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# Current REVIEW

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## TICK TOCK

By Tamara Lytle

It's easy to post contributions to reserve funds when dealing with day-to-day expenses. But time is running out for many communities.

Maria Keyes and other homeowners across the country are battling the economy, cranky neighbors and, most of all, human nature.

Keyes, treasurer of a six-unit community association board in Maywood, Ill., is trying to save money in a reserve fund. That's no easy task for many associations—even in good economic times.

Reserve funds are accounts that boards use to save money for repairing or replacing major property components. On average, associations have only about half as much in their accounts as they should, according to experts.

"The reserve account is vital," says Keyes. But Keyes has two neighbors who successfully pressed to cut in half the board's monthly reserve contribution. And when major bills came due—for tuckpointing and roof repairs—the association wiped out two-thirds of its \$6,000 reserve fund to pay them.

Now the fund is depleted and the board's monthly contributions to it are well below what she believes is needed.

"It scares me because one day I may want to sell my unit," she says. "If I was a buyer, I would think twice."

The economic downturn has exacerbated what has long been a problem for associations across the nation, says Kris Sundberg, an attorney in Mercer Island, Wash.

"Underfunding of reserves has been a long-term problem and is going to continue to be a problem for a lot of reasons, including human nature. People don't want to save for a rainy day tomorrow," says Sundberg, who represents hundreds of community associations. But "there's no money fairy that makes reserve accounts magically full of money."

Robert Nordlund, PE, RS, says most



associations only have between 40 and 60 percent of what they need in reserves and that figure doesn't vary by time, size and type of development or geography.

"The common denominator is people," says Nordlund, president of Association Reserves Inc. in Calabasas, Calif. "Board members are fundamentally not good at collecting enough money for future projects from their own pockets and their neighbors."

And sometimes even when they do, they don't do a good job of investing the money.

Nico F. March, CFM, a San Diego-based investment advisor, says a swanky St. Thomas, U.S. Virgin Island, condominium community ignored his advice and plunked half its reserve fund into an auction rate security. Now the homeowners are out almost \$2 million, virtually the entire investment. The lesson, March says, is hire experts with good track records and listen to them.

But even boards that have invested wisely have

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been hurt by falling interest rates. Many boards refused to raise assessments and instead relied on interest rates being higher than the inflation rate. “More than likely this will result in increased fees and possible special assessments—and a lot of unhappy campers,” March says.

The economy has hit associations in other ways too. Some are unable to collect 20 percent or more of their assessments, says Tyler P. Berding, an attorney in Alamo, Calif. Boards too often defer their reserve contributions to cover shortfalls in their operating expenses because of the unpaid fees. “Between paying the garbage collector . . . or putting away money for a roof that isn’t going to be replaced for 10 or 15 years, you know which one you would pick,” says Berding, who represents about 1,000 community associations.

But the boards that have saved wisely can make the most of the bad economy, Nordlund points out. Contractors are hungry for work and willing to drop their prices. So associations that move some repairs up can save money.

## IT’S THE LAW

A panoply of state laws and lending regulations have begun to address the issue of reserve funds. Fannie Mae, which buys or guarantees a large chunk of U.S. mortgages, requires that condominium associations it deals with put at least 10 percent of their annual budgets into reserve funds. (So do some states, such as Ohio and Michigan.) In November, the Federal Housing Administration (FHA) also adopted a requirement that condominium associations put away at least 10 percent of their budgets.

Sundberg says government officials have focused on the right problem but taken the wrong approach. The amount associations should save in reserves depends on many factors, including what a particular property will need for capital costs and how much has been set aside so far.

John Poehlmann, RS, principal of Reserve Advisors Inc. in Milwaukee, agrees. “We almost never see associations properly funded at 10 percent. It’s almost never enough.”

California kicked off the movement in 1985 and many states have followed its lead. Virginia and Washington state recently joined the many states that now require associations to have periodic reserve studies. A reserve study includes a thorough inspection of the property, a financial analysis and a recommendation of how much

should be saved. The studies list the major components that will need to be fixed or replaced in the next 30 years or so. It projects how long each one will last and how much it will cost to replace or repair.

