

ASSISTANT SECRETARY FOR HOUSING-
FEDERAL HOUSING COMMISSIONER

MORTGAGEE LETTER 2019-XXX
DRAFT
Updated February xx, 2018

TO: All FHA-Approved Multifamily Mortgagees and Servicers

SUBJECT: Delegated Reserve for Replacement Administration

I. Purpose and Background

This Mortgagee Letter (ML) authorizes lender delegated reserve for replacement (RFR) escrow administration, and details instructions for lender application for approval. This ML describes the procedures by which HUD will permit approved Multifamily Lenders and Servicers who apply and are approved by HUD to do so.

The procedures described within this ML are designed to increase efficiency in processing borrowers' requests for disbursement of funds from RFR accounts. Lenders undertaking this task for their portfolio will reduce the need for the Department of Housing and Urban Development (HUD) approval for each disbursement. A prerequisite for Lender's use of this procedure is HUD approval of an amendment to the lender's Quality Control Plan (QCP)

II. Lender Approval Process

Lenders who wish to participate should submit a written request (original hard copy and an electronic copy) to Director of the Multifamily Asset and Counterparty Oversight Division, Department of Housing and Urban Development, 451 Seventh Street, SW, Room 6151, Washington, DC 20410-8000, electronic requests should be submitted to Terry.G.Clark@hud.gov.

The lender's QCP must specify the business processes and controls it will use to administer RFR disbursements consistent with the requirements of this ML. The QCP must address:

1. Procedures for review of form HUD-9250 "Funds Authorizations."
- 2) Identification of the staff assigned to oversee the task, the qualifications of the identified staff, and a primary point of contact.
3. The elements specified in this ML.
- 4) Procedures for monitoring properties with HUD project-based rental assistance (i.e. a Section 8 HAP contract).

III. General Requirements

1. The Lender cannot charge additional servicing fees for administering releases from the RFR account.
2. HUD will retain responsibility for release of RFR funds when there is an identity of interest between the lender and the borrower.
3. HUD will retain responsibility for release of RFR funds on properties in financial distress and under a HUD mandated Action Plan, properties undergoing substantial rehabilitations, properties that have under 60 REAC scores, and other properties identified by HUD. MACOD will provide a list quarterly to the field office of ineligible properties.
4. Lender conformance to the requirements of this ML and the QCP will be monitored in accordance with the specific provisions of the QCP and the MAP Guide provisions for lender quality monitoring as described in Chapters 2, 15 and Appendix 2.
5. This notice only applies to Market Rate insured properties. HUD will issue additional guidance for subsidized properties at a later date.

IV. Processing Instructions

1. The Owner/borrower will request disbursements using form HUD-9250 Funds Authorizations. Qualified Lenders will compare RfR release requests based on the owner's previous disbursements for capital replacements and the most current Capital Needs Assessment (CNA) schedule of repairs and replacements. Lender approval of the disbursements will be evidenced by signing in the space designated for HUB or Program Center Director on the form HUD-9250.
2. The HUD field staff assigned to a project will be the Lender's point of contact for any questions including whether an item is eligible for reimbursement. Lenders shall provide copies of the form HUD 9250 as specified in this ML in Part VII Documenting Reserve for Replacements. Copies will be provided electronically to the appropriate field mailbox listed below:

Atlanta - ATL.incoming@hud.gov
 Baltimore - BAL.incoming@hud.gov
 Boston - BOS.incoming@hud.gov
 Chicago - CHI.incoming@hud.gov
 Detroit - DET.incoming@hud.gov
 Denver - DEN.incoming@hud.gov
 Fort Worth - MFSouthwest@hud.gov
 Jacksonville - JAX.incoming@hud.gov
 Kansas City - MFSouthwest@hud.gov
 Minneapolis - MN.incoming@hud.gov
 New York - NY.incoming@hud.gov

San Francisco - SF.incoming@hud.gov

3. HUD staff will document that a property will have the RFR releases administered by the lender in the Integrated Real Estate Management System (iREMS) e.g. on the Servicing Reserve Tracking screen.
4. HUD reserves the right to request additional documentation and details regarding form HUD-9250 submission if there are concerns with submitted inspection reports or supporting documentation.

