## Under-Funded Reserves, the *Other* Housing Crisis!

As of the end of 2009 approximately 60 million Americans[1] were living in a home or condominium located within some form of private homeowners association (HOA). The majority of these homeowners are unaware of the critical importance of long range financial planning (reserve planning) in creating a sustainable community and most have probably never heard of a reserve study.

As of the end of 2009 approximately 1/3 of the owner-occupied homes in the U.S. (24.4 million) were located within some 300,000 HOAs; considering every one of these 300,000 privately run communities *should* have a reserve funding program in place, the current state of affairs is arguably a serious problem. Nobody really knows how many HOAs have actually conducted a reserve study, or how many are regularly funding a reserve account, but most industry professionals agree that the nation's HOAs and condominium associations are seriously under-funded.

According to the *Community Associations Institute* (CAI) the total amount of money held in reserves (accumulated reserves) by all HOAs and condominiums in the U.S. is approximately $35 billion dollars. When divided by the total number of homes within these HOAs (24 million) we can see that the average accumulated reserves per household are a paltry $1,458!

Approximately 14 million of these homes are 15 years old, or older. The average life expectancy of the components and improvements maintained by the associations in which they are located is no more than 30 years. What this suggests is that within the next 10 to 15 years we are going to see a major financial crisis develop among older HOAs in the U.S. Drawing again from CAI statistics we can see that as of the end of this decade (2020) there will be approximately 225,500 HOAs which are 20 years old or older; 130,000 of which will be at least 30 years old. Adding to the problem is that older HOAs are generally among those with the most severe funding problems.

Assuming there is no change in the average aggregate level of accumulated reserves over the next 10 years, the U.S. will see another form of housing crisis emerge by the end of this decade, as the majority of the older HOAs in the U.S. will be unable to pay for

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needed repair and replacement projects involving the common area improvements within these communities.

Condominiums and other forms of attached housing developments will be impacted the most as these associations typically bear a significant portion of the responsibility for maintaining the exteriors of the homes within the community. The recent trend toward high-rise condominium development will pose an additional problem as these buildings age, due to the inordinately high costs associated with maintenance, repair and replacement of high-rise buildings.

Among the more traditional HOA settings wherein the individual homeowners are responsible for the cost of maintaining their respective homes, it might be assumed the problem is not as big of a concern. Depending on the array of assets and physical improvements maintained by such communities, this may or may not be true. If your association is responsible for the cost of maintaining roads or other transportation related infrastructure, the need for a long range funding program to pay for renovation of these critical elements is imperative.

If you wait until the community is 25 or 30 years old to begin funding such a program, you have essentially "lost" 25 or 30 years of contributions which would have otherwise been made by early generations of owners who have since moved on, thereby shifting the entire burden for road improvements to later generations of owners. As buyers become more savvy with respect to the implications of such fiscal mismanagement, the market will correct itself in the form of lower property valuations within communities which have historically under-funded their reserves.

Although privately owned roads will be a major expense for any HOA, they are not the only common area assets which drive the need for reserves. A typical 1,000 member HOA which includes a couple of swimming pools, tennis courts, and clubhouse, along with a few small parks, playground equipment, park structures, parking lots and several miles of bike paths and fencing, will easily spend $5 million or more every 30 years ($5,000 per household) if they want to properly maintain the common area facilities within their community.[2]

By using the CAI statistics cited previously we can see that this "typical" HOA is likely to have no more than $1,458 per household in

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accumulated reserves. If our hypothetical HOA is already among the 20 year and older age group then they already have a problem. If they are among the 10 to 20 year age group then they need to get busy and start taking their reserve planning process a lot more seriously over the next 10 years.

When the association's responsibility for common area expenditures involves more in the way of non-discretionary assets, as in the replacement of roofs, siding, doors, windows, mechanical equipment, roads and other critical components, the implications are much more severe in terms of the "crisis" which looms as a result of under-funded HOA reserves.

The historical tendency throughout the industry and among HOAs of all types has been to ignore the critical role of reserve planning and funding. In the absence of a major paradigm shift toward more responsible fiscal management across the HOA spectrum, two things will occur:

- Many HOAs will simply be unable to afford to undertake major repair and replacement projects due to a lack of funds. In many instances the owners within these communities simply will not have the financial capacity to pay for the needed expenditures, either by way of a special assessment or an increase in their regular monthly HOA dues. Property values in these communities will reflect the declining physical condition of the community owned facilities. The individual homeowners will be powerless to do anything about the decline in the value of their individual homes.

- Banks and commercial lenders, in particular mortgage lenders, will end up setting the standards for HOA fiscal management through their loan underwriting guidelines. This trend is already beginning to gain momentum and is certain to continue, particularly within the condominium and attached housing sector. The result of such a shift in lending policy will be that the ability to sell or refinance one's home becomes dependent on the willingness and ability of your HOA to maintain the common area assets in a responsible manner which is sufficient to meet the expectations of the mortgage lending industry.

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The failure of the industry and homeowners to address this problem, by making long range financial planning and reserve funding an integral part of the HOA governance and management process, will inevitably lead to another housing crisis within the next 15 years.

The industry can avoid the onset of this crisis through proactive planning, management and good governance practices which must be adopted as the industry-wide standard operating procedure. Failure to address this issue at the present time and react in a positive, meaningful manner may be considered another example of repeating the same behavior and expecting a different result; which was Albert Einstein's definition of insanity!

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[1] http://www.caionline.org/info/research/Pages/default.aspx

[2] Although $5,000 per household over a 30 year period may sound like a lot of money, bear in mind that this amount computes to being a monthly contribution of $13.89 per owner assuming a 1,000 member HOA.

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