Hawaii requires that condominium associations follow the recommendations of the reserve study. But most other states don’t require associations to actually set aside money—only that they have a study done.

“It’s sort of a ‘lead the horse to water’ situation,” Sundberg says. The reserve study must be provided to prospective buyers. “Buyers are going to be more informed consumers,” pressuring associations to manage reserves better, he says.

Banks and government agencies such as the FHA are looking more closely at the association reserve funds since the credit crunch began, according to many experts.

Berding wants to see government action to require associations to save for future capital expenses, not just study them. “Homeowner assessments should be more like property taxes. An association shouldn’t have a choice whether they put away enough money to operate and repair the building. It should be mandatory,” he says.

The laws are meant to counter the instincts of some homeowners to leave the problem to future owners. Even if they won’t be there when the reserves are spent, owners should contribute because they used the facilities while living there.

“This is about the common good of the individuals who live in a community,” Poehlmann says. “That’s a single-family homeowner mentality: ‘I’ll pay for it when it breaks.’”

But even states with reserve laws don’t solve the problem entirely. Although California requires reserve studies, the rule only applies to visible and accessible property components, Berding says. That means items like deteriorating plumbing and framing with dry rot can be ticking time bombs, with no money set aside to deal with them.

The real dark cloud on the horizon is the possibility that, without enough reserves, buildings will fall into such disrepair they become uninhabitable, Berding says. “They (states) can’t be trepidatious about imposing minimum requirements. If they don’t, we are going to lose a major chunk of our (housing) market because they are going to fail,” he says.



## STUDYING UP

State laws frequently specify how often a board must conduct a reserve study. But is that enough?

That depends partly on what funding formula the board has chosen. Baseline funding is cheapest, but also the riskiest, since it leaves little or no cushion in some years. So reserve studies using baseline funding need to be updated more often, says Mitchell Frumkin, PE, RS, CGP, president of Kipcon Inc., an engineering firm in North Brunswick, N.J.

A full study can be followed by an update that is a more cursory analysis. But Frumkin says it's important to do periodic, full-scale reserve studies. If a first study looks at anything that will need to be replaced or repaired within 30 years, then as the building ages, repairs that were once 35 or 40 years away come into that 30-year window and

need to be added to the list.

Money influences how often some boards do a study. Costs vary depending on the type of property. A townhouse association, for instance, is going to be cheaper to analyze than a high-rise because more expertise is needed to evaluate elevators, boilers and other more complicated equipment. Size is also a factor. Inspecting a large community and analyzing a larger budget will cost more than a small one. Updates usually cost about half as much as a full study, Franklin says.

Updates and new studies are important because even a well-done reserve study can be pushed off course by unexpected circumstances. Poehlmann says interest rates can—and have—dropped. Weather conditions can delay or speed up the need for certain repairs. And board members can make changes at their discretion—replacing something for aesthetic reasons or earlier than planned.

## *How Much Is Enough?*

*So how much should you save in your reserve fund? The three main formulas are baseline, full and threshold funding.*

**BASELINE FUNDING.** With this approach, an analyst looks at all the major property components that will need repair or replacement in the next 30 years, their expected costs and when those costs will come due. The contributions are set at a level that ensures the reserve fund balance never dips below zero or some other dollar figure set by the board. It's the least expensive, but riskiest approach. If a piece of equipment fails early or costs more than expected, associations may face a deficit, requiring a special assessment or loan.

**FULL FUNDING.** This is the most expensive formula, but the safest. It's the least likely to leave a board needing an emergency special assessment. Each component is evaluated separately and then the cost of replacement is divided by the number of years left until it needs replacement. For example, a board would save \$10,000 a year for a roof that will cost \$100,000 to replace in 10 years. Then, all those components and their costs per year are added up to establish the annual reserve fund requirement.

Robert Nordlund, RS, of San Diego recommends full funding, even though it costs about 12 percent more than baseline funding. The extra cost gives boards and homeowners peace of mind because there is less potential for political and financial problems, he says. "We don't feel it's responsible to make a recommendation to clients that expose them to special assessments," Nordlund says.