V. **Applicability**

This mortgagee letter will be applicable to RFR in projects insured under Sections 220, 221(d)(3), 221(d)(4), 223(a)(7), 223(f), and 231.¹ HUD will retain responsibility for the release of RFR funds in all cases where there is an identity of interest between Lender and the Borrower as described in the MAP Guide. Additionally, HUD will retain responsibility for release of RFR funds on properties in financial distress and under a HUD mandated Action Plan, properties undergoing with substantial rehabilitations, and properties that have under 60 REAC scores.

VI. **Uses of Reserve for Replacement Account**

1. The RFR account is established by the Office of Multifamily Housing Programs Development staff during the underwriting process in accordance with the requirements published in Chapters 5, 6, and 7 of the MAP Guide, and ML 2012-25. For many recent transactions, a CNA scope of work and lender review responsibilities are defined in Appendix 5G- CNA Instructions of the MAP Guide.
2. The approved lender will approve the release of RFR funds to pay for the replacement of capitalized assets that are part of the mortgaged security. The lender must ensure that the owner and property manager are consistent in following the appropriate treatment of eligible RFR draws versus expenses that are ineligible. A list of ineligible items can be found in HUD Handbook 4350.1

The owner's discretion must be expressed in a defined policy consistently applied year after year. The lender is responsible during in the underwriting process to confirm that the borrower has established, and that the needs assessor has identified, a clear distinction between items classified as capital replacements repairs, and replacements treated as operating expenses.

In recognition of the wide variety of properties HUD insures, HUD does not specify in this ML a standard list of capital items for which replacement costs must be escrowed for each property. Individual property capital needs will be assessed in the initial underwriting process, and every 10 years with a Capital Needs Assessment. The standard

¹See 1.1MAP Guide Bookmarked November 2011 version, r 1.1, page 310 of 736

table of contents for e-CNA reports in the MAP Guide also lists the kinds and categories of building components which should be addressed in e-CNA reports when such components are present. (See Appendix 6.) Replacement of some components may be treated as an expense or as a capital item depending on circumstances and an owner's standard practice (e.g., carpet replacement). As noted in ML 2012-25 there are legitimate differences in the business choices owners make when distinguishing between operating expense and capital replacement items, and reviewers will look at the patterns of spending.

Draws from the RFR escrow will be compared to an owner's past pattern of expenditures or a e-CNA described schedule of repairs and replacements. In general, the lender/servicer will not authorize draws for items or categories of items not within the past pattern or identified by any PCNA.

3. If the property has HUD project-based rental assistance (i.e. a Section 8 HAP contract) or has undergone a PPC and the owner/borrower is **not** requesting releases as defined by the CNA schedule, the lender/servicer should immediately notify HUD. The lender/servicer should include procedures for monitoring this subset of properties in their QCP submission, to ensure HUD is notified as soon as possible if releases are not being made per any applicable CNA schedule.
4. Guidelines for eligible draws from the RFR account.
 - a. Requests for RfR withdrawals exceeding 20 percent of the current RfR balance or \$25,000, must be accompanied by a current reserve needs assessment that shows that the remaining balance in the RfR is sufficient for future needs identified in the CNA.
 - b. The Lender will certify that releases will not be made without prior HUD approval if it will result in the RFR account being drawn below the fixed minimum unit per annum established in the underwriting process. The Lender/Servicer QCP will be consistent with this policy.
5. The RfR should fund, at a minimum, the following primary capital items:
 - a. Major appliance replacements in dwelling units, such as refrigerators, ranges, dishwashers, and garbage disposals;

