CHAPTER 4. RESERVE FUND FOR REPLACEMENTS

4-1 Introduction and Applicability. A Reserve Fund for Replacements exists for most projects with HUD-insured, formerly coinsured, and HUD-held mortgages. This Chapter applies to these projects as well as to Section 202 and Section 162 Direct Loan Program projects and Section 801 and 811 Capital Advance Program projects. The Reserve Fund is generally used to help defray the costs of replacing a project's capital items. Title 24 of the Code of Federal Regulations provides, at Section 207.19(f)(3)(i), "In all projects, except those involving rehabilitation where the mortgage does not exceed $200,000, a fund for replacements shall be established and maintained with the mortgagee. The amount and type of such fund and the conditions under which it shall be accumulated, replenished, and used, shall be specified in the charter, trust agreement, or regulatory agreement."

4-2 Regulatory Agreements for projects generally contain the following typical language pertaining to the Reserve Fund for Replacements to the effect that owners shall establish or continue to maintain a reserve fund for replacements by the allocation to such reserve fund in a separate account with the mortgagee or in a safe and responsible depository designated by the mortgagee, concurrently with the beginning of payments towards amortization of principal of the mortgage insured or held by the Federal Housing Commissioner of an amount equal to $_____ per month unless a different date or amount is approved in writing by the Commissioner. Such fund, whether in the form of a cash deposit or invested in obligations of, or fully guaranteed as to principal by, the United States of America shall at all times be under the control of the mortgagee. Disbursements from such fund, whether for the purpose of effecting replacement of structural elements and mechanical equipment of the project, for the cure of mortgage defaults, or for any other purpose, may be made only after receiving the consent in writing of the Commissioner. In the case of Section 202, 162, 801, or 811 projects, where HUD serves as the mortgagee, the project owner escrows the funds but may not withdraw them from the Reserve for Replacements Account without the Asset Management Branch Chief's written permission. For HUD-Held mortgages, HUD shall exercise control over the Reserve Fund for Replacements by acting pursuant to its own authority as well as in the stead of the mortgagee. This authority may be exercised only by HUD Headquarters.

4-3 Mortgagee's Certificates generally contain the following typical language that pertains to the Reserve Fund for Replacements: "Beginning on the date on which the first payment toward amortization is required to be made by the terms of the insured mortgage or at such later date as may be agreed to by you [the Federal Housing Commissioner], we [the Mortgagee] shall require a monthly deposit with us or in a depository satisfactory to us of one-twelfth (1/12) of the sum set forth in your Commitment for Insurance constituting a 'Reserve Fund for Replacements' which fund shall be subject to our order and from which fund withdrawals may be made only upon the receipt of your written permission. These funds will be deposited with us by the Mortgagor in cash or in the form of obligations of or guaranteed as to principal by the United States of America. We will, upon appropriate request by the Mortgagor, permit the conversion of the whole or a substantial part of such cash deposits into the form of obligations of, or fully guaranteed as to principal by, the United States of America. . . ."

4-4 Remaining Economic Life of Building Improvements. Economic life is the period over which improvements to real property contribute to property value. Because buildings are subject to physical deterioration and functional or economic obsolescence, their periods of usefulness are limited. For purposes of this Chapter 4, "buildings" includes building structures themselves, major movable equipment, and other on-site improvements such as water mains, sewer laterals, swimming pools, parking lots, etc. As buildings deteriorate or become obsolete, their ability to serve useful purposes decreases and eventually disappears. This decline and ultimate disappearance of utility may occur gradually or rapidly.

4-5 Economic Life vs. Physical Life. The period between the time of completion of the building and the time when it is no longer fit or safe for use, or when it is no longer practicable to maintain it in a safe and usable condition, is its total physical life. The total economic life of a structure is the period of time between the completion of the building and the disappearance of its ability to produce the service of providing housing for its intended occupants (in the case of non-profit mortgagors) or net returns over and above a return on the land value (in the case of profit motivated and limited dividend mortgagors), notwithstanding that it is structurally sound, in good condition, and usable (though not functionally or profitably).

