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 **CHAPTER 4. RESERVE FUND FOR REPLACEMENTS**

4-1 Introduction and Applicability. A Reserve Fund for

 Replacements exists for most projects with HUD-insured,

 formerly coinsured, and HUD-held mortgages. This Chapter

 applies to these projects as well as to Section 202 and

 Section 162 Direct Loan Program projects and Section 801

 and 811 Capital Advance Program projects. The Reserve

 Fund is generally used to help defray the costs of

 replacing a project's capital items. Title 24 of the Code

 of Federal Regulations provides, at Section

 207.19(f)(3)(i), "In all projects, except those involving

 rehabilitation where the mortgage does not exceed

 $200,000, a fund for replacements shall be established and

 maintained with the mortgagee. The amount and type of

 such fund and the conditions under which it shall be

 accumulated, replenished, and used, shall be specified in

 the charter, trust agreement, or regulatory agreement."

4-2 Regulatory Agreements for projects generally contain the

 following typical language pertaining to the Reserve Fund

 for Replacements to the effect that owners shall establish

 or continue to maintain a reserve fund for replacements by

 the allocation to such reserve fund in a separate account

 with the mortgagee or in a safe and responsible depository

 designated by the mortgagee, concurrently with the

 beginning of payments towards amortization of principal of

 the mortgage insured or held by the Federal Housing

 Commissioner of an amount equal to $\_\_\_\_\_ per month unless

 a different date or amount is approved in writing by the

 Commissioner. Such fund, whether in the form of a cash

 deposit or invested in obligations of, or fully guaranteed

 as to principal by, the United States of America shall at

 all times be under the control of the mortgagee.

 Disbursements from such fund, whether for the purpose of

 effecting replacement of structural elements and

 mechanical equipment of the project, for the cure of

 mortgage defaults, or for any other purpose, may be made

 only after receiving the consent in writing of the

 Commissioner. In the case of Section 202, 162, 801, or

 811 projects, where HUD serves as the mortgagee, the

 project owner escrows the funds but may not withdraw them

 from the Reserve for Replacements Account without the

 Asset Management Branch Chief's written permission. For

 HUD-Held mortgages, HUD shall exercise control over the

 Reserve Fund for Replacements by acting pursuant to its

 own authority as well as in the stead of the mortgagee.

 This authority may be exercised only by HUD Headquarters.

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4-3 Mortgagee's Certificates generally contain the following

 typical language that pertains to the Reserve Fund for

 Replacements: "Beginning on the date on which the first

 payment toward amortization is required to be made by the

 terms of the insured mortgage or at such later date as may

 be agreed to by you [the Federal Housing Commissioner], we

 [the Mortgagee] shall require a monthly deposit with us or

 in a depository satisfactory to us of one-twelfth (1/12)

 of the sum set forth in your Commitment for Insurance

 constituting a 'Reserve Fund for Replacements' which fund

 shall be subject to our order and from which fund

 withdrawals may be made only upon the receipt of your

 written permission. These funds will be deposited with us

 by the Mortgagor in cash or in the form of obligations of

 or guaranteed as to principal by the United States of

 America. We will, upon appropriate request by the

 Mortgagor, permit the conversion of the whole or a

 substantial part of such cash deposits into the form of

 obligations of, or fully guaranteed as to principal by,

 the United States of America. . . ."

4-4 Remaining Economic Life of Building Improvements.

Economic life is the period over which improvements to

real property contribute to property value. Because

buildings are subject to physical deterioration and

functional or economic obsolescence, their periods of

usefulness are limited. For purposes of this Chapter 4,

"buildings" includes building structures themselves, major

movable equipment, and other on-site improvements such as

water mains, sewer laterals, swimming pools, parking lots,

etc. As buildings deteriorate or become obsolete, their

ability to serve useful purposes decreases and eventually

disappears. This decline and ultimate disappearance of

utility may occur gradually or rapidly.

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4-5 Economic Life vs. Physical Life. 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,

is its total 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 (though not functionally or

profitably).

A. Estimates are made of both physical life and remaining

 economic life, but the estimate of physical life sets

 the maximum for the estimate of economic life.

 NOTE: Judicious use of the Reserve Fund for

 Replacements is expected to extend the physical life

 of the building.