Note: HUD promotes the use of ENERGY STAR labeled appliances. Lender/Servicer staff should communicate this to those requesting the use of RFR for the purpose of replacing major appliances
 - b. Kitchen and bathroom sinks, counter tops, bathroom tubs, water closets, and doors (exterior and interior);
 - c. Major roof repairs, including major replacements of gutters, downspouts, and related eaves or soffits. HUD encourages owners to seek energy-efficient roofing materials;

- d. Major plumbing and sanitary systems repair and replacements, preferably with water-saving features;
 - e. Central air conditioning and heating systems replacements or major overhauls, including cooling towers, water chilling units, furnaces, stokers, boilers, and fuel storage tanks;
 - f. Major elevators or stairways replacement;
 - g. Major sidewalks, parking lots, and driveways repaving or resurfacing;
 - h. Major building exterior repainting;
 - i. Major siding replacement on a building;
 - j. lawn sprinkler systems replacement;
 - k. swimming pool or playground equipment replacement or major repairs.
6. Items paid for using the RfR must be reflected as line items in the most current CNA, If Applicable.

Periodically, modifications to the RFR for items not listed in the CNA may be necessary. When items are paid for using RfR and those items are not reflected in the current CNA or property insurance scheduled, the CNA or schedule must be revised to reflect those items.

A new reserve needs assessment, a feature of the CNA e-Tool, may be required and the monthly RfR deposit may be adjusted if necessary. The Lender must notify HUD of any required adjustments to the monthly RFR deposit. HUD reserves the right to disagree with the adjustment and make adjustments as necessary. Subsidized properties that receive an annual RfR deposit increase, as consequence of a rent increase, are not affected by this process.

7. Owner/managers are required to utilize the RFR account to reimburse any capital item in the same fiscal year in which the expenditure occurs. For additional guidance, owner/managers of Mark to Market properties should refer to Notice H 2011-30 Use of Reserve for Replacement Accounts in Restructured Mark to Market Properties issued October 19, 2011.
8. The RFR provides for project stability, and capital systems and equipment replacement. To ensure this goal is met, the RfR may be used in special circumstances, as determined by the regional center or satellite office director, for the following items:

- a. Lead-based paint elimination, testing, and abatement;
 - b. Asbestos testing, abatement, and elimination;
 - c. Unexpected but significant one-time increases in utility costs or insurance;
 - d. Project-wide repairs or upgrades to eliminate conditions considered health or safety hazards; Third party reports for Section 202 refinancing, up to \$20,000, subject to the Office of Asset Management and Portfolio Oversight approval;
 - e. Certain bedbug remediation activities
 - a) relocation from units is not necessary for effective pest treatment. If reasonable temporary relocation is necessary, the owner/management may request withdrawals from available project funds (which include RfR account, project income, or residual receipts escrow, when authorized by HUD) for any day when treatment for bedbugs may render the unit uninhabitable.
 - b) all withdrawals of this type must be approved by the regional center and/or satellite officer director or designee. These requests should be submitted through the HUB's centralized mailbox, and include the AEs name, and property name in the subject line,
 - c) any temporary relocation must be carried out in accordance with applicable Civil Rights Acts of 1965 and Section 504 of the Rehabilitation Act of 1973
9. Items ineligible for draws from the RfR account include, but are not limited to the following maintenance items:
- a. Appliance part replacements, range burners, controls, wiring.
 - b. Individual dwelling-unit air conditioning components replacements, such as fan motors and window unit compressors;
 - c. Minor repairs to central air conditioning and heating systems, such as valve replacements, periodic routine maintenance, and the cleaning of boiler interiors;
 - d. Minor roof repairs, including repairs and limited replacement of gutters and downspouts;
 - e. Repainting of interior areas that cost under \$10,000;
 - f. Caulking and sealing of building exteriors;
 - g. Window and screen repairs;

- h. Purchase of maintenance tools and equipment, such as lawn mowers or snow blowers, wrenches, hardware, power tools etc.;
- i. Office equipment purchases;
- j. Fire extinguishers inspection and recharging; and
- k. Other items generally considered to be routine maintenance items.

