



**Mortgagor's Guide for Multifamily
Reserve for Replacement Fund**

September 2020

DISCLAIMER

MFA has developed the Mortgagor's Guide for Multifamily Reserve for Replacement Fund as a guide to help developers, owners, and managers of properties with reserve accounts in understanding their responsibilities under the program. However, the information in this plan is presented only as guidance and is not a substitute for applicable regulations and rulings. Owners of properties hold final responsibility for compliance with reserve for replacement requirements established by existing federal laws and regulations, and the contents of this plan do not relieve owners of this obligation.

MORTGAGOR’S GUIDE FOR MULTIFAMILY RESERVE FOR REPLACEMENT FUND

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In accordance with HUD guidelines, “the Reserve Fund was established to help ensure the physical life 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. Judicious use of the Reserve Fund is expected to extend the physical life of the building.”

INTRODUCTION

The Mortgagor’s Guide for Multifamily Reserve for Replacement Fund is applicable to all programs with a reserve account monitored by MFA including but not limited to HUD Risk Share 542(c) loan program, Section 538 Guaranteed Rural Rental Housing Program and the Neighborhood Stabilization Program (NSP). The Reserve Fund is administered by the Asset Management Department. This department will ensure Mortgagors adhere to established guidelines. All guidelines are subject to modification without prior notification to the Mortgagor. MFA guidelines, in part, are based on language adopted from the HUD Handbook, 4350.1, REV-1 and HB-1-3565.

PURPOSE

The guide will identify (for the Mortgagor) general requirements for the Reserve Fund. In addition to general requirements, the guide addresses special requirements, economic life vs. physical life, advances, MFA processing, MFA reserve fund audit, eligibility, adequacy of reserve fund, minimum threshold, adjustments to threshold, and earliest withdrawals.

GENERAL REQUIREMENTS

This section provides instruction on the submission of written requests for funds, the timing involved in processing requests, and mandatory use of HUD forms. HUD forms and other valuable resources are available on MFA’s website. This section also defines the two types of allowable requests.

WRITTEN REQUEST

The Mortgagor is required to make their request for reserve funds in writing. All requests must be submitted electronically (via email). Prior to submittal, the Mortgagor must make every effort to confirm requests are made for eligible items only. The Mortgagor must provide a cover letter with their

submission; the cover letter will include the property name, loan number, and a brief summary of the request and a narrative for any key considerations. There are two types of requests which will be considered for approval. The first is a request for reimbursement of expenditures and the second is a request for future work.

REQUEST FOR REIMBURSEMENT OF EXPENDITURES

A request for reimbursement for completed work (expenditures) requires a copy of all applicable invoices. All requested items must be clearly identified on all invoices and must agree with the information provided on completed HUD forms. All requested items must be paid in full prior to submission to MFA for reimbursement. A clear proof of payment for all invoices is required. MFA will not accept evidence of partial payments on invoices.

REQUEST FOR FUTURE WORK

A request for future work requires at least three formal or informal bids. Mortgagors should provide a written explanation why an advance is needed. Bids are funded as a lump sum or on a periodic basis. The payout method can be negotiated between the Mortgagor and MFA. For example, a request may be approved for the upfront payment required by a vendor to begin work on a long-term project and the remaining balance due payable upon completion of the work. Formal bids will typically provide an estimate based on site visit and subject to expiration. An informal bid may be the result of a research of applicable costs associated with the work to be completed. In either case, the bids must provide enough detail in order to be considered for approval. In most cases the winning bid will be the lowest bid in terms of cost. If the lowest bid has not been selected by the Mortgagor a written explanation is required. For example, the Mortgagor may choose a bid, over cost, based on quality of workmanship or better warranty.