A. Estimates are made of both physical life and remaining economic life, but the estimate of physical life sets the maximum for the estimate of economic life.

NOTE: Judicious use of the Reserve Fund for Replacements is expected to extend the physical life of the building.

B. Economic life can never be greater than physical life but it may be and frequently is less. A structure may be sound and in good physical condition with a number of years of physical life remaining and yet have reached the end of its economic life if its remaining years of physical usefulness will not deliver a positive cash flow or provide the service of supplying housing on a cost-effective basis.

4-6 Estimates of Remaining Economic Life. In predicting the remaining economic life of a building, six types of factors are considered:

A. Economic background of the community or region and the need for accommodations of the type represented.

B. Relationship between the property and the immediate environment.

C. Architectural design, style, and utility from the functional point of view and the likelihood of obsolescence attributable to new inventions, new materials, changes in building codes, and changes in tastes.

D. Trend and rate of changes of characteristics of the neighborhood and their effect upon land values.

E. Workmanship and durability of construction and the rapidity with which natural forces cause physical deterioration.

F. Physical condition and probable cost of maintenance and repair, the practices of owners and occupants with respect to maintenance, and the use or abuse to which structures are subjected.

4-7 End of Useful Life of Building Improvements. The useful life of a building has come to an end when the building is incapable of producing an annual income sufficient to offset the expense of operation and maintenance, insurance, and taxes, and to produce returns upon the value of the land or provide the service of shelter for the intended occupants in the case of non-profit owners. The improvements upon the land at that time possess no more value than the amount which can be obtained from a purchaser who will buy them and remove them from the site. At this point the value of the building has dwindled to "Shell" value less demolition costs. The last years of economic life are more difficult to predict than the first years, so caution must be exercised to avoid over-estimation of the remaining economic life for older buildings in older, declining neighborhoods.

4-8 Many projects with HUD-insured or HUD-held mortgages were underwritten with forty year mortgages and with estimated economic lives of fifty-five years. The Reserve Fund for Replacements was established to help ensure that the physical live of the buildings and structures would extend to the assumed 55-year economic lives. It was not the original purpose of this Reserve Fund to provide for a complete, dollar for dollar, capability of replacing all the building structural components and equipment as these wear out but rather to provide a readily available source of capital that will help defray these costs in the latter years of amortization of the mortgage note.

4-9 Building components generally tend to fall into two categories: 1. Those items that are usually considered to be capital items and eligible for reimbursement from the Reserve Fund for Replacements to the extent of the availability of money in that account; and, 2. Those items that are usually considered to be routine maintenance items. As a guideline, repair/replacement expenditures that are generally capitalized may often be eligible for payment from a project's Reserve Fund, while those expenditures that are expensed are only occasionally eligible for payment from the Reserve Fund.

NOTE: As items, equipment, etc. that fall into either of these classifications are obtained for a project, HUD expects that mortgagors will be mindful of energy and environmental considerations and will be sensitive to issues involving handicapped/disabled persons.

A. Items traditionally contemplated as eligible for draws from this Fund include capital items such as (but not limited to):

1. Replacement of refrigerators, ranges, and other major appliances in the dwelling units.

2. Extensive replacement of kitchen and bathroom sinks and counter tops, bathroom tubs, water closets, and doors (exterior and interior).

3. Major roof repairs, including major replacements of gutters, downspouts, and related eaves or soffits.

   NOTE: When replacing an entire roofing system, HUD encourages owners to seek energy efficient roofs and bonded roofs.

4. Major plumbing and sanitary system repairs.

5. Replacement or major overhaul of central air conditioning and heating systems, including cooling towers, water chilling units, furnaces, stokers, boilers, and fuel storage tanks.

6. Overhaul of elevator systems.

7. Major repaving/resurfacing/sealcoating (sidewalks, parking lots, and driveways).

8. Repainting of the entire building exterior.

9. Extensive replacement of siding.

10. Extensive replacement of exterior (lawn) sprinkler systems.

11. Replacement of or major repairs to a swimming pool.

12. For certain projects, requests for capital improvements or enhancements to the property could be considered. For examples, a personal computer and some associated software could be purchased, or perhaps individual air conditioning units could be added to a project that was not air conditioned when it was built, or perhaps gutters and downspouts could be added where necessary. Some improvements may be eligible if in HUD's opinion such items:

a. Would result in enhancing the mortgage security.

b. Would upgrade the property and place the property in a more favorable competitive position in the rental market.

c. Would be necessary to comply with changes in local, state, or federal laws.

d. Would not inordinately deplete the Reserve Fund, i.e., the improvement must be affordable.