VII. Documenting Reserve for Replacement Transactions

1. The owner/manager completes documentation of RfR transactions by preparing form HUD-9250, Funds Authorizations. The Lender is responsible for reviewing and approving form HUD-9250. The owner must always use current Office of Management and Budget (OMB) approved forms. The Lender is only authorized to approve RfR requests; all of requests made through form HUD-9250 must go through the appropriate field office.

The regional center and/or satellite office ensures all sections of the reserve tracking screen in the Integrated Real Estate Management System (iREMS) are up to date, and the documentation is appropriately retained and stored.

2. In order to ensure proper maintenance of the disbursement the Lender should follow the following procedures:
 - a) Establish internal RfR file for the project.
 - b) Provide copies of form HUD-9250 and other supporting documents for each RfR withdrawal to the HUD Field Staff. This documentation must include the date of the request for RfR.
 - HUD staff is responsible in ensuring the reserve tracking screen in iREMS is up to date.
 - c) The lender/servicer should also retain documents in accordance with the following requirements:
 1. Lender is required to keep copies of all form HUD-9250 on file for the project's lifetime. These forms provide a basis for establishing asset replacement dates.
 2. Except in unusual circumstances, such as defaults or major findings from previous reviews or audits, if the required audited annual financial statement (AFS) covering the time period of the expenditure has been submitted and reviewed, discard copies of supporting materials, such as invoices that are on file and more than a year old.
 3. For projects not required to submit audited AFSs, retain copies of contracts and bids for at least three years or for the term of any warranty or guarantee

VIII. Owner/Manager Documentation of Reimbursement Request:

1. For goods, materials, supplies, equipment, and appliances identified in the CNA, owner/managers must make a RFR reimbursement request to the Lender/Servicer according to contractual agreements among the parties, using form HUD-9250. Owner/managers should include the following information with the request:
 - a. A Mortgagor Certification;
 - b. Specify the unit(s) where goods, materials, equipment or appliances were used or installed;
 - c. Provide copies of the purchase order or paid invoice, including serial numbers for equipment and appliances.
2. For reimbursement for work or services that have been performed, owners must submit a written RFR reimbursement request and must provide a detailed description of the work or services that have been performed following instructions found on the back of form HUD 9250. The description must identify:
 - a. the specific location(s) and service(s) provided, including the affected dwelling unit(s), if applicable, for purposes of a work inspection during subsequent visits to the property;
 - b. a copy of the paid invoice(s) accompanying the request; and
 - c. an owner certification is required.
3. The owner must obtain three bids if the RfR reimbursement request is expected to, or will, exceed the larger of \$25,000 or 20 percent of the current RfR balance.
4. The owner/manager must maintain copies of all bids on site for examination during a management review.

IX. Advance of RFR Funds: For advances from the RFR account for services to be performed:

1. The owner/manager must submit at least three bids together with the bid specifications and/or the scope of work for advances from the RfR account for services to be performed. If an owner/manager is unable to obtain three bids, then the owner/manager must submit a justification to the lender as to why three bids were not acquired.
2. If a request for an advance of RfR funds is not based on bids, the owner/manager must submit justification and supporting documentation for the proposed use of the funds to HUD or the lender/servicer.
3. The lender/servicer reviews, and approves or disapproves, an advanced release based on the use and availability of funds in the project operating and RfR accounts.

4. If the owner does not select the lowest bid, the owner/manager must provide an explanation for why another bidder was selected.
 - a. The lender or account executive, in accordance with contractual agreements among the parties, retains a copy of all documents the owner submits and returns originals to the owner upon completing the review process.
 - b. The owner must retain original documents for three years, or for the term of any warranty or guarantee, whichever is longer.
5. To ensure contract performance, the owner/manager may require the contractor to provide workers compensation or completion assurance bonds.
6. To ensure satisfactory completion of contracts for services, the owner/manager may choose to pay in installments at the completion of stages of work. For example, the owner/manager may pay one-third when the work begins, one-third midway through the work, and one-third at satisfactory completion.

