

THE RIPPLE EFFECT: THE IMPORTANCE OF ADEQUATE RESERVES AND INSURANCE COSTS

By Damian Esparza

Community association living is the nation's fastest growing lifestyle trend. Chances are you or someone you know lives in an association.

According to Community Associations Institute between 6,000 to 8,000 new associations are created every year representing 47 million Americans living in condominiums, planned unit developments, and co-operatives. In California there are over 3 million homes represented by approximately 37,000 associations with 60% of all new single family homes being developed as community associations.

More importantly, in San Diego County there are approximately 4,400 associations with 250 new associations created in 2003, according to Marc Poland at CID Registry of California. Statewide 1,000 associations were created in 2003 which shows the dramatic growth San Diego County has experienced with 25% market share of newly created associations in California.

With this in mind, imagine how many personalities, agendas, and motives navigate the treacherous waters for creating sound communities. Each community has interests and constituencies like that of a city council.

Different views and opinions are often expressed at board meetings, which are valid, but must be viewed in regards to the good of the association. A retired couple may ask, "Our reserve study indicates we have 17 years of remaining life, why do we have to save or increase our assessments for a roof replacement that far out. We won't be around to see it." The young homeowner may inquire, "Why am I getting all these special assessments? I just bought this place."

The Association President may attempt to avoid increasing assessments, while maintaining the upkeep of the property with ever increasing operating costs like insurance. This is politics, at its best or worst, depending on your point of view.

This canvas paints the picture for the perfect storm in regards for proper planning with many different points of view reflected in the community. Sometimes, dissension and lack of proper action can have disastrous results. While the Board may not act due to lack of consensus, Mother Nature waits for no one.

Being in "reactive" mode rather than proactive mode will lead to major consequences. For example, one diligent board member at Happy Green Acres Association monthly board meeting may state, "It's been a very wet winter and resealing the asphalt is needed along with repainting the wood siding to protect against termite and dry rot." This is countered with a reluctant and short sighted counter question, "Where are we to get these

funds? We don't have the reserves allotted for such maintenance programs." The room goes silent, and the "Hot Potato Effect" has occurred. That is, the lack of proper action in planning and increasing assessments necessary to maintain the association has resulted in a systematic 'passing of the buck' from one generation of board members to another. No board wants to face the hard questions and relinquishes current action for future expenditures. As one association attorney states, "When associations underfund their reserves, later generations of owners have to pay increasingly, at times frighteningly large assessments. The impact can be traumatic."

This scenario is unfortunately too common with boards who believe by keeping assessments low (causing deferred maintenance) they are acting in the best interest of the homeowners who now live there. Unfortunately, they are misguided in their precepts, and by their lack of proper maintenance and proper assessing of the homeowners the community association will pay more in the medium and long term than those board members ever imagined.

There is a direct correlation between proper maintenance and adequate reserves, much like that of changing your oil every two to three thousand miles in your car. Everyone knows that if you properly maintain your car, it prolongs the life of the vehicle. On the other hand, the longer you wait to change your oil, the more susceptible the vehicle is to damage. The same is true with asphalt, wood, and a variety of other major common area components. Reserves and component maintenance works in the same fashion. Think of the engine as the common area components and the reserve fund as the oil that lubricates the wear and tear of everyday usage.

In the end, a little money with a proper maintenance program can extend the useful life of your components and defer long term costs with periodical repair and replacement. For example, by adjusting the wood painting cycle from 8 years to 4-5 years they would be less vulnerable to experiencing major problems from longer exposure. As one reserves specialist states, "We have come across associations that have extended cycles for component maintenance such as painting wood and wrought iron, and resealing asphalt. These extended cycles of painting and resealing of the asphalt have had a direct negative effect on the actual replacement life cycle of these components. Far too often we have had to adjust the normal life cycle downward for components such as wood siding, asphalt and fencing due to the lack of regular maintenance."

As well, after a wet winter Happy Green Acres may face a water leak or intrusion into common areas which could lead to even larger problems like mold infestation. Mold has been a prime subject of association meetings over the past few years. Focus should be how to avoid mold through proper maintenance...for those associations with mold problems, generally the Association has not immediately addressed a leak or intrusion, allowing a period of time without attention. Often this results in unnecessarily costly remediation and repairs...mold can be largely prevented with immediate response combined with a periodic mold inspection program. This is an example of how the consequences of deferred maintenance have a ripple effect throughout the association

considering the fact that the repair needs will not magically disappear but rather grow with time along with the expenses.

So let us imagine the worst case scenario. What happens if the association goes bankrupt? So far that hasn't happened, and considering that assessments are cash flow for mutual beneficial nonprofit corporations, or homeowner associations, the chances of an association going bankrupt is slim to none, for now. But with reactive legislation looming on the horizon who knows if associations could be shoved down the road to insolvency, impeded to act reasonably in funding for necessary repairs, insurance and other operational expenses. That being said, association reorganizations have occurred and if your liabilities are greater than your assets you are in trouble. After all, look what happened to the Franklin Villa association of Sacramento now known as the Phoenix Park Project. The association had deteriorated to the point it was compared to living in the projects, infested with drugs, crime and violence. The Sacramento Housing & Redevelopment Agency condemned the old Franklin Villa association and revitalized the area with a new association development to the tune of a reported \$80 million of taxpayer funds. This example is not typical, but merely an illustration of the importance of adequate reserve funding which is closely connected to the proper maintenance of operating a community association including insurance.

Many HOA's are being cancelled by preferred carriers due to poor loss history even after they 'clean themselves up' after 3-5 years. Due to their age most preferred carriers are still not going to look at them. It is extremely important for associations to be proactive, for example adequate reserves that allow for proper maintenance programs, because HOA's are not looking at high deductibles for 3-5 years to mitigate losses that may come in but must also realize it could be longer than that before preferred carriers look at them.

So let us hope boards get the picture and adequately fund their reserves because whether it be deferring maintenance or repairing water damage from an unforeseen natural disaster, the consequences of inadequate reserves can have far reaching implications on the association and its members. The ripple effect can lead to higher insurance costs, litigation, or a decrease in property value.

After all, the decline of adequate reserve funding for property maintenance directly correlates to the appearance of the associations' common area property and cost of insurance.

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