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

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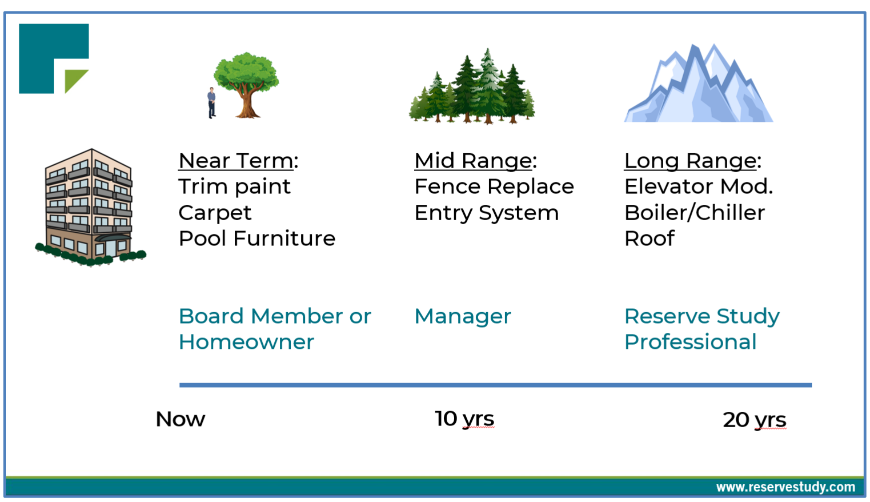
Miss the webinar? Watch it here.

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 update their Reserve Study and follow the funding recommendation. 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. We need to appreciate that no matter how much we counsel, coach and cajole boards to fund their Reserves as recommended, 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 reminded 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 care of all those assets by funding to offset that ongoing deterioration. Those distant projects are approaching rapidly!

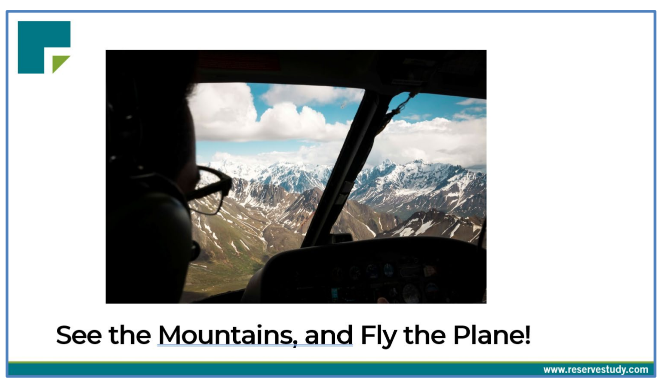
Fortunately, the board has help to "see ahead" – with management and experts like Reserve Study professionals acting like Air Traffic Control, guiding a speeding airplane on its journey over a mountain range from coast to coast.

While it may seem slow, deterioration waits for no one. Enjoy being reminded in this comedy sketch from the old *I Love Lucy* TV show about Lucy and Ethel in the Chocolate Factory having to "pick up the pace" with the assembly line that moves at an unrelenting pace here.

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

We make the point that in all other areas of our life, we expect businesses 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 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.



Get an expert on your side to provide you with the information you need to make the wise decisions that guide you and your association toward an improved future! We can help by preparing your Reserve Study update, ensuring your Reserve Fund

Strength is calculated correctly and a Funding Plan is custom prepared for your association.

Enlist the support of a team who has prepared over 80,000 Reserve Studies for clients in all 50 states over the last 30+ years! Launch a free online proposal request from Association Reserves by clicking here. Or click here to see our network of offices across the country (serving clients in all 50 states!).

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Webinar Questions Asked By Attendees

General Reserve Questions

Q: **Our treasurer and I recently went through our reserve study and found many items that were completely wrong, done, absolutely not needed, and missing. We met with our reserve specialist and made a number of adjustments. Why did we find so many items that needed adjustment? Some of the missing items had been absent from our Reserve Study for years. How can we trust our reserve study specialist?**

A: First, I certainly hope your experience was not with our firm! Your expectations are appropriate, that the Reserve Study be accurate, and that any shortcomings you find would be minor (date of the mailbox replacements was 2021, not 2020, etc.). National Reserve Study Standards guide which components appear for funding in your Reserve Study. That list should be accurate and relatively stable from year to year (update to update). As with any professional, when you find they are underperforming, perhaps it is time to explore a change.

