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ASSET MANAGEMENT AND COMPLIANCE (AMC) and STATE HOME PROGRAM (HOME)

ADMINISTRATIVE NOTICE

Notice Number: 09-02

DATE: **September 15, 2009**

TO: **Sponsors, Borrowers and Management Agents of Rental Projects Directly Funded by HCD**

FROM: **Chris Westlake, Deputy Director**
Division of Financial Assistance

SUBJECT: **Replacement Reserve Guidelines**

Administrative Note: This Administrative Notice establishes a formal written notification of administrative guidelines that affect the operation of Department programs. This format is used to identify, clarify and record administrative guidelines and interpretations of public interest.

Purpose and Background

The purpose of these guidelines is to provide Department staff, project borrowers, Sponsors and management agents of rental projects with loans or grants made directly by the Department, in which the Department is the named beneficiary, with consistent criteria for evaluating replacement reserve withdrawal requests.

The Department has an interest in this subject due to its mandate to ensure the habitability and affordability of developments over the entire term of its regulatory agreements. To preserve the availability of funds for capital improvements and more costly repair items, the Department expects small, regularly occurring repair items to be paid for with funds in the operating account.

Although this Administrative Notice is not mandatory for loans where the HOME State Recipient is the named beneficiary, State Recipients may adopt this as their own policy.

Scope

These guidelines apply to all rental projects that have an outstanding loan balance or regulatory agreement from any of the Department's multifamily programs, including rental projects, mobilehome parks and group homes.

For projects also funded by CalHFA, USDA-RD, HUD 811 or 202, the Department will defer to these agencies' replacement reserve policies and withdrawal approvals, with the exception of HOME-funded special replacement reserves. Once approval is obtained from the other agency, the Sponsor must send verification of such approval to HCD's HOME or AMC Representative, respectively.

Eligible Uses of Replacement Reserve Account Funds – General Information

The Department views the replacement reserve account as the source of funding for capital items that occur infrequently and that are too costly to be absorbed by the project's operating account. Examples would be the replacement or substantial repair of a major building system, new roofs, new boilers, sprinkler upgrades required to meet new fire codes, the repainting of the entire building exterior, and costly new items required to protect the residents' health or safety or to prevent building damage, such as security fences or new drainage systems.

Physical Needs Assessment (PNA) and Replacement Reserve Analysis (RRA)

To assist with long-term physical needs planning, the Department strongly encourages Sponsors or their management agents to develop and periodically update a forecast of future physical needs, the cost of meeting these needs over time, and the amount of funds available each year to cover them. This forecast, or "replacement reserve analysis," allows for evaluation of the adequacy of reserve deposits. It also provides a tool for making sure that scarce funds are reserved for critically important items, and for determining whether there are funds available for desirable but not critical improvements as well. After the initial analysis has been prepared, Sponsors should update it periodically to reflect changes in the project's condition and the cost of replacement items.

- For projects subject to the Department's Uniform Multifamily Regulations (UMRs), the Department may require periodic updates to the PNA and RRA for the purpose of adjusting the amount of required replacement reserve deposits.
- For projects funded through the Department's non-UMR programs, the Department suggests that the Sponsor periodically has a third-party conduct a PNA and RRA.
- For projects requesting loan extensions, transfer of ownership, a new loan or other types of project restructuring, the Department may require a PNA and RRA as a condition of approval, and periodically thereafter. Restructuring activities that involve new financing or re-financing will trigger the PNA and RRA requirement.
- In most cases the Department will permit funds from the operating reserve account to be used for preparation of the PNA and RRA.

Replacement Reserve Withdrawal Process

The process for requesting the withdrawal of replacement reserves to pay for project capital needs is a three step process: 1) analyze what items can be paid for with replacement reserves and which must be paid from the project operating account and obtain three bids for items over $10,000; 2) complete the work (except RHCP-O)*, and; 3) request the withdrawal of replacement reserve funds, within the fiscal year the expense was incurred, before withdrawing the funds.

*NOTE: Rental Housing Construction Program-Original (RHCP-O) projects are required to submit and obtain HCD approval of a Reserve Withdrawal Request form prior to incurring capital improvement costs due to the subsidy-nature of the program.

STEP ONE – Analyze what items can be paid from replacement reserves.

Review the attached Matrix of Capital Expenses versus Maintenance Expenses and identify which of your planned repair and replacement items may be paid from replacement reserves.

Obtain three bids for any individual item(s) anticipated to cost over $10,000:

- Prior to commencement of work or entering into a contract, obtain the following:
  - the scope(s) of work;
  - the specifications for the item(s); and,
  - three bids for each item.
- The bids must be based on equivalent specifications for the work.
- Retain this documentation for your records and to include under step three.

STEP TWO – Complete the Work (except RHCP-O).

Sponsor may proceed with the replacement item, repair or improvement once it has completed Step One.

STEP THREE – Submit the Reserve Withdrawal Request.

- All Requests must be within the fiscal year the expense was incurred.
- Always include a copy of the most current bank statement for Replacement Reserve Account.
- Attach bid documentation for items over $10,000.

You may withdraw funds from the reserve once the Department has returned an approved copy of the Reserve Withdrawal Request to you.