B. Economic life can never be greater than physical life

 but it may be and frequently is less. A structure may

 be sound and in good physical condition with a number

 of years of physical life remaining and yet have

 reached the end of its economic life if its remaining

 years of physical usefulness will not deliver a

 positive cash flow or provide the service of supplying

 housing on a cost-effective basis.

4-6 Estimates of Remaining Economic Life. In predicting the

remaining economic life of a building, six types of

factors are considered:

A. Economic background of the community or region and the

 need for accommodations of the type represented.

B. Relationship between the property and the immediate

 environment.

C. Architectural design, style, and utility from the

 functional point of view and the likelihood of

 obsolescence attributable to new inventions, new

 materials, changes in building codes, and changes in

 tastes.

D. Trend and rate of changes of characteristics of the

 neighborhood and their effect upon land values.

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E. Workmanship and durability of construction and the

 rapidity with which natural forces cause physical

 deterioration.

F. 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.

4-7 End of Useful Life of Building Improvements. The useful

life of a building has come to an end when the building is

incapable of producing an annual income sufficient to

offset the expense of operation and maintenance,

insurance, and taxes, and to produce returns upon the

value of the land or provide the service of shelter for

the intended occupants in the case of non-profit owners.

The improvements upon the land at that time possess no

more value than the amount which can be obtained from a

purchaser who will buy them and remove them from the site.

At this point the value of the building has dwindled to

"Shell" value less demolition costs. The last years of

economic life are more difficult to predict than the first

years, so caution must be exercised to avoid

over-estimation of the remaining economic life for older

buildings in older, declining neighborhoods.

4-8 Many projects with HUD-insured or HUD-held mortgages were

underwritten with forty year mortgages and with estimated

economic lives of fifty-five years. The Reserve Fund for

Replacements was established to help ensure that the

physical live 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.

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4-9 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.

NOTE: As items, equipment, etc. that fall into either of

these classifications are obtained for a project, HUD

expects that mortgagors will be mindful of energy and

environmental considerations and will be sensitive to

issues involving handicapped/disabled persons.

A. 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).

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 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.

B. Items traditionally contemplated as ineligible for

 draws from this Fund include maintenance items such as

 (but not limited to):

 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.

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 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 such

 as 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.

4-10 Adequacy of Reserve Fund for Replacements. Owners should

analyze periodically the amounts in their Reserve Fund in

the light of anticipated replacement needs. Owners 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. Owners 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 owners' analyses indicate a need

to increase the rate of deposits into the Reserve Fund,

the owners should contact the Loan Management Branch Chief

of their HUD Field Office and request HUD to authorize an

increase in the deposits. These requests would usually be

made in conjunction with requests for increases in rental

rates so that enough revenue would exist to make the

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increased deposits.

4-11 Recommended Minimum Threshold. HUD Handbook 4465.1 REV-2,

Valuation Analysis for Project Mortgage Insurance, gives

details on how the initial monthly deposit to the Reserve

Fund is established. 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. Assuming

that a project is in very good physical condition and that

no major replacements are needed in the near future (e.g.,

five years), HUD strongly recommends, but does not

mandate, that owners target a minimum amount to be held in

the Reserve Fund that would equal or exceed the greater of

the following two amounts:

A. The initially established monthly deposit times 144

 (12 years); or

B. At least $1,000 per unit.

4-12 Adjustments to a Recommended Minimum Threshold. The

dollar amount calculated above may need to be increased

for the following variables:

A. Physical Condition of the Project. Projects in less

 than very good condition would almost certainly need

 larger balances.

B. Geographical Location. Exposure to severe or unusual

 weather conditions as well as widely varying costs of

 replacements may have important consequences.

C. 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.

D. 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.

E. 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

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 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.

F. Project Size. Larger projects typically need larger

 reserves than smaller projects.

G. Urban vs. Rural. Urban projects often need larger

 reserves than rural projects.