TIMING

Mortgagors are required to submit requests on a quarterly basis for costs incurred within the quarter. Requests for reimbursement must be submitted by the last day of the month following the end of each quarter. Expenses incurred from January through March must be submitted to MFA by April 30th. April through June must be submitted by July 31st. July through September must be submitted by October

31st. October through December must be submitted by January 31st. The Mortgagor will need to judiciously plan for, monitor, and track capital improvement expenditures and hold them in preparation for submission by the deadline. Requests for future work (bids) and emergency requests will be accepted anytime. Emergencies can be related to natural disasters or other unforeseeable exigent health and safety conditions.

REQUIRED FORMS AND DOCUMENTS

Requests must include the following forms and documents:

1. Cover letter – including any information that requires clarification for the request. If applicable information for direct deposit requests should be included in the cover letter.
2. Form HUD-9250, “Funds Authorization Form” must have the current OMB expiration
3. Attachment 1, Mortgagor Certification and Request Detail
4. Invoices - including item description or description of work completed, unit number(s), common area(s), invoice date, invoice amount, etc.
5. Proof of payment - dated remittance stub referencing invoice number(s)
6. Proof of funds disbursement – bank statement(s)
7. Bids – this applies to requests for future work only

SPECIAL REQUIREMENTS

Mortgagors are encouraged to discuss proposed large withdrawals (\$20,000 or more than twenty percent of the existing balance in the Fund) with MFA staff before making the written request. If this type of large withdrawal brings the account balance below the minimum threshold it may be necessary for the Mortgagor will need to increase monthly deposits in order to replenish the Reserve Fund. In addition, we encourage Mortgagors to consult with MFA for a “pre-approval” prior to obtaining bids for future work or to discuss concerns regarding eligibility of expenditures or budgetary constraints. MFA expects Mortgagors to maintain operations in a cost-effective manner and to be conscientious in preparing and expediting operating budgets. MFA strongly recommends properties develop annual operating budgets through an analysis of previous year expenses, cost projections, and a current capital needs assessment. To be effective, a capital needs assessment should be maintained, and improvements closely tracked year over year. In order to ensure Reserve Funds are available the Mortgagor may need to request an increase to their monthly deposits.

OTHER CONSIDERATIONS

This section provides information from HUD regarding economic life vs. physical life. It also presents the option of requesting an advance from the Reserve Fund.

ECONOMIC LIFE VS. 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. Two important economic life factors which can be controlled are: (1) Workmanship and durability of construction and the rapidity with which natural forces cause physical deterioration; (2) 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. Physical life is 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.

RESERVE FUND ADVANCE

MFA may permit the Mortgagor to "borrow" from the Reserve Fund. 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:

- An unexpected increase in taxes or a special assessment;
- An unanticipated increase in the costs of insurance, utilities, or like items;
- Damage caused by unusually adverse weather conditions, whether or not such damage may be covered by hazard insurance;
- Other uses of the fund not normally contemplated, such as for repairs and maintenance not usually eligible for reimbursement from the Reserve Fund.

MFA will consider such requests for an advance so long as overall management of the project is at least satisfactory and the Mortgagor has been cooperative in complying with requests from MFA. If

such a request is approved the Mortgagor may be required to enter into a formal agreement with MFA to repay the advance on reasonable terms which will be specified in the agreement.

MFA PROCESSING

MFA's processing of Mortgagor's request will depend upon the condition of the Mortgagor's submission. Requests can be pre-approved, approved, partially approved, or denied. Requests submit within the guidelines and required timeframes will likely be approved. However, if MFA must partially approve or deny a request the Mortgagor can resubmit for funds if these actions are due to an incomplete submission. Requests are considered incomplete if required forms are missing or if required documentation, such as proof of payment, is not included in the request. Note: MFA will not accept a resubmission of items denied based in ineligibility. MFA will make a reasonable effort to review and act upon the Mortgagor's request within thirty days (whenever possible) from receipt of a complete submission.

PRE-APPROVAL

As mentioned previously, a Mortgagor may have discussed a request for reimbursement of expenditures or a request for future work with MFA prior to submission. If this is the case and MFA has pre-approved requested items, then the Mortgagor will need to include some form of documentation between the Mortgagor and MFA (such as an email communication) with their submission.