X. Frequency, Timing, and Follow-Up of a Reserve for Replacement Reimbursement Request

1. Quarterly Request

Owners should not make requests for an RfR reimbursement more than quarterly. Owner/managers are required to make reimbursement requests during the same project fiscal year in which the expenditure occurs, unless the lender/servicer or regional center and/or satellite office provides a waiver. OAMPO prefers reimbursement requests be made at least 60 days before the close of the project's fiscal year.

- a. Projects restructured under PPC must have any reimbursement request approved or a waiver of the reimbursement requirement granted during the calendar year in which the work was completed, or capital item was replaced.
- b. If the lender/servicer or regional center and/or satellite office approves a request but has not satisfied the request before the end of the fiscal year, the owner should treat the anticipated reimbursement as a receivable in the surplus cash computation
- c. The lender/servicer or regional center and/or satellite office does not grant reimbursement for invoices older than one year from the date the work was completed.

2. Submission of Owner Reimbursement Request

When submitting an RfR reimbursement request, the owner/management agent should attach an RfR worksheet breakdown, identifying the information addressed in as identifying the following information: purchase; products; manufacturer; model serial

number; dollars expended per unit; and installation location.

3. Follow-up inspection

A follow-up inspection or certification of the satisfactory contract work completion is generally unnecessary if the overall cost is the lesser of \$25,000 or 20 percent of the RfR account balance; however, the regional center and/or satellite office reviews the work during subsequent visits to the property.

HUD only requires inspection for a sample of the repairs or replacements if the owner/manager submits acceptable audited AFSs and if the project is not troubled or potentially troubled or included on the lender's internal watch list. The owner must submit a certification of the satisfactory contract work completion certification for more significant repairs.

4. Retention of bids and invoices

For at least three years, or the term of any warranty or guarantee, the owner must keep all bids and invoices on file and have them available for the Lender, HUD /or the Contract Administrator staff during on-site reviews.

XI. Processing RfR Reimbursement

1. Criteria:

The lender/servicer, according to their contractual agreement, reviews and acts upon the owner/manager's RfR request, or provides the owner/manager in writing with the reason(s) for needing more time, when the following criteria are met:

- a. The loan is current.
- b. There are no known uncured Regulatory Agreement or any other applicable business agreements violations.
- c. The owner has no unresolved findings from management reviews or financial assessment subsystem (FASS) compliance reviews, or other reviews.
- d. The project is not designated as troubled in iREMS.
- e. The withdrawal request does not compromise the established minimum threshold requirement.
 - o **Note:** When addressing the needs of properties with an established 20-year schedule, there may be years when it is appropriate to approve requests allowing the balance to temporarily drop below the minimum threshold requirement
- f. The owner's request does not include payment of special fees to the management agent.

- g. Any owner requests for invoices payable to identity-of-interest vendors are for project capital items reasonable and necessary and for costs as low as or lower than arms-length, open-market purchases.

2. Suspension of Disbursements

If an owner/manager develops a pattern of errors, such as continually requesting ineligible items, the mortgage goes into default, or the project becomes troubled or potentially troubled, the regional center and /or satellite office may temporarily suspend the RfR funds expenditure, except in cases of emergency.

XII. Surcharges and Penalties:

OAMPO will not surcharge or penalize Mortgagee/Serviceers for approved R4R releases, provided the instructions in this mortgage letter, and on designated HUD forms were followed.

XIII. Implementation

This ML is effective immediately. This ML remains effective until amended, superseded, or rescinded.

For further information contact Tamara Di Paolo at 202-402-7135 or Tamara.Dipaolo@hud.gov, in HUD Headquarters. Persons with hearing or speech impairments may access this number via TDD/TTY by calling 1.877.TDD.2HUD 1-877-833-2483.

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Sincerely

Assistant Secretary for Housing-
Federal Housing Commissioner