4-13 Suspension of Deposits to the Reserve Fund for

Replacements. In older projects where the mortgage is

seasoned and the owner has demonstrated the will and the

ability to stay with the property, the Loan Management

Branch Chief may, upon the owner's request and if deemed

appropriate, suspend further payments to the project's

Reserve Fund for Replacements by signing a Form HUD-9250,

"Reserve Fund for Replacements Authorization (Appendix

1)," authorizing a suspension. (Note: If rental rates

are predicated upon a certain rate of deposits being made

into the Reserve Fund, the rental rates may need to be

reexamined if the deposits are suspended.) This suspension

is considered by HUD to be a privilege that may be granted

to an owner for providing competent management and for

keeping the project in good physical condition as

determined by HUD. HUD's approval of suspending future

deposits is subject to the following conditions:

A. A mutually acceptable minimum threshold as calculated

 above and revised as necessary is kept in the Fund.

B. The owner has asked the mortgagee to invest a

 substantial portion of the Reserve Fund.

C. All interest earned by investments of the Reserve Fund

 accrue to the Fund and is kept in the Fund (unless

 released by HUD for repairs/replacements).

D. The property continues to be maintained in good

 physical condition.

E. If the balance in the Fund should fall below the

 recommended minimum threshold, monthly deposits would

 resume at no less than the previous dollar amount

 until a mutually acceptable minimum balance is

 restored.

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F. The project remains under the effective control of the

 same owners and the owners continue in good standing

 with HUD.

G. Projects receiving Section 8 assistance generally may

 not suspend deposits to the Reserve Fund for

 Replacements except for:

 1. Projects that are not subject to Section 8

 Automatic Annual Adjustment Factors (AAFs), i.e.,

 rental rates are established by HUD under the

 budgeted rent increase procedures, and the Reserve

 for Replacement line item is deleted as an

 allowable cost in the rent determination; or,

 2. The projects' rents are adjusted automatically by

 application of the AAF and immediate, temporary

 financial relief is needed. However, in this

 case, the project owner would not be eligible to

 take its distribution as long as the suspension is

 in effect.

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.

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4-15 General Requirements for Requesting Withdrawals From the

Reserve Fund for Replacements.

A. Mortgagors shall make all requests in writing and

 shall provide a detailed description of the work done

 or to be done; the description should identify the

 specific location including the dwelling unit (if

 applicable) in order to permit an inspection of the

 work without needing additional information about the

 work.

B. Owners should be invited to discuss proposed large

 withdrawals ($20,000 or more than twenty per cent of

 the existing balance in the Fund) with the Loan

 Management staff of the HUD Field Office before making

 the written request to agree upon plans for

 replenishing the Fund.

C. If the withdrawal request is a reimbursement for work

 that has been done, a copy of the paid invoice(s)

 normally should accompany the request unless the

 Optional Procedures see below are being used.

D. If the withdrawal request is for work that is to be

 done (an advance from the Fund), at least three formal

 or informal bids together with a copy of the bid

 specifications generally should accompany the request.

 If the lowest bidder was not selected the owners

 should explain their selection of a higher bidder.

 For example, consideration may be given to the

 bidder's reputation for quality workmanship,

 materials, and timely performance and to the urgency

 of the repairs. Owners also should explain why an

 advance is needed. Approval of owners' requests may,

 at the discretion of the Field Office Loan Management

 Branch Chief, be granted on an installment basis

 depending largely upon the scope of work done and

 remaining to be done and upon the availability of

 funds in the project's operating account.

E. Timing. Owners should not make requests for

 withdrawals more often than quarterly unless an

 emergency exists. Owners should make reimbursement

 requests during the same (project) fiscal year in

 which the expenditure occurred, preferably at least

 sixty days prior to the close of the project's fiscal

 year.

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4-16 HUD Actions. Unless the amount of the release is for a

large amount ($20,000 or 20% of the Fund balance,

whichever is greater), an inspection of the work generally

should not be necessary in order to act upon the request;

inspections should be made during subsequent visits to the

property. Inspection of a sample of the replacements

generally would be adequate if the mortgagor is submitting

acceptable annual audited financial statements and if the

project is generally untroubled. The Loan Management

Branch Chief will make reasonable effort to review and act

upon the mortgagor's request within thirty days (whenever

possible) from receipt and, if approved, prepare, sign,

and mail the Form HUD-9250 to the mortgagee of record.

