

REPLACEMENT RESERVE (RR) POLICY

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Purpose of Replacement Reserve (RR)

MSHDA’s Regulatory Agreement requires the establishment and maintenance of a MSHDA-held Replacement Reserve fund. The RR fund is primarily designed to defray the cost of the replacement of major depreciable items provided for in the original mortgage.

Contributions to RR

The initial deposit and funding to the RR designated in the Regulatory Agreement must be deposited at or prior to the closing of the Mortgage Loan. Ongoing funding of the RR is payable in monthly installments of 1/12 of the calculated annual amount and is due with the monthly mortgage principal and interest payment. The required minimum annual ongoing funding is characteristically defined in detail within the Regulatory Agreement and is often expressed as:

- A percentage of the previous year’s approved annual Gross Rent Potential (GRP).
- A flat dollar amount designated by the current finalized Comprehensive Needs Analysis (CNA).
- A flat dollar amount designated by the Regulatory Agreement.
- A percentage increase over the previous year’s annual deposit.

- The greater of a stated percentage increase over the previous year's approved Gross Rent Potential or a stated percentage increase over the previous year's deposit.

MSHDA will invest the RR funds in an interest-bearing account. All interest becomes part of the RR and is subject to the disbursement procedures described herein. The CNA factors in interest earned on the reserves. The RR is an asset of the development and remains with the development upon any change in ownership for the term of the mortgage.

Purpose of the Capital Needs Assessment (CNA)

The CNA is a snapshot in time of the current and future physical needs of the Development. The assessment determines the expected useful life of RR eligible items at the site. The CNA also calculates adequate RR funding levels for the lesser of a twenty-year period or through mortgage maturity. The CNA may require the owner to increase the original funding level established in the Regulatory Agreement to address the development's actual physical needs.

CNA Timeline

The typical timeframe for completing the CNA process follows:

New Construction – The first CNA is usually commissioned 6 years after the cut-off date and is updated every ten years after the initial CNA.

Preservation – The first CNA is completed as part of the preservation transaction. The next CNA is usually commissioned 6 years after the cut-off date and is updated every ten years after the initial CNA.

CNA and RR Funding

Once a CNA is conducted and finalized at a development, the funding recommended by the CNA replaces the Regulatory Agreement's required annual deposit amount. If the development operations are unable to support the CNA recommended annual deposit amount, an RR Needs amount will be carried. The development must fund the RR at the minimum level defined in the Regulatory Agreement regardless of the CNA recommendation. A CNA will always result in at least a Plan 1 analysis.

- *Plan 1* – This analysis evaluates the current reserve balance and funding levels in conjunction with the projected capital costs from the CNA. If the Plan 1 projects a negative reserve balance any time during the analysis period (20 years or the maturity of the loan), a Plan 2 is developed outlining sufficient funding needed to cover future projected deficits.
- *Plan 2* – This plan is generated with increased annual funding through either outside capital contributions (preferred method) and/or an increased per unit deposit in RR contributions to create a positive projected balance in the RR account through the

analysis time frame while addressing all the projected expenditures that contribute to the “Total Capital Costs” as discussed below in the “RR Funding Levels” section.

- *Additional Plans* – Occasionally, alternate funding scenarios are included in the CNA final report. These plans achieve the same results generated by the Plan 2 and are considered alternate Plan 2s.

RR Funding Levels

The RR balance is anticipated to cover capital costs through the life of the mortgage. The following RR funding level categories address the current RR balance, future funding and anticipated capital costs through the life of the mortgage:

- *Full-Funding* – This status can be achieved only if the development:
 - 1) Has a CNA Plan 1,
 - 2) Contributes to the RR in accordance with Plan 1, and
 - 3) The current RR balance has sufficient funding to pay for the “Total Capital Costs” for all the years of the CNA analysis combined. E.g. Sum the “Total Capital Costs” line item of the CNA Plan 1 for the lower of all 20 years of the CNA or through the life of all MSHDA mortgages. If the current RR balance exceeds this summation, then the RR is fully funded, otherwise deposits to the RR must continue.
 - If the full-funding level is achieved, the development may request a deferral in the RR contributions or may request a special disbursement for capital expenditures or amenities not defined in the CNA with prior written approval from the Director of Asset Management or other authorized supervisor of the Asset Management Division. MSHDA will re-evaluate a development’s RR contribution deferral status with each RR draw and with the annual budget review.
- *Adequate Funding* – In this status, contributions are being made according to a CNA Plan 2 recommended funding level or if no Plan 2 exists, the CNA Plan 1 funding level. If no CNA has been completed, contributions are being maintained at or above the minimum funding level stated in the Regulatory Agreement.
- *Under funding* – This status occurs when the contributions to the RR do not meet the levels recommended by the CNA. Whenever an underfunding exists on a Plan 2 CNA, a Replacement Reserve Needs (RR Needs) amount will be calculated to determine the funding shortage to achieve an adequate funding level in the RR. If a CNA has not been completed, then the RR is considered underfunded if the annual contributions are below the minimum funding level stated in the Regulatory Agreement.

RR Needs - Developments with RR Needs amounts must resolve the RR Needs amount before limited dividend payments can be disbursed. RR Needs are calculated monthly and included on monthly mortgage statements if a need exists.

- **RR Needs** = Contributions recommended per the finalized CNA **minus** contributions being made to the account.

Eligible Expenses

If a CNA Exists - Development structural and landscaping replacement items can be paid from the RR account, if the:

- RR Draw Worksheet (MSHDA Mgmt. 503B) form indicates that adequate funding is available.
- Item is identified as eligible in the most current finalized CNA ¹.
- CNA identifies the replacement item as needing replacement within three years.
- Item has exhausted its normal or useful life expectancy.
- Cost for replacement item(s) is reasonable.
- Installation meets the minimum FHA and MSHDA Design Standards.

¹ If a requested item is not included in the CNA, MSHDA will review the request and may permit the use of the RR to address the unexpected repair or replacement capital needs items not included in the CNA.

If No CNA Exists – When No MSHDA-commissioned CNA has been completed, an item(s) may be eligible to receive reimbursement for replacement, if the:

- RR Draw Worksheet (MSHDA Mgmt. 503B) form indicates that adequate funding is available.
- Item has exhausted its normal or useful life expectancy.
- Cost for replacement item(s) is reasonable.
- Installation meets the minimum FHA and MSHDA Design Standards.
- Development has been in operation for five years (*the 5 years starts on the first of the month following the cut-off date*) unless the replacement is the result of an emergency need.
- Item is identified on the list below:
 - Antennas.
 - Appliances (Stove, Refrigerator, Washer/Dryer, Dishwasher, Range Hood, and Microwave).
 - Asphalt.
 - Bathroom Fixtures (Vanity, Tub, Toilet, and Medicine Cabinet).
 - Boiler and “**Major**” Components – See the ineligible expenses section for examples of non-major components.
 - Cabinets.
 - Carpet (including labor to move furniture and appliances when installing the flooring).
 - Carports.

- Common Area Furnishings.
- Chimney.
- Concrete.
- Counter Tops.
- Doors and Hardware.
- Eaves Troughs.
- Elevator Parts.
- Emergency, Fire Protection, and Security Equipment.
- Exercise Equipment.
- Exhaust Fans.
- Faucets.
- Fences.
- Garbage Disposals.
- Handrails.
- HVAC System and “**Major**” Components – See the ineligible expenses section for examples of non-major components.
- Light Fixtures.
- Painting – Exterior and Common Areas.
- Playground Equipment.
- Repaving.
- Roofing.
- Siding.
- Development and Building Signs.
- Sinks.
- Smoke Detectors.
- Swimming Pool Repairs.
- Tile/Linoleum/Sub Floors (including labor to move furniture and appliances when installing the flooring).
- Trees and Foundation Plantings and/or Removals.
- Wall Coverings.
- Water Heaters/Softeners.
- Windows/Screens.
- Window Treatments (Blinds, Drapes, and Other Treatments).