Q: **What does an average Reserve Study cost?**

A: A "Full" Reserve Study, the most expensive Level of Service, is typically in the range of 1% of the association's annual budget or a bit less. Both the Update With-Site-Visit and Update No-Site-Visit are less expensive options. Click here to get an updated proposal for your association, and see for yourself.

Q: **How often do you recommend updating your reserve study?**

A: National Best Practice is to commission an Update With-Site-Visit Reserve Study at least every third year, with inexpensive No-Site-Visit Updates in the in-between years.

Q: **I'd appreciate guidance about tracking scheduled Reserve projects each year, and what to do if/when the Board fails to undertake all the scheduled projects. This happens frequently at our association. What tools can you suggest, generally, to be prepared for the updates.**

A: The Reserve Study itself is a great tool. It outlines the board's Reserve projects in advance of the year. The board needs to keep this reminder refreshed on a monthly basis, as Reserve projects typically take months to get specifications or proposals, select the provider, and accomplish the project. Get in the practice of reviewing the Reserve Study on a monthly basis as a recurring agenda item in your board meetings.

Q: **How should I approach the board when they refuse to fund a reserve fund?**

A: Present the case clearly as we did in the webinar – time marches on, and Mother Nature and Father Time are undefeated. And the board is responsible to budget for the costs at the association. If they still are stubborn, run for the board (with some other like-minded owners), and begin your own personal "Reserve Fund" (approximately ¼ of your current assessments) in order to pay your upcoming and inevitable special assessment. Just because the association isn't ready doesn't mean that you can't become ready.

Q: In an association with term limits and constant revolving of boards, from infrastructure-concerned to aesthetics-concerned members, how can there be consistency and will to keep the reserves strong?

A: Have a review of Reserve projects, Reserve funding, and Reserve balance be part of your recurring monthly board agenda. The Reserve Study itself is a great document for providing consistency across the years. Also consider an official Reserve policy (templates here and here), to provide consistency across the years.

Q: How do we help educate BODs to not view the Reserve funds as a reason to not increase assessments, when they often have to borrow from Reserves at the end of the year?

A: Make sure they understand that reserve funds and operational funds serve separate purposes. Reserve dollars have a job to do. And that job is not to pay for Operational expenses. If those Reserve funds are sidetracked or borrowed, they need to be repaid to Reserves. Borrowing from Reserves is a primary indicator that homeowner assessments need to increase.

Q: How do you sell a fee increase that must result as a result of the Reserve Study?

A: The cost of deterioration (roofing, painting, asphalt, carpeting, etc.) has gone up, and Reserve funding needs to increase to prepare for those higher costs. Proper Reserve funding avoids special assessments and maximizes home values. Ignoring rising costs doesn't prevent homeowners from paying those costs… they just end up paying those costs by way of disruptive special assessments (instead of a few $/mo that will soon not be noticed).

COMPONENT QUESTIONS

Q: We had a reserve study done and I was surprised that the estimates for future projects were not displayed as future value. Example - they expected us to have some pool maintenance expenses in fifteen years and the value they assigned to that was in today's dollars, not a projection of 15 years out. Is that normal?

A: That is normal, and in compliance with national Reserve Study Standards. A display of costs (the Component List) is done in Current Dollars, because that is what is being estimated. In the Funding Analysis, those costs are inflated so appropriately sized Reserve transfers (plus anticipated interest earnings) can provide for those future costs. But in the Component List, current costs are shown.

FUNDING QUESTIONS

Q: **How is baseline funding calculated?**

A: Baseline Funding is accomplished by testing various multi-yr Reserve Funding Plans, until one is found that provides sufficient funds to keep the Reserve balance from becoming depleted for a period of at least 30 years. It is an iterative (try and try again) process. That is the nature of the Cash Flow funding methodology. Note that Baseline Funding is not recommended, as it commonly leads to special assessments (due to lack of "margin" for projects occurring not exactly according to plan).

Q: **What happens when the special assessment vote fails in an association and the HOA does not qualify for the loan?**

A: Hopefully, the board tries again, but harder and more creatively. The board has the responsibility to provide for the needs of the association. Misguided homeowners may wish low monthly assessments. Don't give up easily. Explain again and again (and perhaps go door-to-door) in a campaign to assemble a majority that understands that deterioration is real, and property values are at risk. Note: It's a whole lot easier to collect funds in small budgeted increments over the years than face a lst-minute crisis like this!

Q: **What percentage of HOA's are at a 70% (strong) funding level or better? What percent at 80%? 90%? etc.**

A: Approximately 26% of associations have Reserves that are at or above 70% funded, meaning they are well prepared for upcoming Reserve projects. Join them!