B. Items traditionally contemplated as ineligible for draws from this Fund include maintenance items such as (but not limited to):

1. Repainting of interior areas of projects. Note: A separate interior painting reserve for this kind of work may be established by mutual agreement and consent of the concerned parties.

2. Replacement of range burners, bibs, oven elements, controls, valves, wiring, etc.

3. Replacement of dwelling unit air conditioning components such as fan motors and window unit compressors.

4. Minor repairs to central air conditioning and heating systems such as valve replacements and the cleaning of boiler interiors.

5. Minor roof repairs, including minor repairs to gutters and downspouts.

6. Minor paving repairs.

7. Caulking and sealing.

8. Window and screen repairs.

9. Purchase of maintenance tools and equipment such as lawn mowers or snow blowers.

10. Purchase of minor office equipment.

11. Inspection/recharging/replacement of fire

extinguishers.

12. Other items generally considered to be routine maintenance.

4-10 Adequacy of Reserve Fund for Replacements. Owners should analyze periodically the amounts in their Reserve Fund in the light of anticipated replacement needs. Owners should rely on their own personal knowledge of the physical condition of the project, evaluations made by their managing agents, and physical inspection reports furnished by their mortgagee and by HUD. After reviewing this information, owners should project how much money needs to be on deposit in the Reserve Fund at what points in the future. Owners should then calculate what amounts need to be deposited and when these amounts need to be deposited in order to accommodate the projected future demands on the Reserve Fund. If the owners' analyses indicate a need to increase the rate of deposits into the Reserve Fund, the owners should contact the Loan Management Branch Chief of their HUD Field Office and request HUD to authorize an increase in the deposits. These requests would usually be made in conjunction with requests for increases in rental rates so that enough revenue would exist to make the

increased deposits.

4-11 Recommended Minimum Threshold. HUD Handbook 4465.1 REV-2, Valuation Analysis for Project Mortgage Insurance, gives details on how the initial monthly deposit to the Reserve Fund is established. All owners should strive to reach some minimum threshold for the Reserve Fund for Replacements. The main purpose of having a recommended minimum threshold is to have funds available for an emergency or unforeseen contingency, such as a major roof failure or a water or sewer main break, so that funds could be drawn below the customary threshold. Assuming that a project is in very good physical condition and that no major replacements are needed in the near future (e.g., five years), HUD strongly recommends, but does not mandate, that owners target a minimum amount to be held in the Reserve Fund that would equal or exceed the greater of the following two amounts:

A. The initially established monthly deposit times 144 (12 years); or

B. At least $1,000 per unit.

4-12 Adjustments to a Recommended Minimum Threshold. The dollar amount calculated above may need to be increased for the following variables:

A. Physical Condition of the Project. Projects in less than very good condition would almost certainly need larger balances.

B. Geographical Location. Exposure to severe or unusual weather conditions as well as widely varying costs of replacements may have important consequences.

C. Immediate Replacement Needs. A property may be in good physical condition and yet might have large capital needs in the relatively near (five year) future.

D. Changes in Replacement Items. If non-traditional items, such as routine carpet replacement, are to become eligible Reserve Fund items, the minimum to be held in the fund would certainly need to be increased.

E. Unit composition. Projects with more units of larger size typically need larger amounts in the Reserve Fund than projects with smaller units. For example, a

project designed for large families consisting entirely of three and four bedroom units would almost always need more reserves than a project of the same number of units that consists of efficiencies and one bedroom units because the former project usually experiences greater wear.

