The Importance of Reserve Funds for Your Block: An ARMA Introductory Guide

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Reserve funds and sinking funds. What are they? What are they for? Why should we be putting them in place and how do they work?

Currently under leasehold, each particular lease will determine if a reserve fund can be collected for a building. Where the lease does allow for a reserve fund it is highly likely that a £ amount or even what the reserve fund should be used for will not be stipulated. This makes complete sense as flexibility to deal with unforeseen circumstances is what you need when dealing with reserve funds and block cyclical maintenance.

Reserve vs. Sinking funds

So, what is a reserve fund and how does it differ from a sinking fund? A good distinction is given by Brady Solicitors on their **website** and is copied below for reference with Brady's permission:

What is the Reserve Fund Used For?

The reserve fund helps management companies to prepare for, and manage unexpected expenditure that the service charge budget could not account for. The reserve fund has several distinct characteristics and advantages:

- **Helps deal with overspend:** As it is difficult to know exactly what the yearly expenditure will be on the block, the reserve fund acts as an overdraft on a range of costs such as unexpected communal repair bills. Building up a reserve fund over a short period ensures you can bridge the gap between the budget and actual expenditure.

- **Buffer for leaseholders:** No one likes the idea of being hit with a large bill they cannot manage, and in the same way the service charge works, the reserve fund helps to protect leaseholders from being hit with large bills on unexpected expenses in one go.

- **Recover unexpected costs:** In the event of the lease containing a sweeper clause, you may be able to recover certain costs from the service charge through the reserve fund, which again prevents leaseholders being faced with a large bill. However do not assume that all costs can be recovered through this method.

How a sinking fund is different to the reserve fund

Sinking funds on the surface do not appear vastly different to reserve funds, especially if the wording of the lease is vague. Essentially however, the sinking fund differs from the reserve fund as a mean of collecting extra funds for specific costs that occur occasionally. A good example of this is using the sinking fund for periodic maintenance such as painting or roof repairs that are needed every 5 years or 10 years.

A cyclical maintenance report done by a qualified surveyor or professional will determine the type of works required on the block and over what time period. This can help ascertain time scales and rough costs for future works so appropriate contribution amounts can be calculated."

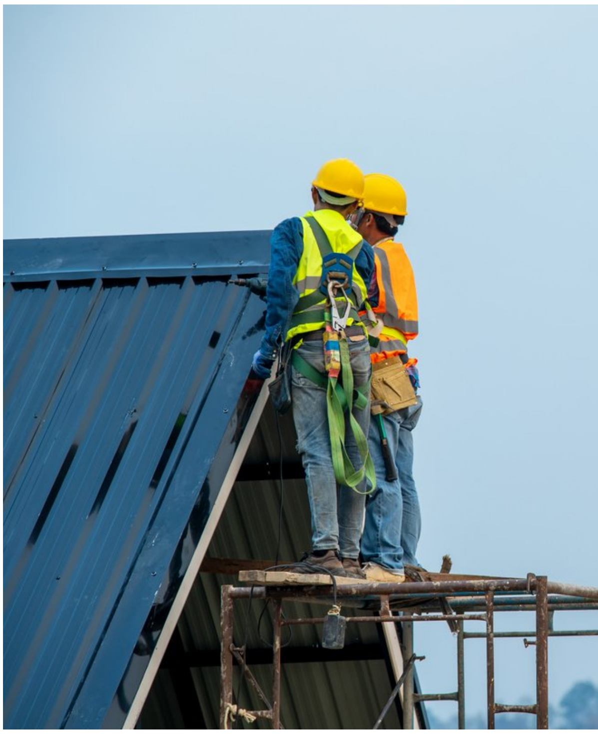
Why Should We Have Reserve/Sinking Funds?

Note: As the phrases sinking funds and reserve funds tend to be used interchangeably in the industry and the latter used most often we will simply use the generic term “reserve funds” henceforth.

