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Proper capital reserves reduces risk of special assessment and maintains property values

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The primary purpose of a capital reserve funding analysis is to offer recommendations as to the amount of monies that a condominium or other form of ownership should fund on an annual basis for the future replacement of commonly owned elements within a building or community. The analysis is important in that it helps to avoid possible future special assessments of the individual unit owners. The analysis should take into account the site-specific existing conditions, the remaining useful life of each element and realistic replacement costs based upon actual material costs and the method of reconstruction of the individual, site-specific, items. Proper funding not only reduces the risk of special assessment but also maintains both property values and real estate marketability.

Federal Housing Administration (FHA) approved financing plays a large role in providing individual mortgages as well as funding for large-scale construction projects in condominium buildings. An FHA approved loan reduces the risk of and protects a lender from financial losses due to defaults and related foreclosures. Due to the recent historical increase in mortgage defaults and related foreclosures, the FHA has adopted new regulations that specifically target and affect lending to condominiums.

In addition to several other more stringent regulations, the newly adopted (December 7, 2009) Federal Housing Administration (FHA) standards for insuring mortgage loans involving condominium units may now require that a current reserve study be performed to ensure that adequate funds are available for funding the replacement or repair of the common elements of the condominium.

The new standards require, among other things, that the capital reserve fund analysis be no more than twelve (12) months old if certain budget documents requested by lenders do not meet specific standards. The new regulations require mortgagees to review the condominium association's budget (the actual budget for established projects or the projected budget for new projects) for all projects. This review must determine that the budget is adequate and if it includes allocations/line items to ensure sufficient funds are available to maintain and preserve all amenities and features unique to the building or development. The funding plans must provide for the funding of replacement expenditures and deferred maintenance in an account representing at least 10% of the total budget. The U.S. Department of Housing and Urban Development website, www.HUD.gov, provides specific information on all of the new requirements.

Unfortunately, and far too often, condominium boards are finding themselves in the position of underfunding at the time of the inception of a major replacement project. Whether reconstructing roofs, façade, HVAC equipment or other aspects of the building or community, the membership relies on the funding that has been recommended and established over the useful life of the item. Some buildings or community associations have no current funding plan and rely upon either the

annual budget for funding or the membership schedules when obtaining bids for the reconstruction project, only to find that the proper funds are not available.

If the study is outdated or erroneous, similar concerns will arise. The recommended useful life may be inaccurate, an item's replacement cost may be incorrect and/or the unit quantities may be smaller than what actually exists. These types of errors can result in special assessments, resident dissention, decreased property value, and ill feelings toward the management company and board members.

Common problems we find with existing reserve schedules include being overly optimistic regarding remaining useful lives and/or replacement costs, not being community specific and/or containing data errors. Errors or deficiencies in either the original capital reserve analysis or an updated analysis can cause this unfortunate position.

Performing a current and accurate reserve funding analysis and continued periodic updates using specific building and site conditions, in addition to realistic projected replacement dates and costs, are extremely effective methods (if not the only methods) to ensure that a condominium's capital replacements are being properly funded.

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