Obsidian | Investment Advisers, LLC

Frequently Asked Questions (FAQ): Condominium & Homeowner Associations - Maintenance Reserves

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

   A: When an Association's Maintenance Reserve Account is under-funded, it means the Association does not have adequate reserves to pay for all future major repairs and replacements within the development. In severe cases, Home owners will likely face large special assessments in future years.

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

   A: The Maintenance 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 assessments 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 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 an Association make money on its Reserve funds?**

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

5. **Does state law govern which securities Associations 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.

6. **Can our management company offer investment advice to the Association?**

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

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7. **What types of securities could an Association invest in?**
   A: The Association can only invest in securities that won't violate its governing documents (i.e., its Declaration, Bylaws or Investment Policy). 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 Associations limit their investments to CDs, but a wider array of investment options are often available.

8. **If 100% of our funds are invested in CDs or long-dated bonds, can we get our money out if we have an unexpected large expense?**
   A: Yes. Investment strategies are based on the Association's reserve study, so large expenses have typically been accounted for. Sudden, catastrophic losses are usually covered by insurance. However, in the unlikely event there is a sudden catastrophic loss that is not covered, we'd work with the Board to develop a cash flow forecast, evaluating all alternatives for sources of funds. CDs and bonds can be sold, though the Association may face a capital gain or loss on such sales.

9. **My Association has a severe Reserve shortfall. What can we do?**
   A: There are several options that Associations with severe shortfalls could pursue:
   i. Special Assessment – The Board could make a special assessment per homeowner to cover the shortfall.
   ii. Raise Dues – Each year, the 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. Manage the Problem – The Association could use a multi-pronged approach that keeps dues payments reasonable and contributes money toward the Reserve. Elements of this plan might include:
      1. Investing Reserve Funds that won't be needed for several years into higher-yielding securities. Increasing the rate of return on uninvested funds can increase funds available for future years.
      2. Synchronizing investment time horizons with future capital spending needs. 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. Scrutinizing the Operating Budget, refraining from adding new spending items, and trying to reduce and/or eliminate expenses. Ultimately, it will be extremely important to keep the HOA's yearly spending in check.

10. **The developer of my condo just turned the Association 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, an Association might have a cause of action against a developer that breaches their fiduciary duty to the Association before its ultimate transfer to buyers.

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