F. Project Size. Larger projects typically need larger reserves than smaller projects.

G. Urban vs. Rural. Urban projects often need larger reserves than rural projects.

4-13 Suspension of Deposits to the Reserve Fund for Replacements. In older projects where the mortgage is seasoned and the owner has demonstrated the will and the ability to stay with the property, the Loan Management Branch Chief may, upon the owner's request and if deemed appropriate, suspend further payments to the project's Reserve Fund for Replacements by signing a Form HUD-9250, "Reserve Fund for Replacements Authorization (Appendix 1)," authorizing a suspension. (Note: If rental rates are predicated upon a certain rate of deposits being made into the Reserve Fund, the rental rates may need to be reexamined if the deposits are suspended.) This suspension is considered by HUD to be a privilege that may be granted to an owner for providing competent management and for keeping the project in good physical condition as determined by HUD. HUD's approval of suspending future deposits is subject to the following conditions:

A. A mutually acceptable minimum threshold as calculated above and revised as necessary is kept in the Fund.

B. The owner has asked the mortgagee to invest a substantial portion of the Reserve Fund.

C. All interest earned by investments of the Reserve Fund accrue to the Fund and is kept in the Fund (unless released by HUD for repairs/replacements).

D. The property continues to be maintained in good physical condition.

E. If the balance in the Fund should fall below the recommended minimum threshold, monthly deposits would resume at no less than the previous dollar amount until a mutually acceptable minimum balance is restored.

F. The project remains under the effective control of the same owners and the owners continue in good standing with HUD.

G. Projects receiving Section 8 assistance generally may not suspend deposits to the Reserve Fund for Replacements except for:

1. Projects that are not subject to Section 8 Automatic Annual Adjustment Factors (AAFs), i.e., rental rates are established by HUD under the budgeted rent increase procedures, and the Reserve for Replacement line item is deleted as an allowable cost in the rent determination; or,

2. The projects' rents are adjusted automatically by application of the AAF and immediate, temporary financial relief is needed. However, in this case, the project owner would not be eligible to take its distribution as long as the suspension is in effect.

4-14 Earliest Withdrawals. Projects which were newly built or substantially rehabilitated normally should not need withdrawals from the Reserve Fund during the early years of occupancy for repairs to or replacement of capital items. For example, many building components may be covered by a latent defects bond, roofs should be guaranteed, and most appliances should be under warranty. Projects insured under Section 223(f) are an exception to this general statement; these projects may need and be eligible for withdrawals from the Reserve Fund at any time following Final Endorsement. Owners of Section 223(f) projects should be urged to make and submit to the Field Office an early analysis of their Reserve Fund requirements in accordance with the procedures described above.

4-15 General Requirements for Requesting Withdrawals From the Reserve Fund for Replacements.

A. Mortgagors shall make all requests in writing and shall provide a detailed description of the work done or to be done; the description should identify the specific location including the dwelling unit (if applicable) in order to permit an inspection of the work without needing additional information about the work.

B. Owners should be invited to discuss proposed large withdrawals ($20,000 or more than twenty per cent of the existing balance in the Fund) with the Loan Management staff of the HUD Field Office before making the written request to agree upon plans for replenishing the Fund.

C. If the withdrawal request is a reimbursement for work that has been done, a copy of the paid invoice(s) normally should accompany the request unless the Optional Procedures see below are being used.

D. If the withdrawal request is for work that is to be done (an advance from the Fund), at least three formal or informal bids together with a copy of the bid specifications generally should accompany the request. If the lowest bidder was not selected the owners should explain their selection of a higher bidder. For example, consideration may be given to the bidder's reputation for quality workmanship, materials, and timely performance and to the urgency of the repairs. Owners also should explain why an advance is needed. Approval of owners' requests may, at the discretion of the Field Office Loan Management Branch Chief, be granted on an installment basis depending largely upon the scope of work done and remaining to be done and upon the availability of funds in the project's operating account.

E. Timing. Owners should not make requests for withdrawals more often than quarterly unless an emergency exists. Owners should make reimbursement requests during the same (project) fiscal year in which the expenditure occurred, preferably at least sixty days prior to the close of the project's fiscal year.