All buildings age, all machinery fails over time. This will equally be true for houses and flats, whether leasehold, freehold or commonhold. Whatever the tenure, careful ongoing maintenance can extend the life of some items, but eventually significant repairs or replacement will be necessary. A good analogy is to think of your car. You can save money in the short term by not servicing it – but this may come back to bite you with a reduced sale price or expensive repairs when the engine seizes up. Most people agree that the sensible way to run a car is to service it regularly and put some money aside each year for those major items such as new tyres or exhaust. Similarly with a building, the prudent way to look at matters is to perform sensible maintenance on items as a part of the service charge and collect and put aside sums for when major expenditure inevitably happens. And the analogy of getting a better price for your flat if it is well maintained is also proven. So, it makes sense to have a reserve fund if you can as this will usually mean that expenditure over the longer term is kept as low as possible.

There is also a matter of time. Should something unfortunate happen, such as a badly leaking roof or a broken lift or entrance gate, there is an urgency to the repair. Collecting money from flat owners will always be a lengthy process and cause delays – some people cannot pay or there are complications (the owner lives abroad; the flat is under probate). But there are only two basic ways to handle such a call for cash – either you build up funds over time or you wait for it to happen and pay all in one go. What are the pros and cons of each of these strategies?

Looking at the “wait until it happens” option first. What benefits does this strategy have? If the lease will not allow you to collect reserve funds (as some indeed do not) then one benefit is that you are conforming with the terms of your lease, so there can be no legal disputes and costs arising around that aspect. A second benefit is of course that flat owners will have the money in their own bank accounts rather than in one dedicated to the building. What are the downsides? When something unpleasant does happen, flat owners will be facing a one-off big bill. This in itself is an issue, leading to mental and financial stress if funds are not readily available. Furthermore, if not all can afford to pay it this can mean that the project, although desperate, might not be able to go ahead at all. For example, you have a lift that cannot be economically repaired and is out of action, but half of the flat owners don’t have the cash available – how can the managing agent or building owner instruct a contractor, knowing full well that they cannot pay them? The lift will have to remain out of action until funds have been raised.



There is also an unfairness to the "wait until it happens" strategy. For example, someone has lived in the block for fifteen years and has used the lift every day. That person sells and one year later the lift needs replacing. That means that the new owner has to pay for the entire cost of the lift, even though they have only used it for a year. Of course, it could be argued that the new owner benefits from the new lift, but what if they sell a year later? For only two actual years of use they will have paid for a full new lift.

The alternative, that of building up funds over time is felt to be the fairest and most sensible mechanism. The benefits of such an approach are primarily that of fairness – reserve funds are built up over time by those living in the block and using the facilities. So, in the lift example above, the old owner would already have paid a contribution for fifteen years, softening the blow for the new owner. And the new owner would only contribute for the two years of ownership, again a much fairer outcome. As funds are raised over years any sudden, substantial works, can be paid for from the reserve fund and hence large calls for cash to the flat owners would be reduced. The disadvantages of this approach are that the annual call for cash will be higher than just service charges alone (it is not unrealistic to expect the reserve fund contribution to be of the same order as the service charge) plus the cash is in a holding account rather than the flat owners account.

A further advantage of building up a reserve fund over time is for when an owner comes to sell a flat. Demonstrating to a potential purchaser that there is a sensible cushion against future works will reassure a prospective buyer and can only lead them to the conclusion that the block is being sensibly and well maintained. We do not have the data yet in the UK, but in America a study showed that flats in blocks with a well-funded reserve fund sold at a 12.6% premium to those with a poorly funded reserve fund. This requires prospective buyers to be aware of the value of a reserve fund, but as the cladding crisis has made people more aware of the cost of communal living, this will become a more critical question amongst purchasers.

How Could Reserve Funds Work?

Once it's been determined that collection of a reserve fund is allowable, what is the best way to set, start and manage such a fund?

