



## Proper Capital Reserves: More Important Than Ever!

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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 of their 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, remaining useful lives of each element and realistic replacement costs based upon actual material costs and the site specific individual item's method of reconstruction. Proper funding reduces the risk of special assessment and now also maintains 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 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 in 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, now may require that a current reserve study be performed to assure 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 to be no more than 12 months old if certain budget documents requested by lenders do not meet specific standards. The new regulations require mortgagees to review the condominium associations' 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 website at HUD.gov has the specific information on all of the new requirements.

Unfortunately, and far too often, condominium boards are finding themselves in an underfunded position 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 on the annual budget for funding or the membership schedules and obtains bids 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 not be accurate, the item's replacement cost is wrong and/or the unit quantities were smaller than what actually exists. These types of error can result in special assessments, resident dissension, lost



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property value, and ill feelings toward the management company and board members.

The problem always seems to be that the original and/or updated analyses were not realistic, not site specific or not accurate. Errors or deficiencies in either the original capital reserve analysis or even an updated analysis can cause this unfortunate position.

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

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