Reserve and Sinking Funds

Many leases provide for a contribution towards a reserve fund or sinking fund in the service charge payment. Although reserve funds and sinking funds are technically different things, it has become common for either term to be used in residential leases and this paper uses the term reserve fund to cover both types. They are funds built up, over a number of years, to cover the cost of significant expenditure. That expenditure can either be planned and recurring, such as redecoration every 5 or 6 years or more major one-off replacements such as replacing a worn-out lift.

It is good practice for landlords to collect service charge contributions to build up reserve funds where the lease allows. By law, all service charge money collected must be held 'on trust' for the benefit of the leaseholders throughout the life of the development.

Think of it as being like operating a current account and a savings account. Your service charge contributions are placed in a current account which is held on trust, separate from the landlord's money. Every time you make a service charge payment, a small amount is transferred from the current account and invested in a savings account (the reserve fund). All of the day to day costs of running the development are met out the current account. The intention is that when major works are required, the money is available in the savings account to cover the anticipated costs of those works.

The reserve fund should not be used to subsidise day to day service charge costs, nor to offset the effects of under budgeting. If day to day service charge expenditure is higher than anticipated in a financial year, leases typical provide for additional funds (a balancing charge) to be collected from leaseholders to fund the overspend. Any overspend should not be taken out of the reserve fund as this will reduce the level of funds available when major works are required.

A well-managed reserve fund benefits everybody. The landlord can plan for expected works knowing the funds will be available. Leaseholders make small additional contributions throughout the life of the development and are therefore, not required to make large additional payments at the time the works are required. As properties change hands, the identity of leaseholders changes. A reserve fund spreads the cost of major items throughout the life of the development, with every individual leaseholder making contributions throughout the time they own the property. The cost is spread amongst all leaseholders who have benefited from using the building and is not met solely by the one person who happens to own the lease at the time the works are being undertaken. Funds are not refundable to the outgoing leaseholder on sale but the fact that funds have been saved is attractive to potential purchasers.

Other Guides:

Reserve and Sinking Funds

It is good practice for landlords to prepare, and regularly update, planned maintenance and capital expenditure plans related to the condition of the development. These are often referred to as CapEx Plans. You should expect to see the level of reserve fund contributions being based upon the CapEx Plan i.e. the amount of money being collected is related to planned expenditure in the future. If necessary, ask the landlord how the level of reserve fund contributions has been calculated. It should relate to the future requirements of the building and not be kept artificially low to the benefit of current leaseholders (which is a detriment to future leaseholders).

Some leases (common in retirement properties) provide for a contribution into the reserve fund out of sale proceeds whenever the lease is sold. This is typically a percentage of the sale price or a percentage of any increase in value since purchase. These leases are designed to keep the monthly (or annual) service charge costs at a more affordable level by deferring the reserve fund contributions until the leaseholder has received a capital receipt out of which a one-off contribution can be made.

With either type of reserve fund (regular contribution or resale contribution), there is no guarantee that there will be enough money in the fund to pay for works when required. Leaseholders may still be required to make additional one-off contributions if sufficient funds have not been saved at the time the works are required.

Before purchasing a lease, you should therefore request information about the amount of money currently held in any reserve fund and how that relates to planned works over the next few years. You should also request information on how the level of your likely contributions has been calculated and whether that is based on an up to date assessment of the condition of the building and a CapEx plan for the future.

Other Guides:

- Glossary
- What is a Lease?
- Who is who in a block of leasehold flats?
- Who has responsibility for what?
- Carrying out alterations or improvements
- What costs will I have to pay each year?
- The money – service charges & ground rent in leasehold homes
- Reserve & sinking funds
- Section 20 information
- Shared ownership
- Common misconceptions about leasehold?
- Your leasehold home – making a complaint