Obsidian | Investment Advisers, LLC

Frequently Asked Questions (FAQ): Condominium Homeowners - Capital Reserve Underfunding

1. **What's the Problem?**

   A: When a Home Owners Association (HOA) Capital Reserve Account is under-funded, it means the HOA does not have adequate reserves to pay for all future major repairs and replacements within the development. In severe cases, Homeowners will likely face large special assessments in future years.

2. **What's a Capital Reserve?**

   A: The Capital Reserve is money that's been set aside for capital projects in common areas of a development. The Reserve is meant to pay for long-term expenses or capital projects for refurbishment or replacement of things like sidewalks, roads, fences, elevators, roofs, and exterior painting.

   A portion of monthly dues go toward Reserves, but sometimes it's not enough to meet all the expenses for future projects. In other words, while there is money in the Reserve to fund *some* projects, there may not be enough to fund *all* projects.

3. **What's an adequate level of Reserve funding?**

   A: Reserve funding levels are judged by the "% Funded", which is calculated by taking the value of Reserve funds and dividing it by the Net Present Value of the total projected HOA Reserve expenditures over the next 30 years (which is obtained from a Reserve Study). Industry experts judge 70% to be the minimum standard for a "strong" Reserve, while amounts ranging from 0% to 30% are considered "weak" and deemed severely underfunded.

4. **Does a HOA make money on its Reserve funds?**

   A: Yes. The return will be directly related to how effectively the Reserve funds are invested. The return on Reserves, as well future inflation, can significantly impact the amount of funds available to the HOA. Keep in mind that it takes investment knowledge to find safe investments offering adequate yield; and it takes a certain degree of financial sophistication match investment maturities to the timing of Reserve expenditures. Seeking professional investment advice can prove helpful.

5. **Does state law govern the types of securities HOAs can buy with Reserve funds?**

   A: No. For example, the Revised Code of Washington (RCW) Title 64 Chapter 64.38, which governs Homeowner Associations in the Washington state, does not restrict the investments that HOAs may purchase, and there is nothing in this section that speaks to how monies under HOA control must be invested. Instead, an HOA's governing documents (i.e., its Declaration or Bylaws) specify what investments are allowed. It is common, however, to see language in the governing documents stating that funds must be invested in securities that are insured by agencies of the United States.

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6. What types of securities could a HOA invest in?

A: The HOA can only invest in securities that won't violate its governing documents (i.e., its Declaration or Bylaws). If the governing documents allow investment in securities insured by agencies of the United States (which is typical), then there are a wide variety of bonds and certificates of deposits (CDs) that could be purchased. Many HOAs limit their investments to CDs, but a wider array of investment options are often available.

7. Can our management company offer investment advice to the HOA?

A: Only investment professionals like the representatives of Registered Investment Advisers and the agents of Broker-Dealers can legally offer investment advice.

8. My HOA has a severe Reserve shortfall. What can we do?

A: There are several options that HOAs with severe shortfalls could pursue:

i. <u>Special Assessment</u> – The HOA Board could make a special assessment per homeowner to cover the shortfall.

ii. <u>Raise Dues</u> – Each year, the HOA Board can increase dues to the level needed to fund the Reserve given the considerations of the operating budget, investment returns, and estimated costs of capital projects.

iii. <u>Manage the Problem</u> – The HOA could use a multi-pronged approach that keeps dues payments reasonable and contributes money toward the Reserve. Elements of this plan might include:

1. <u>Place Reserve Funds that won't be needed for several years into higher-yielding investments</u>. Increasing the rate of return on uninvested funds can increase funds available for future years.
2. <u>Synchronize investment time horizons with future capital spending needs</u>. For example, if Reserve funds are needed in 5 years, funds should be invested in a security that maximizes returns over the 5 year timeframe, subject to constraints.
3. <u>Scrutinize the Operating Budget, refrain from adding new spending items, and try to reduce and/or eliminate expenses</u>. Now matter what, it will be extremely important to keep the HOA's yearly spending in check.

9. The developer of my condo just turned the HOA over to homeowners, but it has a severely underfunded Reserve. What can we do?

A: This is a legal matter. So consult an attorney knowledgeable about community associations. Not all states require developers to create a Reserve, however, in those states where it's mandatory, a HOA might have a cause of action against a developer that breaches their fiduciary duty to the HOA before its ultimate transfer to buyers.

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