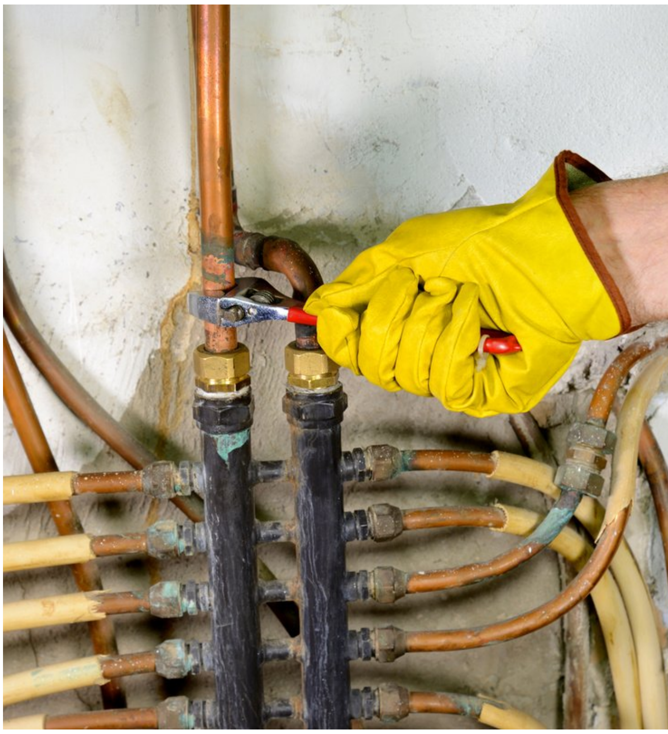
Ideally, setting the fund should be done by a professional third party, typically a surveyor. They will assess the current state of plant and buildings (and a side benefit is they may be able to advise on maintenance to extend the working life of some aspects), and they will calculate when items need repairing, how often and what will be the likely cost. This is typically referred to as a PMP – Planned Maintenance Programme and is a routine part of property management, giving a reasonable estimate of requirements. Looking over whatever period (e.g., 25 years) the surveyor recommends there will be recurring expenditure, (for example a lift will last 15 years and cost circa £60k to replace, so put aside £4k per annum for this) and some larger one-off items such as boiler replacement or roof refurbishment. A further advantage of this holistic view is to try to group items that can share costs – if a building is being scaffolded for external painting, perhaps that is also the time to repair/replace windows. This procedure gives insight into how much should be collected each year, when certain items must or should be replaced, how to best manage projects where costs can be shared and so forth.

Another reason to have an independent assessment is that it avoids any conflict of interest or "gaming" of the system. For example, should reserve funds be made a mandatory requirement (which ARMA believes they should), a building owner/RMC/RTM director(s) could simply collect a token amount or produce a scaled down PMP, all to keep down current costs. Alternatively, the building directors may try to reduce or move costs to beyond when they see themselves living there and paying. Having an independent third-party advisor, coupled with transparency throughout the whole process, will help maintain fairness.

So how much should you collect? This is up to each block owner to decide, but a significant advantage of the PMP is that when demands are issued people will naturally ask how you arrived at the sum. It therefore makes sense to share the PMP at the earliest opportunity so flat owners can give their input and will be aware of why the money is being demanded.
The next question is, if you don't have a reserve fund and want to start, should you ask for more in the first few years in order to make up the shortfall? The lease won't mean that you can charge someone who has lived in the building proportionally more than someone that has just moved in – the amount demanded will have to follow the lease and there will not be a "time living in the block" element to that. Each building will be different, but it makes sense to at least demand the "fair share" from each flat. This will be the amount calculated in the PMP and represents the depreciation of the building on a per year basis. By so doing the reserve fund will be established and people will come to terms with and accept the concept of paying into a future fund. This "fair share" may well lead to a shortfall when the first big ticket item comes around, and hence require a cash call, but over time the reserve fund will establish itself at the correct level.

Next Steps

If your block doesn't currently have a reserve fund it makes sense to at least ask, why? If the answer is that the lease will not allow it, you may be able to get a lease variation for all the leases – although this is not as easy as it sounds and could prove costly. ARMA is pressing the Government to make independently set PMP's and reserve accounts a mandatory requirement, no matter what the lease says. If you can set up a reserve fund then the next step is to either appoint yourself or ask your managing agent to appoint a surveyor to construct the PMP and take it from there.



A Final Word

Flat owners will naturally have concerns about potentially large sums of their money being held by third parties. However, the law dictates that such funds must be held in Trust accounts (Section 42 of the Landlord and Tenant Act 1987 to hold reserve and sinking funds in trust). The reserve/sinking funds should be held in an interest-bearing account and be ring-fenced from any day-to-day service charge monies.

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