4-16 HUD Actions. Unless the amount of the release is for a large amount ($20,000 or 20% of the Fund balance, whichever is greater), an inspection of the work generally should not be necessary in order to act upon the request; inspections should be made during subsequent visits to the property. Inspection of a sample of the replacements generally would be adequate if the mortgagor is submitting acceptable annual audited financial statements and if the project is generally untroubled. The Loan Management Branch Chief will make reasonable effort to review and act upon the mortgagor's request within thirty days (whenever possible) from receipt and, if approved, prepare, sign, and mail the Form HUD-9250 to the mortgagee of record.

4-17 Optional Procedures. HUD has developed optional procedures in an effort to respond to industry requests for expediting the procedures for requesting withdrawals from the Reserve Fund for Replacements. Loan Management Branch Chiefs may invite project owners to use these optional procedures at their discretion. If the mortgage is current, if there are no known major, uncured violations of the Regulatory Agreement, and if there are no major, unresolved findings from management reviews, analyses of annual financial statements, or other known and documented reasons that would tend to preclude use of these optional procedures, HUD Field Offices may avail themselves of the following optional procedures. If these optional procedures are followed, the HUD Field Office will make every effort to act on the mortgagor's request within ten (10) business days from receipt. If a mortgagor develops a pattern of errors when using these optional procedures (such as continuing to request ineligible items) or if the mortgage goes into default, the project becomes troubled or potentially troubled, etc., the mortgagor can expect the HUD Field Office to suspend temporarily or deny the use of these optional procedures.

A. A narrative request for the release of funds is to be made by the mortgagor/managing agent.

B. A Mortgagor Certification is required; it should be as follows:

"I (Mortgagor) certify that:

1. "Funds expended or to be expended have been or will be used for the work indicated in this request;
2. "I have inspected/will inspect the work and have determined/will determine that the damaged area(s) or equipment have been restored to as good or better condition;
3. "No mechanic's or materialman's liens will be or have been attached to the property as a result of the repair;
4. "The repairs have been or will be completed in accordance with all applicable building codes and ordinances;
5. "All contract materials, supplies, and services as applicable have been obtained at the most reasonable cost and on terms most advantageous to the property;
6. "All discounts, rebates, or commissions have been credited to the property;
7. "Any expenditures that are determined by HUD to be ineligible, as a result of an inspection, will be repaid to the property's Reserve Fund;
8. "All goods and services purchased from individuals or companies with which the Owner or Managing Agent has an identity-of-interest were or will be purchased at costs not in excess of those that would be incurred in making arms-length purchases on the open market;
9. "Under the penalties and provisions of Title 18, United States Code, Chapter 47, Section 1001, the statements contained in this request have been examined by me and to the best of my knowledge and belief are true, correct, and complete."

C. Requests, except for emergencies, should be made no more often than quarterly and at least annually (if applicable) at least sixty days before the close of the project's fiscal year.

D. Copies of invoices are not required to be submitted to HUD if the description of the work done or items replaced is sufficiently detailed to permit an inspection and verification; however, the mortgagor must keep copies of the invoices on file for at least three years and have the invoices available for HUD staff to review.

E. The mortgagor/management agent is to prepare the Form HUD-9250 for signature by the Field Office Loan Management Branch Chief, who also can provide further guidance on information that should be shown on the Form. NOTE: Many mortgagees appreciate showing their loan number on the Form HUD-9250 next to the HUD Project Number and find that this makes their processing of the form quicker and easier. Owners/agents would be well advised to check with their own lenders for their preferences in this regard. NOTE: Mortgagors must never submit a Form HUD-9250 directly to their mortgagees (other than HUD).

F. If funds are to be released based upon bids alone, three bids and a brief statement about why an advance is necessary should accompany the request. The bid selected should be identified in the narrative; if the selected bid is not the lowest bid, a brief statement about the reason for selecting a higher bidder should be made. If a (selected) bid for items being purchased is for more than $10,000, copies of all the bids should accompany the request. The mortgagor must keep copies of all the bids on file for at least three years and have them available for HUD staff to review.

