, upcoming major expenses, Percent Funded, actual Reserve funding compared to budget, etc.

Q: Why does a special assessment cost so much more than gradually funding the same project through reserves?

A: Because when gradually funding Reserves over time, the bank pays the association interest earned on those funds, and then year after year even the interest begins to earn interest (called "compound interest"). That adds up to a significant sum over the years, requiring significantly less cash from your homeowners than a last minute special assessment. Budgeted Reserve funding is the least expensive way to pay for predictable major projects.

Q: How do we overcome inadequate funding by previous owners without putting too much burden on today's owners?

A: Unfortunately, yesterday's owners have left the building, and they took their checkbooks with them. You can't go backwards and collect the money they should have paid into Reserves. So you start now by identifying the size and timing of the problem. Then with the help of your Reserve Study professional you create a realistic recovery plan.

That likely means increased Reserve funding during the "catch-up" years in order to rapidly prepare for one or more major upcoming projects, or finding ways to extend a project's Remaining Useful Life, or find ways to phase out an expensive project. The goal isn't to punish (or not punish) today's owners. The goal is for the community to (finally) start funding honestly in order to sustain the common areas.

Q: There was mention that condo associations will have new Fannie Mae lending parameter requirements beginning in January 2027.

A: Yes, that is part two of a step program that Fannie Mae and Freddie Mac have instituted to gradually increase Reserve funding requirements in the country so that associations will be funding more sustainably (more cash to sustain the physical common areas, and smaller or less frequent special assessments falling on owner shoulders). Part 1 began in Aug 2026 and tightened up the standard by which associations request an exception to the minimum "percent of budget" funding requirement. Part 2 begins in Jan 2027 where the minimum percentage of budget going towards Reserves rises to 15% from 10%. See this article, and the last item in our website's FAQ here.

Q: Is the Fannie Mae/Freddie Mac "15% percent of budget" reserve requirement for condo associations based on the gross budget or the budget before reserve contributions?

A: Technically, before Reserve funding. But that requires math on the part of the lender and the board, and likely a discussion between the two. See here, specifically the section under "Lenders must review the HOA's projected budget…". But you're missing the point. Most associations require about 25% of budget going towards Reserves to sustain the association. Sustainable Reserve funding should be your objective, not finding ways to minimize a minimum standard. Your property needs what it needs. Lowering your funding doesn't lower your costs. You'll just pay them later by way of a special assessment when the project finally comes due. Fund honestly, and avoid a crisis.

Q: We're 300% Funded. Do we still need to budget regular Reserve transfers?

A: Being 300% Funded places your association in a rare position. Discuss with your Reserve Study professional. Likely the solution will be to fund your Reserves at a low level that gradually increases over the years, so by the time your Reserve surplus has been largely depleted your Reserve funding rate will have grown to the point that it can keep up with ongoing deterioration, stabilizing your Reserve Fund near the 100% range.