Ineligible Expenses

The following items are not eligible for RR reimbursement:

- Items **not** noted in the CNA, except when major depreciable items not typically identified by the CNA fail, such as foundations, plumbing and sanitary systems, or other unfunded items of an emergency nature.
- Items noted in the CNA as operating expenses.
- Items reimbursed by a previous draw.
- Items eligible to be replaced from alternative funding sources, such as:
 - 236 Excess Income approved by HUD for funding the replacement items.

- Damages paid for by the resident or legally deductible from a resident's security deposit that has available funds to pay for the replacement.
- Insurance reimbursements.
- Trade-in allowances.
- Warranties.
- Minor repairs, such as locksmith fees, plumbing repairs, and other typical "Non-Capitalized Repairs and Maintenance" items expensed to line items 14a through 14o of the Monthly Income and Expense reports.

Unless specifically noted in the finalized CNA for the development, the following items are also **not** eligible for replacement:

- Computers and/or software.
- Deferred maintenance items – Items requiring replacement due to deferred maintenance. For example, deferred replacement of a roof that allows water to damage further items in the development's structure. The roof would be covered, but not the additional items.
- Lawn maintenance equipment.
- Maintenance supply items for routine items, such as batteries, light bulbs, and cleaning supplies.
- Minor HVAC system and boiler components, such as blower motors, circuit boards, heat exchangers, pilot lights, thermal couplings, thermostats, and other general maintenance components.
- New additions to a site.
- Office equipment and furniture.
- Trucks or other vehicles.
- Uninstalled replacement items – Items kept in stock for anticipated replacements.
- Annual landscaping items, such as mulch, flowers, etc.

Requests for RR Disbursement

For the first 5 years after the 1st of the month following the mortgage cut-off date, the RR may only be used for emergency replacement needs. For the next year until a CNA is completed, the items listed under the "Eligible Expenses" section of this policy may be eligible for reimbursement from RR funds. Once the CNA is complete, amounts for reimbursements may be drawn from the RR fund based on the items detailed in the CNA and the parameters defined in this policy.

The Owner/Management Agent must submit an original written request for RR disbursement to the assigned Asset Manager to receive RR reimbursement. The net amount of the request must exceed \$1,000 and include the following:

- Replacement Reserve Request (MSHDA Mgmt. 503A) form.
- Replacement Reserve (RR) Draw Worksheet (MSHDA Mgmt. 503B).

- Summary of invoices (MSHDA Mgmt. 503E) including the vendor, item description, quantity, invoice date, invoice number, unit number, and invoice amount.
- Invoices for all expenses requiring reimbursement must be:
 - Dated within 12 months of the draw request date to be eligible for reimbursement.
 - Included on the invoice summary.
 - Listed on the summary with the invoice amount being billed.
 - Invoices *not* previously submitted for reimbursement.
 - Identify specific items to be reimbursed if multiple items are on the invoice. For example, an invoice including garbage disposals, light bulbs, cleaners, and faucets must have the garbage disposals and faucets identified to clarify the items for which funds are being requested.
- MSHDA Exception Response Letter – if an exception has been approved. See the “Requests for RR Draw Exceptions” section of this policy for further information.
- MSHDA Pre-approval Response Letter – if the cost of a single item (or project) replacement expenditure exceeds \$10,000, pre-approval of the expenditure is required as described in the “Requests for Pre-approval” section of this policy.
- Sworn Statements and Lien Waivers – if the cost of project expenditures exceeds \$100,000, sworn statements and lien waivers are required to be signed by the contractors and submitted with the draw.
 - If multiple draws for reimbursement occur during a project, the development should request a sworn statement and conditional lien waiver with each payment to the contractor as the MSHDA Asset Manager may need these to approve the draw. The final sworn statement and lien waiver are required to be submitted with the final draw.
- For developments with a finalized CNA, include copies of the CNA pages marked to identify that the requested items are eligible expenses included in the finalized CNA.
 - Sometimes eligible expenses are negotiated out of the CNA as the plan is finalized, which makes those expenses ineligible for reimbursement.

