CHAPTER 5. RESERVE FOR REPLACEMENTS

Section 1. Establishment and Investment of the Reserve

5-1. GENERAL. The regulatory agreement requires owners to establish and maintain a reserve for replacements. The reserve provides cash for the replacement of capital items - generally, those items listed in Appendix 16. The reserve is funded from two sources - a lump sum deposit made at the time of loan closing and monthly deposits made as part of the monthly mortgage payments. The regulatory agreement shows the amounts of these deposits. The reserve is held by the lender pursuant to the terms of the Mortgagee's Certificate and the regulatory agreement.

5-2. HOW THE RESERVE IS HELD. The reserve may be invested in Treasury securities, securities issued by a Federal agency, or deposits which are insured by an agency of the Federal government. Since the regulatory agreement and the Mortgagee's Certificate require that the reserve must at all times be under the control of the lender, investments must be either payable to the bearer and held by the lender or established so as to permit the lender, at its sole option, to convert the investment to cash at any time.

a. Replacement reserve funds may be invested in the accounts or securities listed below:

(1) Direct Obligations of the Federal Government Backed by the Full Faith and Credit of the United States. These include U.S. Treasury Bills, Notes and Bonds.

(2) Obligations of Federal Government Agencies. These include, for example, GNMA Mortgage-Backed Securities, GNMA Participation Bonds and Farm Credit Administration issues.

(3) Demand and Savings Accounts. Demand and savings deposits at commercial banks, mutual savings banks, savings and loan associations and credit unions are permitted, provided that the entire deposit is insured by the Federal Deposit Insurance Corporation (FDIC), the National Credit Union Share Insurance Fund (NCUSIF), or the Federal Savings and Loan Insurance Corporation (FSLIC).

(4) Insured Money Market Accounts. Investment in money market accounts is permitted, provided that the account is insured by one of the Federal agencies identified in subparagraph (3) above.

b. Since the reserve for replacements is an asset of the project and the lender merely acts as an escrow agent, generally the owner has the right to determine what form of investment will be used and the lender may not restrict the owner's choice. The owner may authorize the lender to select the investment vehicle, if the lender is willing to accept that responsibility. If the owner retains the authority to choose the investment vehicle, the owner must provide the lender with written directions as to the type of investment desired. A

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lender may refuse to honor an owner's request for a specific investment only if:

(1) the lender determines that the mortgagor's choice of investment will significantly increase the lender's cost of administering the reserve and the lender identifies another investment which offers liquidity, security and yield equal to or better than that proposed by the owner; or

(2) the proposed investment does not meet the criteria specified in Paragraph 5.2.a., above.

5-3. SERVICING FEES. The lender may charge a fee for administering invested residual receipts or replacement reserves if the fee is acceptable to the owner. If there is an identity-of-interest between the lender and either the owner or its management agent, the owner must assure that such fees do not exceed the amounts commonly charged when there is no identity-of-interest between the lender and owner. The owner must disclose any such fees in the replacement reserve or residual receipts footnotes to the annual financial statement.

Section 2. Withdrawals

5-4. USE OF RESERVE FUNDS. Generally, the replacement reserve may be used only to pay for replacement of those items listed in Appendix 16. The reserve is not intended to cover routine maintenance costs. Routine maintenance costs should be included in the project's budget and paid from operating income.

a. Reserve funds may be used for purposes other than those itemized in Appendix l6 only if the lender determines that: (1) the project's cash flow is not sufficient to cover the outlay; and (2) such uses would be the best use of the reserve funds. The lender may authorize such uses only after the owner has evaluated the project's future reserve needs. If the lender reviews the owner's analysis and the project's cash flow and determines that the project will later need the reserve funds requested for these alternate uses, as a prerequisite for the withdrawal, the lender should require the owner to temporarily or permanently increase the reserve deposits. HUD expects that lenders will only rarely approve withdrawals for other than the uses listed In Appendix 16.

b. Generally, the lender should release reserve funds only after the owner has completed the replacement and submitted an invoice. However, if a replacement will be unusually expensive and a contractor requires progress payments, the lender may release funds in draws as work is completed.

5-5. OWNER REQUESTS FOR WITHDRAWAL. All requests for withdrawal must be written. A request must list the items for which the withdrawal is requested, the number of each item and the dollar amount requested for each item. The request must be supported by invoices showing what was purchased and the cost of the purchase. If the owner is requesting a withdrawal for other than the uses listed in Appendix 16, the owner must explain why other project funds cannot be used and must analyze the reserve's ability to cover future replacement costs.

