

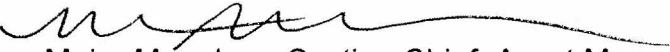
**DEPARTMENT OF HOUSING AND COMMUNITY DEVELOPMENT
DIVISION OF FINANCIAL ASSISTANCE**

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**ASSET MANAGEMENT AND COMPLIANCE (AMC)
Fiscal Section****ADMINISTRATIVE NOTICE
Notice Number: 16-02**

DATE: February 11, 2016

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

FROM: 
Moira Monahan, Section Chief, Asset Management & Compliance Branch

SUBJECT: **Replacement Reserve Guidelines**

Administrative Note: This Administrative Notice establishes a formal written notification of administrative guidelines that affect the operation of Department programs. It updates and supersedes AN 09-02. 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.

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 may defer to these agencies' replacement reserve policies and withdrawal approvals during the time such projects are regulated by HUD, CalHFA or USDA-RD, with the exception of HOME-funded special replacement reserves. Once approval is obtained from the other agency, the Sponsor/Borrower must send verification of such approval to HCD's AMC Fiscal Representative.

Eligible Uses of Replacement Reserve Account Funds – General Information

The Department views the replacement reserve account as the source of funding to repair or replace capital items or to fund extraordinary maintenance. The account is not intended to cover routine and preventative maintenance or repairs. Examples of eligible replacement reserve uses include 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.

Please note: The Department's Audit Handbook requires that funds withdrawn from the replacement reserve for non-capital items be added back to cash flow; therefore, a project's capitalization policy may result in increased net cash flow. Please consult your Accountant if you have questions about the audit requirements or a project's capitalization policy.

Replacement Reserve Withdrawal Process

The process for requesting the withdrawal of replacement reserves to pay for project capital needs is as follows:

STEP ONE -Analyze which items can be paid from replacement reserves.

Review the matrix of expenses eligible for replacement reserve withdrawal (attached to this memo) and identify which planned repair and/or replacement items are eligible to be paid from replacement reserves.

STEP TWO – Determine whether any individual contract will exceed \$10,000.

If no individual contract will exceed \$10,000, proceed with the work (except for RHCP-O projects, which must obtain HCD approval first for **all** replacement reserve withdrawals) before submitting the replacement reserve withdrawals.

If any individual contract **DOES** exceed \$10,000, obtain the following and submit to HCD before selecting a contractor:

- The scope(s) of work;
- The specifications for the item(s); and
- Three bids for each contract. The bids must be based on equivalent specifications for the work.

Retain a copy of this documentation for your records and to submit a copy to HCD under step two.

If the three bids are not obtained, the Sponsor/Borrower should provide a written explanation addressing why three bids were not obtained. The Department reserves the right to reject a request for a withdrawal which is based on insufficient bid documents.

STEP THREE – Submit the fully completed Reserve Withdrawal Request to HCD.

Submit request on completed HCD Reserve Withdrawal Request form in Excel format. The form is available on the Department website at:

http://www.hcd.ca.gov/fa/amc/Reserve_Withdrawal_Request.xls

- All Requests must be submitted no later than 45 days after the fiscal year end in which the expense was incurred.
- Always include a copy of the most current bank statement for the Replacement Reserve Account.
- Include copies of all invoices with vendor, item description, quantity, invoice date, invoice number, unit number, and invoice amount. It is not necessary to submit copies of checks.
- For contracts over \$10,000, attach copies of the scope of work, job specifications, and bid documentation.

STEP FOUR – Receive HCD Approval.

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

Timing of Reserve Request Submittals

To avoid delays, the Department recommends the submission of quarterly or semi-annual requests rather than one large request at the end of the fiscal year. Should the Department fail to take action on a request for an eligible withdrawal from the reserve accounts within 30 days from documented receipt of the request, that request shall be deemed approved. If the withdrawal does not contain the required information, it will be returned to the Sponsor/Borrower with a request for additional information. A new 30-day approval period will begin when all required information is received by the Department.

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 the property. Due to the immediate nature of the situation, the Sponsor/Borrower is not required to obtain three bids for jobs over \$10,000, but is encouraged to do so, if doing so will not incur additional damage or put people at risk of injury.

If improvements have been made without Department approval because of an urgent need, the Sponsor/Borrower must submit documentation as soon as possible after the repair has been completed to substantiate the urgent need.