FULL APPROVAL

The Mortgagor's request will be approved if the submission is complete, includes all forms, supporting documentation, all items are eligible, and expenditures are submitted timely. MFA will send the Mortgagor an approval letter to confirm the amount being approved. The Mortgagor can expect to receive payment within two weeks following receipt of the approval letter.

PARTIAL APPROVAL

MFA will be able to partially approve the Mortgagor's request if the Mortgagor has submitted a request where only a few items are ineligible or are lacking insufficient information. In this case, MFA will adjust the amount being requested and send the Mortgagor an approval letter to confirm the adjustment; the letter will also provide a brief explanation why certain items were not approved. Note: If the Mortgagor

develops a pattern of errors (such as continuing to request ineligible items or submit incomplete requests) MFA will discontinue processing partial approvals. The Mortgagor's request will be denied in full and the Mortgagor will need to correct and resubmit their request.

DENIAL

Occasionally, MFA will not be able to approve the Mortgagor's request. The Mortgagor's request will not be approved if expenditures are not submitted timely; the submission is incomplete, does not include all forms and supporting documentation, or if the request is otherwise ineligible. MFA will send the Mortgagor a denial letter which will provide a brief explanation to support the denial. Note: A request may be denied due to insufficient funds. For more on this topic, please refer to the section titled, Minimum Threshold.

MFA AUDIT

MFA conducts an annual MFA Compliance Review at each covered property. As part of the review process, MFA will perform a comprehensive audit of the Mortgagor's management of the Reserve Fund. Specifically, MFA will follow-up on all pertinent capital improvements over the previous twelve months to ensure the Mortgagor's Certification for each approval is valid. Therefore, the Mortgagor must provide complete and accurate data on HUD form, Attachment 1 – Mortgagor Certification and Request Detail. For example, if funds were disbursed to purchase new appliances the Attachment 1 must include a description of the appliances and the location (unit number) where the appliances were installed. Also, as part of the review process MFA may request to audit the Mortgagor's inventory tracking log and unit and/or building maintenance records. If the MFA audit yields a discrepancy between observations made during the property visit and the Mortgagor's certification then the Mortgagor will receive an audit finding on the MFA Compliance Review report. The Mortgagor will have the opportunity to respond to and resolve audit findings. Note: The Mortgagor will receive a penalty for audit findings in this area which are unresolved. Penalties may include: (1) Temporary suspension of access to reserve funds, and/or; (2) repayment back to the Reserve Fund (for expenditures determined to be ineligible, as a result of inspection).

KEY POINTS: HUD HANDBOOK, 4350.1, REV-1

This section only applies to reserve funds managed in accordance with HUD Programs.

PARAGRAPH 4-9.A ELIGIBLE ITEMS

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.

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.

PARAGRAPH 4-9.B INELIGIBLE ITEMS

The following items are ineligible, as they are considered routine maintenance. Note: this is not a comprehensive list.

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 -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.

PARAGRAPH 4-10 ADEQUACY OF RESERVE FUND FOR REPLACEMENTS

The Mortgagor should periodically analyze the amounts in their Reserve Fund in the light of anticipated replacement needs. The Mortgagor 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. The Mortgagor 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 Mortgagors' analyses indicate a need to increase the rate of deposits into the Reserve Fund, the owners should contact MFA and request MFA to authorize an increase in the deposits.

PARAGRAPH 4-11 MINIMUM THRESHOLDS

HUD states, "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." A minimum threshold is a monetary figure which must be maintained in the Reserve Fund. HUD's method for determining minimum threshold is to use the greater of the following two amounts: (1) The initially established monthly deposit times 144 (12 years) or (2) at least \$1,000 per unit. (The initial monthly deposit amount is documented in the executed Loan Agreement). For example, if a property has 100 affordable units and their initial monthly deposit is \$2,500 (based on \$300/unit annual and \$2,500 times 144) and \$1k/unit is equal to \$100,000 then HUD recommends a minimum threshold of \$360,000 which is the greater of the two calculations. Regarding use of minimum threshold, HUD assumes "a property is in very good physical condition and that no major replacements are needed in the near future (e.g., five years)." Note: If it is determined there are major capital improvements, as determined through inspection or otherwise reported in a capital needs assessment, then the Mortgagor will need to develop a plan to increase the Reserve Fund over time in order to address capital needs.