Q: **If a master association annually grants funds to an HOA, which is used to enhance/update an existing reserve asset, should this grant amount be included as a loan/special assessment revenue when calculating the required Reserve transfers? Note that in the past, the projects exceed the amount of the grants and own reserves funds make up the difference.**

A: Since these funds are not being repaid, they should be considered grants (not loans). For the association, they sound like they can be considered supplemental income to Reserves (something akin to how a special assessment supplements budgeted Reserve funding).

Q: **We collect $30,000 in monthly assessments. What percentage should be allocated to the reserve fund each month? This amount will vary depending on upcoming major projects?**

A: This is one of the three results of a Reserve Study. Your Reserve Study will tell you what's right for your association, but I expect you'll find it to be in the range of $10,000. This is because most associations need to set aside anywhere from 15% of total to 40% of total budget towards Reserves, with 25% being a common "sweet spot". With

$10,000 going towards Reserves and $30,000 towards the Operating Fund, 25% of your total $40,000 monthly budget would be going towards Reserves.

Q: How does anyone calculate the cost of a new roof 20 years in advance?

A: Nobody does. You simply estimate the cost today. Then you apply a reasonable long-term inflation factor, and perform a Reserve Study update at least every third year to update your estimate on the latest "current cost". That way you're never projecting farther than a modest 3 years away.

Q: What is our annual budget? Is it the total at the bottom line?

A: Your annual budget is the total income for the association. It is collected to pay all your operating expenses and ongoing Reserve project deterioration.

Q: I have devised a funding plan for my HOA that I refer to as "10/50/100" 10% for big ticket items over $500K; 50% for items between $499K and $100K; and $100% for all under $100K. Does anyone have any experience with this type of plan or would it be feasible?

A: It would not be feasible. You are not collecting funds for all your projected upcoming projects. How do you expect to pay the roofer with money you don't have? Those projected costs are real. Those projected costs are inevitable. You can't pay for those upcoming projects with money that does not exist. That's also called "planning to special assess some poor sucker in the future".

Q: Do you recommend working with a money manager to manage reserve balances given the reserve balances can be quite large?

A: Yes, absolutely. No manager or board member is a licensed money manager or financial planner. Leave that important project to a professional (keeping your Reserve funds safely under the $250,000 FDIC insured limit, investing Reserves in secure ways to there is no chance of loss of principal, etc.). Use a local Reserve fund planning expert or a national firm like HOAInvest.com.

Q: Our association has kept the monthly fees low by deferring adequate reserve contributions for the first 20 years, and we are unprepared for looming expenses. Is there any strategy that will help in addressing the future - corrective actions?

A: Update your Reserve Study so you have a current plan. Much has changed in the way of pricing the last few years, and interest earnings are now "significant". There's no time to waste… the future is "now". Expect to raise your level of Reserve funding now, and perhaps for a few years, and brace yourself for a special assessment. There's no dodging repair and expenses, as your association is finding.

Q: **What about a board that refuses to accept the remaining useful life of a roof that is not having any issues, and will be fully funded within the useful life remaining, but wants to move forward with replacing the roof immediately and imposing a special assessment to do so?**

A: Stereotypically, boards are slow to replace things, not early! I expect there's a reason we both don't know. Perhaps replacing the roof early will reduce insurance costs enough to make the "early replacement" a wise financial decision. But generally, following the timing outlined in the Reserve Study is usually a good plan.

Q: **A few years back our association decided to not increase annual dues but collect a separate assessment twice a year to go directly to reserves. Is this good/bad/neutral?**

A: Bad. Cash is cash, of course. But you're creating a false sense of costs. The cost of deterioration is as real as all your Operational costs. It is best to confront the owners with the true cost of home ownership in the association, not the Operating Budget and what sounds like an apology twice a year for Reserve funding.

Q: **Comment on maintenance by special assessments versus dues because dues are always with you, assessments are here and gone.**

A: I think you said it clearly. Be transparent with the homeowners. Show them the true cost of home ownership. Special assessments are by nature not a sure source of funds, and they are rarely a timely source of funds. Boards are responsible per the Governing Documents to collect to offset the expenses of the association (although the association has special assessment powers, the budget is where the board should be collecting funds for known expenses).