Property Condition Assessment (PCA) and Replacement Reserve Analysis (RRA)

The Department is updating its guidance on Property Condition Assessments (PCA) (formerly referred to as Physical Needs Assessment, or PNA). The new requirements will be released by July 2016. Until the updated guidance is released, the Department continues to strongly encourage Sponsors/Borrowers 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 the costs. This periodic analysis is important in long-term physical needs expense planning.

The forecast, or PCA and replacement reserve analysis (RRA), allows for evaluation of the adequacy of reserve deposits. It also provides a tool for ensuring that funds are available for critically important items.

After the initial analysis has been prepared, Sponsors/Borrowers should update it periodically to reflect changes in the project's condition and the cost of replacement items. The Department requires PCAs to adhere to the Fannie Mae Instructions for Performing a Multifamily Property Condition Assessment (Version 2.0, 2014):

https://www.fanniemae.com/content/guide_form/4099.pdf

- For all projects, the Department may require periodic updates to the PCA and RRA for the purpose of adjusting the amount of required replacement reserve deposits.
- For projects requesting loan extensions, transfer of ownership, a new loan or other types of project restructuring, the Department requires a PCA and RRA as a condition of approval, and periodically thereafter.
- In most circumstances, the Department will permit funds from the operating reserve account to be used for preparation of the PCA and RRA. Please follow the applicable reserve withdrawal request process prior to using any reserve funds for this purpose.

Replacement Reserve Balance

The Department expects the replacement reserve to be sized according to the needs of the project. For that reason, the Department requires 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 minimum, the Department will:

- Establish a plan to return the account to the required minimum balance;
- Require Sponsor to obtain a Property Condition Assessment (PCA) and Replacement Reserve Analysis that complies with the Fannie Mae Instructions for Performing a Multifamily Property Condition Assessment (Version 2.0, 2014);
https://www.fanniemae.com/content/guide_form/4099.pdf
- 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 Fiscal Representative to discuss the situation and obtain further guidance. If you need assistance in identifying your Fiscal Representative, please contact AMCBranch@hcd.ca.gov.

The following table differentiates between what should be treated in reserve and operating account processing as a "Capital Expense" (which is eligible to be paid from the replacement reserve) versus a "maintenance expense" (which must be paid from the operating account).

Categories	Eligible Expense To Be Paid from Replacement Reserves	Maintenance Expense Must Be Paid from Project Operating Account
Appliances Range, Hood, Refrigerator, Washer & Dryer, Garbage Disposal, Dishwasher, Microwave	Any replacement of a built-in appliance	Replacing or repairing components (burners, bibs, elements, controls, valves, wiring)
Cabinets & Countertop Kitchen & Bathroom	Replacement	Repairs, refinishing, component & hardware replacement
Flooring (Units and Common Area)	Any replacement	Repairs, patching, shampooing & cleaning
Doors (Exterior and Interior)	Any interior or exterior door replacement	Any door repair or hardware replacement, keys or locksmith
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	Replacement or installation of fire suppression devices (except fire extinguishers)	Replacement, recharging of fire extinguishers, inspections and repairs
Furniture (Common Areas and Owner-Furnished Within Units)	Replacement in living units if furnished by owner	Repairs including cleaning, replacement in common areas
HVAC - Heating, Ventilation, Air Conditioning, Including Boilers & Furnaces	Replacement or major overhaul	Repairs, changing filters, replacement of components (such as blower motors, circuit boards, thermostats)

Categories	Eligible Expense To Be Paid from Replacement Reserves	Maintenance Expense Must Be 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 and Gates	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	Tree removal, sprinkler system repairs, routine grounds maintenance (such as mulch and flowers)
Maintenance Supply Items	Ineligible	Such as batteries, light bulbs, cleaning supplies, maintenance equipment and tools
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, or installation	Patching and crack sealing

Categories	Eligible Expense To Be Paid from Replacement Reserves	Maintenance Expense Must Be Paid from Project Operating Account
Plumbing		
Fixtures - Bathtubs, Shower Enclosures, Sinks, Toilets, Water Heaters, Water Softeners (when on well water), Pumps	Any replacement	Repairs, parts replacement
Water & Sewer Pipes, Fire Sprinkler Systems	Replacement or major repair	Fixing leaks
Medicine Cabinets	Ineligible	Replacement
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
Structures		
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 coating, flashing, 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
Bedbug Eradication	Ineligible for Replacement Reserve, but eligible for Operating Reserve	
Insurance Deductible for Losses	Eligible	