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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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CHG-9

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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CHG-9

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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CHG-9

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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CHG- 9

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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CHG-9

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

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G. Supplemental Loans (under Section 241).

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Appendix 1

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Reserve Fund for

Replacements

Authorizations

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