

**WHAT IS THE RIGHT WAY TO FUND YOUR RESERVE ACCOUNT?**

In other words, how much do you need to have in your reserve account at any given time? The answer is not as simple as it seems. The real answer is, it depends. And it changes over time. So, to answer the question: “what is the right way to fund your reserve account?” let’s look at the variables:

* Is there an accurate and complete list of common and limited common elements that everyone agrees on?
* If the association has not attended to maintenance issues over the years, a greater amount may be needed in the short term.
* If components are reaching the end of their useful life, more money may be needed sooner, rather than later. Conversely, if major elements are new or have been recently updated, there is a longer time to accumulate funds.

There are also administrative concerns:

* Inflation and return on investment may also affect the balance that may be needed, especially when projecting over the next 15-30 years.
* What about vacancies and delinquencies? How are they to be budgeted?

Then there are the institutional issues:

* States and municipalities may have restrictions and regulations that need to be complied with.
* If the association wants new buyers to have access to federally insured loans (e.g. FHA/VA), there are specific requirements as well.
* Is the association willing to consider debt financing for major capital needs?
* Are new mandated issues properly dealt with (e.g. The Americans with Disabilities Act)?

Finally, there are discretionary concerns:

* Do owners prefer to be conservative in their funding with plenty of reserves for contingencies, or would they rather take a “wait and see” attitude which may require a special assessment.
* When common elements reach the end of their useful life, does the association prefer to “replace in kind” or rather employ the latest technology which may increase (or potentially decrease) reserve requirements.
* Are there any improvements that the association would like to make?

Some time ago, the Community Associations Institute (CAI) came up with the concept of ***Full Funding***. This is defined as “*the reserve balance that is in direct proportion to the fraction of ‘used’ life of the current repair or replacement cost*.” In other words, if an item has an Estimated Useful Life (EUL) of 20 years and will cost $20,000 to replace, to be fully funded the association in year five should have $5,000. Sounds simple enough. Repeat for each common element, and you have your reserve budget.

In practice, however, this approach has proven to be of limited value, largely due to the variables listed above.

The answer, therefore, to the question: “What is the right way to fund your reserve account?” is not as straightforward as it may seem.  Setting a threshold for the minimum balance, based on statutory requirements and risk tolerance is a good place to start. A few guidelines that have been used include:

* Never fall below the average annual reserve expenditure.
* Maintain a funding strategy that is no less than 10% of total revenue.
* Maintain a funding balance of 60-70 percent of the fully funded balance.

Finally, you should update your reserve study regularly (every 3-5 years) and be sure to freely discuss with your consultant the issues mentioned above. It’s not that hard once all the variables are known and accounted for.

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