**THRESHOLD FUNDING.** Under this method, the goal for the reserve fund balance is set at a level between baseline and full funding. That level is based on the association's tolerance for risk, among other factors. It's recommended by John Poehlmann, RS, of Milwaukee. "It protects the association from getting into a difficult situation because it's above the baseline. And unlike full funding, the association isn't putting money into reserves that it probably won't use for a long, long time," he says.

The age of the association—and therefore its components—affects how often a study should be done. Frumkin recommends a new study every three or four years for associations up to 10 years old. Older associations should conduct a full study every other year.

But Nordlund recommends more often. Reserves are between 15 percent and 40 percent of most association budgets, he points out. "Any number that big should be addressed every year. It's the elephant in the living room."

While there are no requirements for who can prepare reserve studies, associations should look for qualified experts such as Reserve Specialists (RS), a designation awarded by CAI, or licensed Professional Engineers (PE). Some boards choose to do their own studies. Poehlmann said figuring the measurements of how siding is needed—once doors and windows are deducted—can be daunting for a novice. Knowing the portent of a curled roof shingle or whether cracked pavement is a problem that will spread through the community or just an isolated issue, for instance, can take a practiced eye.

"We don't believe the board members can do the single most important factor of a reserve study—properly assessing the condition of the elements," Poehlmann says.

However, Nordlund points out that small associations like Maria Keyes' in Illinois—that can't afford a reserve study—can benefit from do-it-yourself workbooks and software. "There are tools out there for board members or managers to do it themselves cost effectively," says Nordlund.

## WILLPOWER

Once the reserve study is completed—by a professional or by the board—one of the biggest challenges many boards face is summoning the political will to put aside the right amount of money.

Nordlund estimates that fewer than half of associations put aside what the reserve study recommends. He suggests boards communicate upcoming projects so residents understand the need to put money away. A \$500,000 roof project in five years can put the scare of special assessments into homeowners if they know about it, he says.

"The roof doesn't care if you have enough money set aside or not," Nordlund says. "It's going to fail."

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## TICK TOCK

And it's good to remind homeowners that most reserve contributions cost less per day than a Starbucks treat. "To take care of your home—most people's biggest investment—that's not a large number," Nordlund says.

But the average person occupies a condominium only about 7 years, Berding says. Problems that will crop up in 15 years aren't a high priority for some residents. "You move out and pass on the underfunded reserve to the next guy, and the next guy," and the reserve fund becomes increasingly inadequate, he says.

In the long run, healthy reserve funds can be good for an association's finances. Reserve funds can increase property values and reduce the need for special assessments, Frumkin says. That's an important issue to buyers.

Frumkin sells boards on the value of putting aside reserve funds by showing them how it can save them money. Frumkin, who holds a National Association of Home Builders' designation as a

certified Green Professional, looks at how capital costs, energy costs and maintenance expenses interact. For example, a 21-story New Jersey development planned to replace its boiler in 13 years. He showed the board that doing it now with an energy-efficient model could save them enough in energy costs that they could pay off the boiler in a year.

Frumkin cites another example of what he calls "value engineering." Wood decks need to be replaced every 15 years and sealed every 5 years. Replacing wood with a plastic-wood composite that never needs to be replaced means the deck can be dropped off the reserve list and its maintenance costs eliminated. The composite material is more expensive, but installation is about the same. Frumkin can tell a board exactly how long it takes to break even.

"This is real-time, cutting-edge change to the way associations look at their budgets and reserve funds," he says.

Whether its value engineering through green technologies or the traditional use of reserve funds to replace major components, healthy reserve funds have critical benefits to homeowners.

"Not only will the property be maintained properly by putting the right amount of money in, the aesthetic value will enhance the marketability," says Poehlmann.

Association professionals say the evidence is strong that a healthy reserve raises property values, helps avoid special assessments and shields board members from complaints that they have neglected their duties.

March's advice to board members is simple: "Cover your assets."

*Tamara Lytle is a freelance writer in the Washington, D.C. area. Reprinted from Common Ground, March April 2010, a publication of Community Association's Institute.*

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