5-6. LENDER'S PROCESSING OF OWNER'S REQUESTS FOR WITHDRAWALS. The lender must document the purposes for which it approves a withdrawal. To do so, the lender may develop its own format or use Form HUD-9250, Reserve for Replacements Authorization. Form HUD-9250 is shown in Appendix 17. The lender may refuse to release funds if the owner has not submitted an analysis or agreement to increase monthly deposits, if the lender had previously requested such an analysis or increase in accordance with Section 3 of this Chapter.

5-7. MONITORING THE OWNER'S USE OF RESERVE FUNDS. The lender should be alert for possible abuses of the replacement reserve and, within staff constraints, should attempt to ensure that these funds are used only for the purposes for which withdrawals are approved. The lender should spot check replacements and repairs during the annual physical inspection, unless the lender believes an earlier inspection is warranted because of the owner's abuses or the nature of the work.

a. If the owner submits withdrawal requests during the early years of the coinsured loan, the lender must assure that the items included in the request are not repairs or replacements which were required to be completed prior to endorsement or from an escrow established at closing.

b. If a project has a higher than normal frequency or cost of repairs, the lender must determine the cause of the unusually high frequency. The high frequency could mean that maintenance is inadequate, or poor quality equipment is being purchased. High costs could be caused by management's failure to compare prices and to purchase services and materials on terms most advantageous to the project.

5-8. DISPOSITION OF THE ACCOUNT. If the project is sold and the coinsured loan remains in place, the reserve for replacements remains with the project and the new owner. If an owner defaults and the lender accelerates the debt, the lender must apply any balance in the reserve to the amount due on the mortgage debt, as accelerated. When the mortgage insurance is terminated through prepayment in full or voluntary termination, after receiving HUD acknowledgement of the termination the lender may pay the reserve balance to the owner.

Section 3. Assessing the Adequacy of the Reserve

5-9. GENERAL. The recurring monthly reserve deposit is initially set at .006 times the total cost of project structures (Line 62 of the Form HUD-92264). The .006 factor was developed based upon a 1967 sampling of what average replacement needs were on fully insured, unsubsidized projects. More recent studies have shown that .006 factor may not provide sufficient funds for future replacement needs for the following reasons.

a. The .006 factor was derived from the average of several projects' replacement needs; it has little or no relationship to the specific equipment and/or structural elements that will need to be repaired or replaced at a specific project.

b. The .006 formula uses construction costs in effect at the time of loan closing. Replacements must be made at prices in effect at the time the replacement is made. Because of inflation, those prices will usually exceed the costs used in the .006 formula.

c. The .006 formula does not recognize that repair and replacement needs will vary according to quality of maintenance or equipment in use at a project.

5-10. PLANNING FOR FUTURE REPLACEMENTS. Since few projects' cash flow is sufficient to pay for replacement of capital items, both HUD and standard property management practices require that project owners periodically project and budget for future replacement costs. Ideally, such analyses should be completed annually in conjunction with development of the project's annual budget. The regulatory agreement gives the lender authority to require the owner to submit such analyses and to increase the monthly deposits to the reserve if an increase is needed to assure that funds will be available to cover replacement costs.

a. While all owners should periodically estimate replacement costs and assess the adequacy of their replacement reserves, owners need submit their analysis to the lender only if the lender requests the owner to do so. Lenders should require owners to submit the analysis: (1) when the project's frequency or cost of repairs is higher than normal; (2) when preventive maintenance is poor; (3) prior to releasing reserve funds for uses other than those specified in Appendix 16; or (4) when a withdrawal would reduce the reserve to less than some minimum balance (e.g., 24 times the monthly deposit) and the owner has not recently submitted an analysis.

b. When determining whether to require an increase in the monthly deposit, the lender should consider: (1) the owner's willingness to pay replacement costs out of the project operating account or owner advances; (2) the size of the project's current and projected cash flow; (3) the adequacy of the reserve; and (4) whether any investment earnings are being retained in the account. If the lender

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determines that the owner should increase the monthly deposit, the owner and lender must execute a written agreement specifying the amount of the new monthly deposit and the date the new deposit will be effective. Appendix 19 provides a sample agreement.

5-11. SUSPENSION OR REDUCTION OF DEPOSITS. If the reserve accumulates to a level that is sufficient to cover all replacement costs expected over the term of the mortgage, the lender may approve an owner's request to suspend or reduce deposits. Lenders may authorize suspensions only in one year increments and only if the lender's annual physical inspection confirms that the owner's analysis is reasonable and the project is well maintained.