4-17 Optional Procedures. HUD has developed optional

procedures in an effort to respond to industry requests

for expediting the procedures for requesting withdrawals

from the Reserve Fund for Replacements. Loan Management

Branch Chiefs may invite project owners to use these

optional procedures at their discretion. If the mortgage

is current, if there are no known major, uncured

violations of the Regulatory Agreement, and if there are

no major, unresolved findings from management reviews,

analyses of annual financial statements, or other known

and documented reasons that would tend to preclude use of

these optional procedures, HUD Field Offices may avail

themselves of the following optional procedures. If these

optional procedures are followed, the HUD Field Office

will make every effort to act on the mortgagor's request

within ten (10) business days from receipt. If a

mortgagor develops a pattern of errors when using these

optional procedures (such as continuing to request

ineligible items) or if the mortgage goes into default,

the project becomes troubled or potentially troubled,

etc., the mortgagor can expect the HUD Field Office to

suspend temporarily or deny the use of these optional

procedures.

A. A narrative request for the release of funds is to be

 made by the mortgagor/managing agent.

B. A Mortgagor Certification is required; it should be as

 follows:

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 "I (Mortgagor) certify that:

 1. "Funds expended or to be expended have been or

 will be used for the work indicated in this

 request;

 2. "I have inspected/will inspect the work and have

 determined/will determine that the damaged area(s)

 or equipment have been restored to as good or

 better condition;

 3. "No mechanic's or materialman's liens will be or

 have been attached to the property as a result of

 the repair;

 4. "The repairs have been or will be completed in

 accordance with all applicable building codes and

 ordinances;

 5. "All contract materials, supplies, and services as

 applicable have been obtained at the most

 reasonable cost and on terms most advantageous to

 the property;

 6. "All discounts, rebates, or commissions have been

 credited to the property;

 7. "Any expenditures that are determined by HUD to be

 ineligible, as a result of an inspection, will be

 repaid to the property's Reserve Fund;

 8. "All goods and services purchased from individuals

 or companies with which the Owner or Managing

 Agent has an identity-of-interest were or will be

 purchased at costs not in excess of those that

 would be incurred in making arms-length purchases

 on the open market;

 9. "Under the penalties and provisions of Title 18,

 United States Code, Chapter 47, Section 1001, the

 statements contained in this request have been

 examined by me and to the best of my knowledge and

 belief are true, correct, and complete."

C. Requests, except for emergencies, should be made no

 more often than quarterly and at least annually (if

 applicable) at least sixty days before the close of

 the project's fiscal year.

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D. Copies of invoices are not required to be submitted to

 HUD if the description of the work done or items

 replaced is sufficiently detailed to permit an

 inspection and verification; however, the mortgagor

 must keep copies of the invoices on file for at least

 three years and have the invoices available for HUD

 staff to review.

E. The mortgagor/management agent is to prepare the Form

 HUD-9250 for signature by the Field Office Loan

 Management Branch Chief, who also can provide further

 guidance on information that should be shown on the

 Form. NOTE: Many mortgagees appreciate showing their

 loan number on the Form HUD-9250 next to the HUD

 Project Number and find that this makes their

 processing of the form quicker and easier.

 Owners/agents would be well advised to check with

 their own lenders for their preferences in this

 regard. NOTE: Mortgagors must never submit a Form

 HUD-9250 directly to their mortgagees (other than

 HUD).

F. If funds are to be released based upon bids alone,

 three bids and a brief statement about why an advance

 is necessary should accompany the request. The bid

 selected should be identified in the narrative; if the

 selected bid is not the lowest bid, a brief statement

 about the reason for selecting a higher bidder should

 be made. If a (selected) bid for items being

 purchased is for more than $10,000, copies of all the

 bids should accompany the request. The mortgagor must

 keep copies of all the bids on file for at least three

 years and have them available for HUD staff to review.

G. A supply of the Forms HUD-9250 may be obtained from

 the HUD Field Office.

4-18 Mortgagor and Mortgagee Records. Since appliances and

 similar items such as office equipment constitute security

 under the mortgage, project owners should keep their

 mortgagees fully informed when appliances and items that

 are normally identified by make, model, and serial number

 are replaced. Mortgagors are expected to provide their

 mortgagees with this identifying information as it

 changes; mortgagors also should provide HUD with copies of

 the documentation they furnish their mortgagees.

 Additionally, mortgagors should keep their insurer(s)

 informed of changes or additions to the property.