G. A supply of the Forms HUD-9250 may be obtained from the HUD Field Office.

4-18 Mortgagor and Mortgagee Records. Since appliances and similar items such as office equipment constitute security under the mortgage, project owners should keep their mortgagees fully informed when appliances and items that are normally identified by make, model, and serial number are replaced. Mortgagors are expected to provide their mortgagees with this identifying information as it changes; mortgagors also should provide HUD with copies of the documentation they furnish their mortgagees. Additionally, mortgagors should keep their insurer(s) informed of changes or additions to the property.

4-19 Field Office Records. HUD Field Offices are encouraged to establish a Reserve Fund for Replacements File for each project. Forms HUD-9250 authorizing releases of funds are to be kept on file for the present fiscal year and for the previous three fiscal years of the project. Except in unusual circumstances, such as defaults or major findings from various project reviews or audits, copies of invoices that are on file and more than a year old may be discarded if the required audited financial statement covering the time period of the expenditure has been submitted and if a management review or a physical inspection has been conducted during that time period. Forms HUD-9250 that change (increase, decrease, or suspend) the monthly Reserve deposits are to be maintained on file until the mortgage matures or is prepaid in full or until mortgage insurance is terminated.

4-20 Investment Requirements for Reserve for Replacement funds in Section 8 projects. Investment of the Reserve Funds in interest-bearing
* accounts is required for certain projects receiving Section 8 assistance:

A. The revised Section 8 regulations apply to all owners of older Section 8 projects where the owners voluntarily opted to be bound thy those regulations.

B. Except for owners of previously HUD-owned projects sold pursuant to 24 CFR Section 886 (Subpart C), partially assisted projects, and Section 202/8 projects, the revised Section 8 regulations apply to projects for which:

1. Agreements to Enter Into Housing Assistance Payments Contracts (AHAPs) were executed on or after November 5, 1979, for New Construction projects.

2. AHAPS were executed on or after February 20, 1980, for Substantial Rehabilitation projects.

C. For these projects, earned interest is to remain in the Reserve Fund until its release is authorized by HUD.

4-21 Liquidity Requirements. HUD recognizes that most property owners and managing agents can make fairly good estimates of the amount and timing of future replacement needs. Mortgagors should use prudence when selecting the durations of investments and make their selections according to anticipated and projected needs, including contingencies. Therefore, HUD is not establishing specific liquidity requirements for the Reserve Fund for Replacements. The mortgagor, not the mortgagee, is responsible for deciding the liquidity requirements of funds held in the

Reserve Fund. The mortgagor should maintain some portion of its reserves in the form of very liquid assets such as passbook savings accounts. As a guideline only and depending on the specific project, $50/unit or three or four month's required deposits to the Reserve Fund should be enough to meet minimum liquidity requirements for some projects. HUD does not encourage project owners to commit too large a portion of Reserve Funds to excessively long term investments in order to achieve a marginal increase in the net return on the investment. Preservation of principal is of utmost importance when owners evaluate various investments and formulate their investment strategies.

NOTE:- ALL MORTGAGORS SHOULD BE CAUTIONED. If any principal is lost as a result of an early or premature liquidation of an investment that is caused by an owner's requested withdrawal from the Reserve Fund for Replacements, the lost principal must be repaid to the project. This repayment must be repaid to the project (mortgagor entity) by the owning persons, by persons with a controlling interest in the project, or by such affiliated/related parties as the project's sponsors. This caution is particularly important for non-profit mortgagors. Accordingly, the terms and durations of investments should be selected prudently and with great care.

4-22 Investment of Reserve for Replacements Funds. Consistent with program
* regulations and the Regulatory Agreement, the reserve for replacement funds must be maintained by the mortgagee. Investment options should be determined jointly by the mortgagor and mortgagee. The Regulatory Agreement requires, ".. such fund, whether in the form of a cash deposit, or invested in obligations of, or fully guaranteed by the United States of America, shall at all times be under the control of the mortgagee."

A. This paragraph suspends this provision by authorizing the mortgagee to invest funds in excess of $100,000 in U. S. government-backed securities and to hold funds in excess of $100,000 in institutions under the control of, and whose deposits are insured by, the Federal Deposit Insurance Corporation, National Credit Union Association, or other U.S. government insurance corporations under the following conditions:

1. Mortgagees must determine that the institution has a rating consistent at all times with current minimally acceptable ratings as established and published by Government National Mortgage Association (GNMA).