PARAGRAPH 4-12 ADJUSTMENTS TO A RECOMMENDED MINIMUM THRESHOLD

The dollar amount calculated above [minimum threshold figure based on HUD's calculation method] may need to be increased for the following variables:

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

1. Geographical Location. Exposure to severe or unusual weather conditions as well as widely varying costs of replacements may have important consequences.
2. 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.

3. 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.
4. 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.
5. Project Size. Larger projects typically need larger reserves than smaller projects.
6. Urban vs. Rural. Urban projects often need larger reserves than rural projects.

PARAGRAPH 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.

KEY POINTS: HB-1-3565

This section only applies to reserve funds managed in accordance with the Section 538 Guaranteed Rural Rental Housing Program.

PARAGRAPH 7-7 D3 OBTAINING BIDS IN USE OF THE RESERVE ACCOUNT

Mortgagors should obtain bids on major repairs, construction projects, or purchases. A recommended standard is three written bids for any single purchase or project that exceeds \$10,000. Mortgagors must justify any bid accepted that is higher than the lowest bid.

PARAGRAPH 7-7 D4 MINIMUM REPLACEMENT RESERVE LEVELS

For new construction, a replacement reserve balance of \$1,000 per unit is the minimum level for the reserve account by the time the project reaches the end of its third year of occupancy. The replacement reserve balance of \$1,000/unit must be maintained through whichever occurs first: year seven or the performance of a capital needs assessment (CNA) that supports maintaining, decreasing, or increasing the yearly contributions. The CNA must be performed by year seven and updated every five years thereafter. The replacement reserve balances should be reviewed annually, and modifications made if the reserve balances are not sufficient to address long term replacement needs.

Any drop below required levels for new construction or rehabilitated projects should be reported to the Agency as part of the annual report on the property.

PARAGRAPH 7-7 D5 ELIGIBLE USES OF RESERVE FUNDS

Reserve funds should be used for the repair and replacement of depreciable physical property. MFA has the discretion to approve or disapprove the use of reserve funds, even if an item is permitted by Agency guidance, if the lender feels it is in the best financial interest of the property. Suggested eligible uses:

1. Replacement of refrigerators, ranges, and other major appliances in the dwelling units.
2. Replacement of kitchen and bathroom sinks and counter tops, bathroom tubs, toilets, and doors (exterior and interior).
3. Major roof repairs, including replacement of sheathing, gutters, downspouts, and eaves or soffits.
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. Repaving/resurfacing/seal coating of sidewalks, parking lots, and driveways.
8. Repainting of the entire building exterior or interior common areas.
9. Replacement of siding.
10. Replacement of fire alarms.
11. Playground equipment.
12. Replacement of exterior (lawn) sprinkler systems.

Replacement items should be at least comparable in quality to items approved at the time of the original construction of the property and in accordance with the initial plans and specifications. When replacing obsolete or broken appliances, the purchase of new energy efficient models is encouraged.

CLOSING

MFA is dedicated to the success of our housing partners. We are also intent on preserving these funds to ensure the physical and economic lives of all properties under covered loan programs. MFA is open to comments regarding the Mortgagor's Guide for Multifamily Reserve for Replacement Fund. Please send any written comments to:

Director of Asset Management
New Mexico Mortgage Finance Authority
344 4th Street SW
Albuquerque, NM 87102

LIST OF EXHIBITS:

- I. HUD Form, 9250, Funds Authorization form
- II. HUD Form, Attachment 1, Mortgagor Certification and Request Detail