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4-19 Field Office Records. HUD Field Offices are encouraged to establish a

 Reserve Fund for Replacements File for each project. Forms HUD-9250

 authorizing releases of funds are to be kept on file for the present

 fiscal year and for the previous three fiscal years of the project.

 Except in unusual circumstances, such as defaults or major findings from

 various project reviews or audits, copies of invoices that are on file

 and more than a year old may be discarded if the required audited

 financial statement covering the time period of the expenditure has been

 submitted and if a management review or a physical inspection has been

 conducted during that time period. Forms HUD-9250 that change

 (increase, decrease, or suspend) the monthly Reserve deposits are to be

 maintained on file until the mortgage matures or is prepaid in full or

 until mortgage insurance is terminated.

4-20 Investment Requirements for Reserve for Replacement funds in Section 8

 projects. Investment of the Reserve Funds in interest-bearing

\* accounts is required for certain projects receiving Section 8

 assistance:

 A. The revised Section 8 regulations apply to all owners of older

 Section 8 projects where the owners voluntarily opted to be bound

 thy those regulations.

 B. Except for owners of previously HUD-owned projects sold pursuant to

 24 CFR Section 886 (Subpart C), partially assisted projects, and

 Section 202/8 projects, the revised Section 8 regulations apply to

 projects for which:

 1. Agreements to Enter Into Housing Assistance Payments Contracts

 (AHAPs) were executed on or after November 5, 1979, for New

 Construction projects.

 2. AHAPS were executed on or after February 20, 1980, for

 Substantial Rehabilitation projects.

 C. For these projects, earned interest is to remain in the Reserve

 Fund until its release is authorized by HUD.

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4-21 Liquidity Requirements. HUD recognizes that most property owners and

 managing agents can make fairly good estimates of the amount and timing

 of future replacement needs. Mortgagors should use prudence when

 selecting the durations of investments and make their selections

 according to anticipated and projected needs, including contingencies.

 Therefore, HUD is not establishing specific liquidity requirements for

 the Reserve Fund for Replacements. The mortgagor, not the mortgagee, is

 responsible for deciding the liquidity requirements of funds held in the

 Reserve Fund. The mortgagor should maintain some portion of its

 reserves in the form of very liquid assets such as passbook savings

 accounts. As a guideline only and depending on the specific project,

 $50/unit or three or four month's required deposits to the Reserve Fund

 should be enough to meet minimum liquidity requirements for some

 projects. HUD does not encourage project owners to commit too large a

 portion of Reserve Funds to excessively long term investments in order

 to achieve a marginal increase in the net return on the investment.

 Preservation of principal is of utmost importance when owners evaluate

 various investments and formulate their investment strategies.

 NOTE:- ALL MORTGAGORS SHOULD BE CAUTIONED. If any principal is lost as

 a result of an early or premature liquidation of an investment that is

 caused by an owner's requested withdrawal from the Reserve Fund for

 Replacements, the lost principal must be repaid to the project. This

 repayment must be repaid to the project (mortgagor entity) by the owning

 persons, by persons with a controlling interest in the project, or by

 such affiliated/related parties as the project's sponsors. This caution

 is particularly important for non-profit mortgagors. Accordingly, the

 terms and durations of investments should be selected prudently and with

 great care.

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4-22 Investment of Reserve for Replacements Funds. Consistent with program

\* regulations and the Regulatory Agreement, the reserve for replacement

 funds must be maintained by the mortgagee. Investment options should be

 determined jointly by the mortgagor and mortgagee. The Regulatory

 Agreement requires, ".. such fund, whether in the form of a cash

 deposit, or invested in obligations of, or fully guaranteed by the

 United States of America, shall at all times be under the control of the

 mortgagee."

 A. This paragraph suspends this provision by authorizing the mortgagee

 to invest funds in excess of $100,000 in U. S. government-backed

 securities and to hold funds in excess of $100,000 in institutions

 under the control of, and whose deposits are insured by, the

 Federal Deposit Insurance Corporation, National Credit Union

 Association, or other U.S. government insurance corporations under

 the following conditions:

 1. Mortgagees must determine that the institution has a rating

 consistent at all times with current minimally acceptable

 ratings as established and published by Government National

 Mortgage Association (GNMA).