Revised Form

The Department has revised its Reserve Withdrawal Request form in order to improve Replacement Reserve tracking. The new form is an MS Excel file and has been posted on HCD's website for your use, at: http://www.hcd.ca.gov/fa/amc/
or, http://www.hcd.ca.gov/fa/home/monitoringforms.html

Emergency Repairs

An emergency repair is defined as a health and safety issue for which immediate action must be taken to prevent harm to a person or extensive damage to a property. Due to the immediate nature of the situation, the Sponsor is not required to obtain three bids for jobs over $10,000, but is encouraged to do so.

Replacement Reserve Balance

The Department suggests that projects maintain a minimum balance in the replacement reserve account of $1,000 per unit. When the Department approves a withdrawal reducing the amount below the suggested minimum, the Department may:

- Establish a plan to return the account to the required minimum balance;
- Require Sponsor to obtain a Replacement Reserve Analysis;
- Review the adequacy of the annual reserve deposits and increase the amount.

Projects With Negative Cash Flow

When an expense required by the Matrix to be paid from the operating account will result in a negative cash flow for the project, and there are inadequate operating reserves available, the Department will consider a request for withdrawal from the Replacement Reserve.

Additional Information

Given the variety of Department programs and the fiscal and physical condition of the projects, there may be instances where the provisions in these guidelines cannot be implemented. If that is the case, please contact your Asset Management Representative or HOME Representative to discuss the situation and obtain further guidance. If you need assistance in identifying your Representative, please call (916) 324-8282 for the AMC Section or (916) 322-0356 for the HOME Program.

The following table is a guide for differentiating between what should be treated in reserve and operating account processing as a "Capital Expense" (paid from the replacement reserve) versus a "maintenance expense" (paid from the operating account).

Categories	Capital Expenses Paid from Replacement Reserves	Maintenance Expenses Paid from Project Operating Account
Appliances Range, Refrigerator, Washer & Dryer, Garbage Disposal, Dishwasher	Any replacement	Replacing or repairing components (burners, bibs, elements, controls, valves, wiring)
Cabinets & Countertop Kitchen & Bathroom	Replacement and refinishing	Repairs; component & hardware replacement
Carpet and Flooring (Units and Common Area)	Any replacement	Repairs; patching; shampooing & cleaning
Doors (Exterior and Interior)	Any exterior door replacement	Any interior door replacement; any door repair or hardware replacement
Electrical		
Fixtures, including lighting	Replacement of fixtures for an entire building (or an entire exterior area), or as part of project remodel.	Replacement of individual fixtures; repairs; parts replacement; light bulbs, switch plates, etc.
Security and Alarm Systems	New or Replacement System	System Repairs
Wiring and Electric Panels	Major electrical work or rewiring	Repairs
Elevators	Professional repairs or replacement	Routine maintenance and inspections
Fire Extinguishers and Smoke Detectors	Ineligible	Replacement, refills, inspections and repairs
Furniture (Units and Common Areas)	Replacement in living units	Repairs including cleaning; replacement in common areas.
HVAC – Heating, Ventilation, Air Conditioning, Including Boilers & Furnaces	Replacement or major overhaul	Repairs; replacement of components; changing filters

Categories	Capital Expenses Paid from Replacement Reserves	Maintenance Expenses Paid from Project Operating Account
Landscape, Grounds and Other Common Areas		
Childcare: Non-Commercial Resident Use Only	Replacement of fixtures; major repairs	Routine maintenance and minor repairs
Computer Lab Equipment	Ineligible	Purchase, replacement or repair
Exterior Walls – Retaining/Enclosure	Major replacement	Patching and repairing
Fencing	Major replacement	Patching, repair and board replacement
Irrigation System	Replacement of irrigation system or major components	Repairing leaks and broken sprinklers
Landscaping	Major non-routine landscaping	Routine grounds maintenance
On-Site Rental/Management Office	Ineligible	Computer and business software (including industry interface), copier, fax machine, small office equipment and furniture
Recreational Areas, Playgrounds and Pool	Replacement of equipment and fixtures; major repairs and resurfacing	Routine maintenance and minor repairs
Signs	Replacement of primary project sign	Minor repairs, repainting, lighting and other signage replacement
Painting		
Exterior	Painting an entire building or project	Touch-up painting; graffiti removal
Interior – common areas	Entire project only	All other interior painting
Interior – units	Entire project only	Upon move-out, touch up
Paving – Asphalt or Concrete Sidewalks, Parking Lots, & Driveways	Major repaving, resurfacing, seal coating, striping	Patching and crack sealing
Plumbing		
Fixtures – Bathtubs and Shower Enclosures, Sinks, Water Heaters, Toilets	Any replacement	Repairs; parts replacement
Water & Sewer Pipes, Fire Sprinkler Systems	Replacement or major repair	Fixing leaks

Categories	Capital Expenses Paid from Replacement Reserves	Maintenance Expenses Paid from Project Operating Account
Window Screens and Window Coverings	Replacement of window screens or window covering for an entire building or project	Replacement of window screens or window coverings for less than an entire building; any hardware replacement; fixing screens; caulking and sealing
Structure		
Accessibility Features	Extensive accessibility work, ramps, railings	Minor repair, modifications and hardware
Elevated Walkways and Balconies	Major replacement of components	Minor repairs
Roofing	Major replacement, including gutters, downspouts and eaves	Minor roof, gutter, downspout and eaves repair
Siding/Stucco	Extensive replacement	Patching; panel replacement
Walls - Interior	Major replacement	Repairing holes
Windows	Any replacement	Repairs, hardware replacement