Inflation Questions

Q: **We have recently seen 3 years of steep increases in recommended reserve funding due to inflation, while simultaneously seeing our reserve strength drop from 98% to 70%. How common is this scenario among all HOA's?**

A: Inflation can ravage an association's Reserve Fund. 18 years of responsible funding, and two or three years of high inflation can mean you are now "behind". So update your Reserve Study regularly to stay "on target". Many associations have noted their Reserve fund strength has fallen in the last few years (due to costs rising more than their Reserve balance grew). That's yet another reason to build a strong Reserve Fund… because it gives you "margin" when things don't work out exactly according to your (well crafted) plan.

Legal/Insurance/Investing Questions

Q: Can a board member be held legally liable for mismanagement of reserve funds?

A: That's a better question for your attorney. There are plenty of ways to mismanage Reserve Funds, and most boardmembers and managers are not well trained or equipped (or insured?) to handle that task. There's no reason to do it yourself when there are trained professionals capable of doing a great job for your association (at a nominal cost).

Q: In states that mandate certain levels of reserve funding, what is an average or range of levels (percentages) they are mandating?

A: Some states require Baseline Funding (maintaining just a cash-positive Reserve Fund), some states require the association pursue a "Full Funding" goal. So there is no average. The consistent guidance is to not kick the can down the road like so many associations have done for the last few decades!

Q: What kind of advice can you give on how HOA's can invest their reserves to bring in revenue? Our HOA has invested in Money Markets and CD's and have earned $22K in the past 6 months

A: We recommend you seek professional assistance in this area. That means finding a Reserve Fund investment counselor (see your local CAI chapter directory of professionals), or reach out to a company like HOAInvest.com.

Q: Where is 4% available on reserve accounts? Traditional banks? We are seeing far less. Less than 1% unless you get a CD.

A: It depends on the financial institution. Most banks serving community associations are now offering returns in the 4% range. Or reach out to a Reserve Fund investment specialist company like HOAInvest.com. Their professionals can find suitable, safe investment with maximized market-rate returns.

Q: What, if anything, can Association Reserves do to help with Fannie Mae and Freddie Mac requirements? We find that these requirements are getting more and more strict.

A: Our studies meet Fannie and Freddie standards, helping your association qualify by documenting the property's financial health and guiding you financially towards having sufficient funds to care for the property.

Q: Have you ever seen where an association had to contend with legal issues by <u>not</u> following the data in a reserve study?

A: We have not, but plenty of community association attorneys and D&O insurance providers have. Boards have a fiduciary responsibility to care for the physical and financial assets of the association. When they don't, they have legal exposure.

FL Specific Questions

Q: **Do you offer any state specific webinar's or information? Florida attendee**

A: Please go to our Florida's office web page (here), and scroll to the bottom to sign up for their email list. They have regular monthly webinars.

Q: **Please talk about the most important reserve issue, the SIRS report.**

A: A Structural Integrity Reserve Study is an overnight construct of the FL Legislature. It is a particular version of a Reserve Study, for associations with at least one building three stories tall or higher, where certain components must be funded through Reserves (amazingly, the Legislature still has given homeowners the power to waive Reserve Funding for most components). A SIRS must be done at least every 10th year. So update your Reserve Study regularly (Best Practice is a With-Site-Visit at least every third year), which means updating your SIRS "earlier than required by State Law". Stay on top of your Reserve Funding. Fund all that is needed at your association, not just the select few components the FL Legislature has called as "mandatory".

Q: **Do we need 2 separate accounts starting January 1st?**

A: There are different interpretations on this matter due to how quickly this legislation materialized, and how it was written. Clearly you need an Operating and a Reserve account, many/most professionals recommend a Reserve fund for Mandatory components, and another for non-Mandatory components. Check with your association's Reserve Study provider, your legal counsel, and your accountant to come to consensus on a proper course of action.

Q: **We had a reserve study recommending what should be funded yearly. Can we arbitrary do what the board sees fit?**

A: It's risky to stray from professional recommendations. It exposes the board to liability – for thinking they "know better" than a credentialed industry professional. Understand that owning Real Estate is expensive, understand that deterioration is expensive, swallow hard, and fund your Reserves as recommended.

Q: **Can we take funds from Non-mandatory items and transfer to our SIRS account (for "Mandatory" components?**

A: Check with your association's Reserve Study provider, your legal counsel, and your accountant to come to consensus on a proper course of action.

Q: **Full funding laws in Florida- where can we find this? What is the baseline to start a reserve fund in this state?**

A: Current FL legislation affecting Reserves can be found here (and on our FL office's web page). The issue is complicated enough that Florida, even more than other states, is where you should get a Reserve Study by a local credentialed professional.