 2. Mortgagees must monitor the institution's ratings no less than

 on a quarterly basis, and change institutions when necessary.

 The mortgagee must document the ratings of the institutions

 where the funds are deposited and maintain the documentation

 in the administrative record for three years, including the

 current year.

 3. If the mortgagee does not perform the required quarterly

 review of the institutions where there are deposits in excess

 of $100,000 and does not maintain the funds in an institution

 with a rating consistent with current minimally acceptable

 ratings as established and published by GNMA, and the

 institution fails, the mortgagee is held responsible for

 replacing any lost funds. In addition, the mortgagee shall be

 subject to sanctions. In the event the mortgagee fails to

 replace the lost funds, HUD will seek all available remedies

 to recover whatever funds are lost as a result of the failed

 institution.

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 B. The above language is not deemed a modification of the Regulatory

 Agreement. Therefore, HUD reserves the right to invoke this

 Regulatory Agreement provision and make it operational in the

 future through notice or handbook change, if it is determined that

 such a policy is necessary or desirable.

4-23 Interest on Investments. HUD encourages and in some cases requires that

 interest earned on Reserve Fund investments remain in the Reserve

 Account. Interest must remain in the Reserve Account for those Section

 8 projects listed in paragraph 4-20 of this Chapter 4. When this earned

 interest remains in the account, this interest will not be considered by

 HUD when processing requests for increases in rental rates if this

 interest is clearly and separately identified on the project's Form HUD-

 92410. In other words, HUD will not offset newly computed gross

 potential rents by the amount of interest that accrues to and remains in

 the Reserve Account.

 NOTE: Interest may never be disbursed directly to the owners of a

 project or directly to any individuals associated with the owners. All

 interest earned must flow through the accounts of the project and must

 be disclosed on the project's accounting records.

 A. With the issuance of this Chapter 4, owners of any of the following

 types of projects are instructed to ask their mortgagees to invest

 all or a substantial portion of their Reserve Fund for

 Replacements; all interest on Reserve Fund investments must remain

 a part of the Reserve Account. This

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 procedure applies if the project's mortgage is insured or held by

 HUD under any of the following Sections of the National Housing

 Act:

 1. Section 236, a "Special Risk Insurance Fund."

 2. Section 221(d) (3) BMIR [Section 221(d) (5)].

 3. Section 221(d) (3) if the project receives Rent Supplement or

 Section 8 Assistance.

 4. Section 223(e), a "Special Risk Insurance Fund."

 5. Section 223(f).

 6. Any project that has an Operating Loss Loan or a Supplemental

 Loan that is insured or held by HUD must keep all Reserve Fund

 interest earned by any of its Replacement Reserve Funds in the

 respective Funds.

 B. With the issuance of this Chapter 4, owners of Section 202, 162,

 801, and 811 projects are instructed to invest all or a substantial

 portion of their Reserve Fund for Replacements.

 C. HUD strongly encourages owners of all other projects to ask their

 mortgagees, including HUD when the mortgage is HUD-held, to invest

 a significant portion of the money held in the Reserve Fund for

 Replacements. When making these investment requests, owners should

 specify the desired form(s) of investment.

4-24 Insured Mortgagee Charges for Handling Investments of the Reserve Fund.

 Reference is made to HUD Handbook 4350.4 for additional information on

 this topic. If a mortgagee proposes to assess charges for investing the

 Reserve Fund, the Field Office Loan Management staff are reminded to

 examine the Mortgagees Certificate for the project to see if any fees or

 charges for making or accepting investments were disclosed or stated.

 Any fees so collected by the insured or coinsured mortgagee may only be

 collected according to an agreement between the mortgagee and the

 mortgagor.

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4-25 Other Fees. HUD does not recognize special fees or charges that might

 be paid by project mortgagors to investment brokers or other parties

 (other than HUD) such as managing agents for providing investment advice

 or for making or brokering investments except where the nature of the

 investment itself requires that it be brokered, i.e., obligations of

 federal agencies such as GNMA. Such fees, other than those involving

 the above exception, are not considered to be necessary expenses, should

 not be paid from project funds, and are not considered by HUD when

 calculating rental rates.

