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INFLATION AND RESERVES PLANNING: ADJUSTING TO RISING COSTS

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Inflation is an economic force that affects everything, from household expenses to the long-term financial planning of homeowners associations (HOAs). For HOAs, reserve planning is particularly vulnerable to inflationary pressures, as rising costs for materials, labor, and services directly impact the ability to fund major projects. A $50,000 roof replacement a decade ago might easily now cost $80,000-$100,000… or more. Without a proactive approach, inflation will create funding shortfalls that leave associations unprepared, scrambling to make up the difference. This article offers strategies for adapting to rising costs while maintaining financial stability.

How Inflation Impacts Reserve Planning

Inflation refers to the steady increase in prices over time which erodes the purchasing power of money. For HOAs, this means that the same project planned today will cost more in the future. Common reserve-funded projects—such as roofing, road repaving, or elevator modernization, are particularly susceptible to inflation because they rely heavily on both materials and labor that consistently and predictably increase in price.

A reserve study helps associations prepare financially for future projects over the next 30 years. But even if the *timing* of the future project is estimated correctly, without realistic inflation adjustments those projections will underestimate future expenses and leave the association without enough reserve funds to perform the project. That puts the association in an awkward spot, trying to quickly collect funds from the owners (via a special assessment), or saddling *future* owners with even the *higher* cost of a loan repayment.

Planning for Future Costs

Effective reserve funding requires inflation adjustments. This starts with projecting expenses over the 30-yr planning period using historical inflation rates. In some future years inflation may be higher, in some future years inflation may be lower. For instance, we've recently seen higher inflation rates than "normal", but national policy and economic pressures are bringing them back down to more accustomed levels. Regular Reserve Study updates help increase the accuracy of the overall plan, adjusting in response to these fluctuations.

Because of the tragic Champlain Towers South collapse in FL in 2021 and recent years of "high" inflation, national Reserve Study "Best Practice" has been defined as a site-inspection-based Reserve Study update at least every third year. This ensures that boards are getting a regularly updated multi-yr Reserve Funding Plan that outlines how much to set aside this year and in future years, in light of the building's aging components and changes in component costs. This multi-yr Funding Plan typically recommends annual funding increases. The costs go up each year, so it is natural (and intuitive) that Reserve funding should increase each year.

The Misconception of Interest Offsetting Inflation

One persistent misunderstanding among HOA boards is the belief that interest earned on reserve funds can offset inflation. It doesn't, and never will. While interest can provide a modest boost to reserve accounts, remember that interest is only earned on Reserves actually on-deposit. Inflation works on the entire value of your common area projects, which always greatly exceeds the Reserve cash-on-hand earning interest.

This pursuit of "higher earnings" tempts some boards to invest reserve funds in riskier investment vehicles such as stocks, mutual funds, or real estate (because higher risk = higher rewards). However, such strategies violate the fiduciary duty of board members, who are legally and ethically obligated to protect the assets of others. This means appropriate investment vehicles are more conservative, where the principal is never at risk of loss. Risky investments may offer higher potential returns, but just as often as they make more money for the association (see above… more, but it will never be enough), they yield losses.

The solution is to simply plan appropriately in light of this reality. Be patient, set aside enough funds to Reserves to offset deterioration, let those funds gradually accumulate, and let compound interest work its magic. The key to combating inflation lies in realistic multi-yr funding plans, not in trying to "beat the market."

Adapting Reserve Planning to Inflation

A well-structured reserve plan pursues a Full Funding goal, meaning the HOA strives to set aside enough money to match *100% of the deterioration* at the association. Associations that are Fully Funded (or close to being Fully Funded) have sufficient cash on-hand to handle unexpected cost increases without experiencing cash flow concerns (project delays or special assessments). Thus Fully Funded associations are insulated from the consequences of a project that, because of inflation, is more costly than expected.

Transparency plays a critical role in gaining homeowner support for inflation-related adjustments. Many homeowners may not immediately understand why reserve funding needs to regularly increase (because the costs are regularly increasing!). That is why clear, consistent communication - explaining how Reserve projects require years of financial preparation, with everyone paying "their fair share" over the time they own a home in the association, is essential. Reserve expenses don't go away if ignored. They are still there, drawing closer each year, and getting more expensive each year. Homeowners need to be reminded of this regularly. Everyone owning a home in the association is "on the same team". Remind them they all bear a share of the financial obligation for these upcoming, predictable costs that don't go away if ignored!

Avoiding Common Pitfalls in Inflation Planning

One of the most significant pitfalls in reserve planning is relying on an old Reserve Study (and continuing to fund Reserves as recommended "back then" (without inflationary adjustments). That old Reserve Study (more than two years old – remembering that "Best Practice" is a site-visit-based update at least every third year) doesn't accurately reflect the current physical condition of your upcoming Reserve projects. Some are advancing faster than expected, and some will arrive slower than expected. Another common mistake is thinking interest can "pretty much" offset inflation. See above… it doesn't, and never will.

The Role of Reserve Studies

A regularly updated Reserve Study is the foundation of effective Reserve planning, and inflation management. Remember that different component projects are affected differently by inflation… some increasing faster than others. Getting behind… presuming all are inflating identically, is a mistake. And just as inflation changes from year to year (or as economic cycles change), the interest earned on Reserves on-deposit should be expected to change. The inter-relationship between the two is regularly adjusted in each Reserve Study update.

By partnering with your local, independent reserve study provider, HOAs can ensure that their planning remains both realistic and responsive to changing economic conditions. The result is a sound financial platform where homeowners pay their fair share of the "deterioration bill" over the years they own a home in the association via nominal annual increases to their assessments. The result is budget stability and maximized property values.

Inflation as a Challenge and Opportunity in Reserve Planning

While inflation presents challenges, it is just another reason HOAs need to regularly update their Reserve Study. By addressing inflation proactively at regular intervals, boards can build a stronger, more resilient Reserve fund, build greater homeowner understanding of the true cost of owning and maintaining a home in the association, and reduce the likelihood of an unwelcome special assessment.

The key is to adopt a long-term perspective that balances present-day information and expectations with the reality that future costs will indeed be higher. Inflation is an unavoidable reality, but with prudent planning and regular updates, HOAs can readily adapt to rising costs while keeping the association financially strong and physically sustainable, with maximized property values. In other words, by regularly updating your reserve study and adjusting Reserve funding annually, you ensure a stronger, more secure future for your HOA.