Replacement Reserve (RR) Draw Worksheet (MSHDA Mgmt. 503B) form –

Completing this form helps the management agent determine if MSHDA will allow the release of funds for an RR draw request or if operating funds are available at the development for use in funding the RR items being requested. The worksheet compares the cash allowed to be retained on-site against the development’s total available cash. If the calculation determines that a development has enough on-site funds to pay for the requested items, the development will not be eligible for an RR draw.

RR Funding Criteria: Developments may receive an RR draw despite available cash on-site if one of the following RR funding criteria exists:

- The RR escrow is fully funded (as defined in the RR Funding Levels section of this policy) based on the MSHDA-commissioned CNA.

- The RR is adequately funded (as defined in the RR Funding Levels section of this policy) based on the MSHDA-commissioned CNA (Plan 1 or 2) and the owner(s) has been making all recommended contributions.
- No MSHDA-commissioned CNA has been completed and the RR is funded above \$3,000 per unit.

Requests for RR Draw Exceptions

In extenuating circumstances, exceptions to the policy may be granted. The Owner\ Management Agent may submit an electronic or original written request for exception to the development's assigned Asset Manager and must include:

- Replacement Reserve Exception Request (MSHDA Mgmt. 503D).
- Adequate documentation to justify the exception.

A few examples of exception requests are:

- Down payment toward a contract – Down payment requests must be greater than 5%, but not more than 50% of the contract, must exceed \$1,000, and must be documented on the bid or contract.
- Different RR deposit amounts or possible deferral of the RR deposit amount.
- RR draw for items cited by MSHDA's physical inspection.
- Loans from the RR account for:
 - Deferred maintenance items or for minor replacement items.
 - Capital improvements.
 - Items not included in the CNA.

Loans received from the RR account must be repaid and a signed letter agreeing to the repayment terms must be submitted by the Owner and approved by the Director of Asset Management or other authorized supervisor of the Asset Management Division. Additionally, loans from the RR may improve the development's liquidity position but **cannot** be used to protect the one month's gross rent potential cash on hand.

Requests for Pre-approval

Regardless of the funding source (RR account, Operating Reserve Cash, or other development reserves or operating cash), the Owner/Management Agent must request pre-approval of substantial replacements of building components, capital improvements, and other major repairs for single items (or projects) that exceed \$10,000. The Owner/Management Agent may submit an electronic or original written request for pre-approval to the development's assigned Asset Manager and include the following:

- Bid/Contract Pre-approval Request (MSHDA Mgmt. 503C).

- Scope of Work that meets MSHDA's Standards of Design as posted on the MSHDA website at [MSHDA Architect and Contractors webpage](#) and includes a comprehensive description of the items to be replaced and all the work required to complete the replacement.
- A summary of the bids comparing each bid against the others to help validate the requested bid's benefits over the competing bids and identification of the bid being selected.
- At least three (3) independent comparable bids from qualified contractors for the completion of the work described in the scope of work.
- Copies of the applicable CNA pages identifying the required replacement, if a MSHDA-commissioned CNA exists.

Bid Information – Bid for work must include the following:

- Name, address, and telephone number of the bidder.
- Name and address of the development where the work is to be completed.
- Building number, unit number, and/or specific location where work is to be completed.
- Description of the work to be completed.
- Specifications and total costs of materials and labor that the bidder proposes to use.
- Certification that the materials to be used as described above meet or exceed the FHA minimum property standards and/or MSHDA Design Standards.
- Name of the bidder's insurance agency, if applicable.
- Down payment terms, if applicable.
- Signature of bidder.

Mortgage Loan Prepayment

Upon payment in full of the Mortgage Loan, the disbursement of excess funds is governed by the legal documents and applicable law.

Forms and Attachments

- 503A – Replacement Reserve Draw Request
- 503B – Replacement Reserve Worksheet
- 503C – Bid/Contract Pre-approval Request
- 503D – Replacement Reserve Exception Request
- 503E – Summary of Invoices