4-26 Combined Investments. For HUD-insured mortgages, monies held in the

 Reserve Fund for Replacements and the Residual Receipts Account (if

\* such an account exists) may be combined to purchase a single investment

 or combination of investments.

 A. Earned interest and the return of principal when the investment is

 liquidated must be prorated to the respective bookkeeping accounts.

 B. The mortgagor must take care to preserve sufficient liquidity in

 these accounts. Some forms of investment, such as passbook savings

 accounts, are very liquid. Others are increasingly less liquid,

 such as Thirty, Sixty, or Ninety Day Certificates of Deposit (CDs),

 then U.S. Treasury Bills, U.S. Treasury Notes, etc.

4-27\* HUD recognizes and appreciates the cooperation exhibited by many

 mortgagees when facilitating investments of the Reserve Accounts on

 behalf of mortgagors and acting on the mortgagors' requests. HUD

 considers the ability to invest a project's Reserve for Replacement

 Funds to be a right that accrues to the mortgagor. The mortgagor

 and mortgagee are encouraged to jointly decide on the investment

 vehicle for funds in the Reserve Accounts.

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4-28 "Borrowing" from the Reserve Fund, other than advances from the Reserve

 Fund for curing a delinquency or a default. (The uses of a project's

 Reserve Fund for Replacements in curing mortgage delinquencies is

 covered in Chapter 5 of this Handbook.) The Asset Management Branch

 Chief may authorize the mortgagor to make brief, temporary uses of some

 portion of the Reserve Fund for Replacements for purposes other than

 those normally contemplated by the establishment of the Fund if:

 A. There are no funds in a Residual Receipts account that could be

 used first.

 B. An immediate crisis exists.

 C. The mortgagor agrees in writing to repay the advance from the Fund

 over a reasonable period of time.

4-29 The Asset Management Branch Chief should exercise customary good

 business judgement when making a decision to permit the mortgagor to

 "borrow" from the Reserve Fund.

 A. 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:

 1. An unexpected increase in taxes or a special assessment.

 2. An unanticipated increase in the costs of insurance,

 utilities, or like items.

 3. Damage caused by unusually adverse weather conditions, whether

 or not such damage may be covered by hazard insurance.

 4. Other uses of the fund not normally contemplated, such as for

 repairs and maintenance not usually eligible for reimbursement

 from the Reserve Fund.

 B. Overall management of the project is at least satisfactory and the

 mortgagor has been cooperative in complying with requests from HUD

 and the mortgagee.

 C. There is a formal agreement with the mortgagor to repay the advance

 on specified terms.

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4-30 The Reserve Fund for Replacements will not always be adequate to meet

 the future capital needs of a project nor is it expected to do so.

 There are other sources of capital available to projects. Depending on

 the project, these include:

 A. Residual Receipts Accounts.

 B. General Operating Reserves.

 C. Debt Service Reserves.

 D. Owner Contributions in the form of equity.

 E. Owner contributions in the form of unsecured debt (loans). These

 loans may, on a case-by-case basis, be allowed to carry a nominal

 interest rate that normally should not exceed the interest rate

 that the project owner or sponsor could earn elsewhere in a

 reasonably safe security, such as a Certificate of Deposit of the

 same duration as the loan to the project. The right to earn this

 interest must be pre-approved by the Loan Management Branch Chief

 and the terms and conditions of repayment should be formally

 negotiated and committed to writing.

 F. Capital contributions from Transfers of Physical Assets (TPAs).

 G. Supplemental Loans (under Section 241).

 H. Flexible Subsidy, both Operating Assistance and Capital Improvement

 Loans.

 I. Loans from the National Cooperative Bank for some projects.

 J. Energy Loans.

 K. Funds from private foundations.

 L. Loans or grants from other governmental agencies or private

 foundations.

 M. Cash flows from operations.

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F. Capital contributions from Transfers of Physical

 Assets (TPAs)

G. Supplemental Loans (under Section 241).

H. Flexible Subsidy, both Operating Assistance and

 Capital Improvement Loans.

I. Loans from the National Cooperative Bank for some

 projects.

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K. Funds from private foundations.

L. Loans or grants from other governmental agencies or

 private foundations.

M. Cash flows from operations.

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Appendix 1

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Reserve Fund for

Replacements

Authorizations

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