Consumer Warning: Underfunded Homeowners Associations

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The California Department of Real Estate (DRE) has issued this warning as a result of the growing number of homeowners associations (HOAs) that do not have sufficient funds or reserves to adequately maintain the common areas in the housing developments for which the HOA is responsible.

This warning will explain the negative effects and impacts of an underfunded HOA, offer suggestions on how to gauge the financial health of an HOA, and discuss some typical causes of an underfunded HOA.

Negative Effects of an Underfunded HOA:
An underfunded budget may cause unexpected expenses for the owners living in a CID and/or have a deleterious affect on the value or condition of an owner's property. If the HOA cannot properly maintain the common areas due to budget constraints, roads, pools, exterior paint, and roofs may fall into disrepair. Moreover, underfunded HOA budgets may create pitfalls for homebuyers who do not investigate the financial health of the HOA prior to buying into a CID. HOAs facing severely underfunded budgets often must resort to levying special assessments on the owners living within the CID in order to pay for needed repairs or maintenance. Special assessments can run into the tens of thousands of dollars so owners and buyers would be wise to look into the financial health of the HOA to ensure they aren't exposing themselves to unexpected expenditures and financial problems.

How to know if the HOA is Financially Healthy:
HOAs are required to produce a yearly budget and to furnish it to the owners in the association. In addition, at least once every three years, the HOA is required to review the major components of the CID that the association is obligated to repair, replace, restore, or maintain, as part of a study of the reserve account requirements, to ensure sufficient funds are, or will be, available to adequately maintain the common areas. Included in the budget documents, the HOA is required to provide a summary of its reserves and whether the reserves are adequate to maintain all the major components of the CID. This summary disclosure document is an excellent tool to determine the long term financial health of any HOA.

In addition, the law affords a potential buyer or an owner in an association the opportunity to review the HOA's financial documents. For a potential buyer, the financial documents may be requested from the seller. For an owner in the association, the financials should be received from the HOA at least annually.

Typical Causes of HOA Underfunding:
Foreclosures are a significant cause of underfunded HOA budgets. Homeowners in foreclosure often do not make their assessment payments. Due to the length of the foreclosure process, the non-payment of assessments may cover a period of 90 days to a few years. Although HOAs have the ability to place a lien against a homeowner's property for non-payment of assessments, HOA liens are often extinguished at the foreclosure sale because the value of the property is insufficient to pay off all the liens against the property. This is especially true in cases where the value of the property is less than the mortgage. The end result is the HOA ends up with less than the projected assessment income, which leads to an underfunded budget.

Inadequate planning on behalf of an HOA board can also lead to an underfunded budget. In instances where a CID or HOA is facing dire economic conditions, an HOA board may succumb to the pressure of its association members and not increase assessments or even reduce assessments and forego on-going maintenance. These types of bad decisions inevitably result in the HOA levying special assessments against the owners to address health and safety issues that arise from neglect. In addition, reduced care and upkeep of a CID's common areas result in the inability to sell or secure financing because of the dilapidated condition of the property.

HOAs that rely on inadequate assessment collection procedures usually suffer from insufficient funding to satisfy their financial obligations. For example, homeowners who are not in foreclosure but refuse to pay their assessments may rely on the association's poor collection process as a way to delay making their assessment payments. This may result in a "domino effect" where other members stop paying their assessments under the rationale that since others are not paying, why should they.

What to be Aware of when a CID has an Underfunded Budget:

- Special assessments. Inevitably, underfunded budgets lead to special assessments as mentioned above. This is the common method HOAs use to satisfy financial obligations. While an HOA is limited on how much it can increase assessments - typically 5% per year - a special assessment can be assessed in order to resolve a health and safety issue. This means the entire cost to make a repair can be levied against all its members, or members who are paying assessments. Special assessments can be tens of thousands of dollars.

- Inability to sell or declining property values. It can be very difficult to sell a home if the HOA's assets are inadequate to satisfy its financial obligations. Buyers will be leery of special assessments and/or increased monthly assessments. Moreover, property values may depreciate dramatically because of deferred maintenance and inadequate funds to satisfy financial obligations.

- Inability to secure financing. Lenders (subject to underwriting guidelines from Fannie Mae or Freddie Mac) may deny funding loans whenever an association funds less than 10% of its operating funds into its reserves. In addition, lenders are reluctant to fund loans when an association cannot meet its financial obligations.

Quick Tips for Evaluating the Financial Health of an HOA:

- If you are a buyer, demand that the seller provide you with copies of the most current financials for your review.

- If you are an owner, make sure that you are given annual financial reports, especially the delinquency report and those pertaining to the adequacy of the reserve account.

- If you are a buyer, do a physical review of the property and observe how the common areas are maintained. For example, assess the condition of exterior paint, amenities, roads, roofs, drives, fencing, etc.

- If you are an owner, be involved with the board and its decisions, especially when you see deferred maintenance of common areas or are subject to special assessments.

Conclusion:
The issues raised in this warning, along with the suggested steps to take to avoid potential financial problems, are not all inclusive. Each project in California may have unique issues that can only be addressed by you, as either the buyer or owner, performing your due diligence.

However, what appears to be a common thread in today's real estate economic climate is that many projects are falling victim to hard times and the result is the underfunding of HOA budgets.

Please refer to DRE's web site, www.dre.ca.gov for additional information on Common Interest Subdivisions, including the brochure Living in a Common Interest Development.

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