2. Mortgagees must monitor the institution's ratings no less than on a quarterly basis, and change institutions when necessary. The mortgagee must document the ratings of the institutions where the funds are deposited and maintain the documentation in the administrative record for three years, including the current year.

3. If the mortgagee does not perform the required quarterly review of the institutions where there are deposits in excess

of $100,000 and does not maintain the funds in an institution with a rating consistent with current minimally acceptable ratings as established and published by GNMA, and the institution fails, the mortgagee is held responsible for replacing any lost funds. In addition, the mortgagee shall be subject to sanctions. In the event the mortgagee fails to replace the lost funds, HUD will seek all available remedies to recover whatever funds are lost as a result of the failed institution.

B. The above language is not deemed a modification of the Regulatory Agreement. Therefore, HUD reserves the right to invoke this Regulatory Agreement provision and make it operational in the future through notice or handbook change, if it is determined that such a policy is necessary or desirable.

4-23 Interest on Investments. HUD encourages and in some cases requires that interest earned on Reserve Fund investments remain in the Reserve Account. Interest must remain in the Reserve Account for those Section 8 projects listed in paragraph 4-20 of this Chapter 4. When this earned interest remains in the account, this interest will not be considered by HUD when processing requests for increases in rental rates if this interest is clearly and separately identified on the project's Form HUD-92410. In other words, HUD will not offset newly computed gross potential rents by the amount of interest that accrues to and remains in the Reserve Account.

NOTE: Interest may never be disbursed directly to the owners of a project or directly to any individuals associated with the owners. All interest earned must flow through the accounts of the project and must be disclosed on the project's accounting records.

A. With the issuance of this Chapter 4, owners of any of the following types of projects are instructed to ask their mortgagees to invest all or a substantial portion of their Reserve Fund for Replacements; all interest on Reserve Fund investments must remain a part of the Reserve Account. This

procedure applies if the project's mortgage is insured or held by HUD under any of the following Sections of the National Housing Act:

1. Section 236, a "Special Risk Insurance Fund."

2. Section 221(d) (3) BMIR [Section 221(d) (5)].

3. Section 221(d) (3) if the project receives Rent Supplement or Section 8 Assistance.

4. Section 223(e), a "Special Risk Insurance Fund."

5. Section 223(f).

6. Any project that has an Operating Loss Loan or a Supplemental Loan that is insured or held by HUD must keep all Reserve Fund interest earned by any of its Replacement Reserve Funds in the respective Funds.

B. With the issuance of this Chapter 4, owners of Section 202, 162, 801, and 811 projects are instructed to invest all or a substantial portion of their Reserve Fund for Replacements.

C. HUD strongly encourages owners of all other projects to ask their mortgagees, including HUD when the mortgage is HUD-held, to invest a significant portion of the money held in the Reserve Fund for Replacements. When making these investment requests, owners should specify the desired form(s) of investment.

4-24 Insured Mortgagee Charges for Handling Investments of the Reserve Fund. Reference is made to HUD Handbook 4350.4 for additional information on this topic. If a mortgagee proposes to assess charges for investing the Reserve Fund, the Field Office Loan Management staff are reminded to examine the Mortgagees Certificate for the project to see if any fees or charges for making or accepting investments were disclosed or stated. Any fees so collected by the insured or coinsured mortgagee may only be collected according to an agreement between the mortgagee and the mortgagor.

4-25 Other Fees. HUD does not recognize special fees or charges that might be paid by project mortgagors to investment brokers or other parties (other than HUD) such as managing agents for providing investment advice or for making or brokering investments except where the nature of the investment itself requires that it be brokered, i.e., obligations of federal agencies such as GNMA. Such fees, other than those involving the above exception, are not considered to be necessary expenses, should not be paid from project funds, and are not considered by HUD when calculating rental rates.

4-26 Combined Investments. For HUD-insured mortgages, monies held in the Reserve Fund for Replacements and the Residual Receipts Account (if
* such an account exists) may be combined to purchase a single investment or combination of investments.

A. Earned interest and the return of principal when the investment is liquidated must be prorated to the respective bookkeeping accounts.

B. The mortgagor must take care to preserve sufficient liquidity in these accounts. Some forms of investment, such as passbook savings accounts, are very liquid. Others are increasingly less liquid, such as Thirty, Sixty, or Ninety Day Certificates of Deposit (CDs), then U.S. Treasury Bills, U.S. Treasury Notes, etc.

4-27* HUD recognizes and appreciates the cooperation exhibited by many mortgagees when facilitating investments of the Reserve Accounts on behalf of mortgagors and acting on the mortgagors' requests. HUD considers the ability to invest a project's Reserve for Replacement Funds to be a right that accrues to the mortgagor. The mortgagor and mortgagee are encouraged to jointly decide on the investment vehicle for funds in the Reserve Accounts.

4-28 "Borrowing" from the Reserve Fund, other than advances from the Reserve Fund for curing a delinquency or a default. (The uses of a project's Reserve Fund for Replacements in curing mortgage delinquencies is covered in Chapter 5 of this Handbook.) The Asset Management Branch Chief may authorize the mortgagor to make brief, temporary uses of some portion of the Reserve Fund for Replacements for purposes other than those normally contemplated by the establishment of the Fund if:

A. There are no funds in a Residual Receipts account that could be used first.

B. An immediate crisis exists.

C. The mortgagor agrees in writing to repay the advance from the Fund over a reasonable period of time.

4-29 The Asset Management Branch Chief should exercise customary good business judgement when making a decision to permit the mortgagor to "borrow" from the Reserve Fund.

A. The purpose of such an advance is not merely to forestall an assignment of the mortgage but it may be related to a condition or circumstance beyond the normal course of business. Examples of these kinds of events include but are not limited to:

1. An unexpected increase in taxes or a special assessment.

2. An unanticipated increase in the costs of insurance, utilities, or like items.

3. Damage caused by unusually adverse weather conditions, whether or not such damage may be covered by hazard insurance.

4. Other uses of the fund not normally contemplated, such as for repairs and maintenance not usually eligible for reimbursement from the Reserve Fund.

B. Overall management of the project is at least satisfactory and the mortgagor has been cooperative in complying with requests from HUD and the mortgagee.

C. There is a formal agreement with the mortgagor to repay the advance on specified terms.

4-30 The Reserve Fund for Replacements will not always be adequate to meet the future capital needs of a project nor is it expected to do so. There are other sources of capital available to projects. Depending on the project, these include:

A. Residual Receipts Accounts.

B. General Operating Reserves.

C. Debt Service Reserves.

D. Owner Contributions in the form of equity.

E. Owner contributions in the form of unsecured debt (loans). These loans may, on a case-by-case basis, be allowed to carry a nominal interest rate that normally should not exceed the interest rate that the project owner or sponsor could earn elsewhere in a reasonably safe security, such as a Certificate of Deposit of the same duration as the loan to the project. The right to earn this interest must be pre-approved by the Loan Management Branch Chief and the terms and conditions of repayment should be formally negotiated and committed to writing.

F. Capital contributions from Transfers of Physical Assets (TPAs).

G. Supplemental Loans (under Section 241).

H. Flexible Subsidy, both Operating Assistance and Capital Improvement Loans.

I. Loans from the National Cooperative Bank for some projects.

J. Energy Loans.

K. Funds from private foundations.

L. Loans or grants from other governmental agencies or private foundations.

M. Cash flows from operations.

F. Capital contributions from Transfers of Physical Assets (TPAs)

G. Supplemental Loans (under Section 241).

H. Flexible Subsidy, both Operating Assistance and Capital Improvement Loans.

I. Loans from the National Cooperative Bank for some projects.

J. Energy Loans.

K. Funds from private foundations.

L. Loans or grants from other governmental agencies or private foundations.

M. Cash flows from operations.

Reserve Fund for
Replacements
Authorizations

GRAPHICS MATERIAL IN ORIGINAL DOCUMENT OMITTED