

RENOVATION

Review

VOLUME 10



Planet Home Lending[®]
CORRESPONDENT DIVISION

CORRESPONDENT LENDERS' GUIDE TO

Accessory Dwelling Unit Financing

Rising home prices and a lack of inventory have led to growing demand for accessory dwelling units (ADUs), both as places to live and for their potential to generate rental income. Lenders can boost volume by responding to that demand with renovation mortgages to add ADUs to an existing home, and purchase loans for properties with existing ADUs.

ADUs range from cozy apartments over garages or in a basement, to small additions to the main home or a detached unit built on the property. They can be site-built, modular, or manufactured homes on a permanent foundation and titled as real property.

In this Renovation Review, we highlight a sample of FHA, Freddie Mac, and Fannie Mae ADU guidelines to help correspondent lenders take advantage of ADU lending opportunities.

Fannie, Freddie, and FHA agree an ADU is a habitable living unit with separate ingress and egress, added to, created within, or detached from a primary single-family dwelling, forming a single interest in real estate. Guidelines diverge from there on issues like what amenities the ADU must have, its size in relationship to the main residence, whether an ADU separate from the main home can be financed, and whether ADU rental income can be included when calculating borrower income.

FHA ADU Guidelines

Let's start with FHA's ADU guidelines. For FHA, an ADU is a smaller living space on the same property as the main house but in a different location. It might or might not have separate utility meters. The ADU must comply with local zoning rules, which may include a legal nonconforming use.

FHA recently made two updates to its ADU guidelines (see Mortgagee Letter 2023-17):

- 203(k) loans can now be used to renovate a home to add an ADU.
- ADU rental income can be included in the borrower income calculation.

The new rules also clarify that you can create a "detached ADU" as long as it is on an "existing structure" on the property. Popular options would include renovating a garage or other outbuilding to add a second floor or expanding the footprint to include a first floor ADU.

203(k) ADUs

Borrowers can use an FHA 203(k) loan for ADU-related projects:

- Adding a new ADU attached to or inside the existing home
- Converting a single-family home into a one-family with an ADU
- Converting a single-family into a two-, three-, or four-unit
- Renovating an existing ADU, whether it's attached or detached from the main structure

Note:

203(k) cannot be used to add an ADU to two-, three-, or four-unit properties.

Rental Income

The new rules allow borrowers to use 75% of the estimated ADU rental income to qualify for an FHA-insured mortgage on a property with an existing ADU. This additional income flexibility will help to increase access to homes with ADUs for homebuyers with limited incomes, allowing them to benefit from the wealth-building opportunity of a property with an ADU.

When a borrower has a rental history for the ADU, FHA guidelines say to annualize the rental income and confirm it using Schedule E of the tax return. Verify and document the lease and rental history over the previous 24 months, with no gap in occupancy lasting more than three months. Add the ADU's net rental income to the borrower's gross income (but do not reduce the total mortgage payment in the DTI calculation).

If there's limited or no ADU rental history, use 50% of the lesser of the appraiser-reported fair market rent or lease rent, FHA says.

Either way, the ADU's rental income can't exceed 30% of the borrower's total monthly effective income. If you use rental income to qualify the borrower, verify and document reserves of two months' PITI for a one-unit property with an ADU. or three months' PITI for three- to four-unit properties, the FHA guidelines say.

FHA ADU Appraisals

When evaluating a property backing an FHA ADU loan, the appraiser needs to determine if it's a single-family home with an ADU or a multi-unit home. For a single-family home with an ADU, the appraiser has to describe the ADU, summarize its market acceptance, report its size separately from the main house, mention if it can be legally rented without restrictions, and provide details on its current occupancy and any known lease agreements.

There's also an optional appraisal analysis to determine the market rent of a legally rentable ADU of a single-family home. The appraiser estimates market rent based on long-term (non-transient) comparable rental units.

FHA ADU Guidelines

Key Takeaways:

- FHA includes ADUs in its 203(k) program and new construction financing.
- Rental Income from ADUs can now be included under updated protocols.

Fannie Mae ADU Guidelines

Let's move on to Fannie Mae's perspective on ADUs. Fannie Mae stipulates only one ADU is allowed per parcel, and it must not be part of a multi-unit structure.

It must be the smaller counterpart to the main house and boast its own entrance, kitchen, sleeping area, and bathroom — a true standalone living space. The kitchen must include cabinets, a countertop, a sink with running water, and a stove or hookup – hotplates or microwaves won't suffice.

Unlike FHA and Freddie Mac, Fannie Mae borrowers must qualify without considering rental income from the ADU.

Fannie Mae Zoning Considerations

Some ADUs may predate local zoning ordinances and be classified as legal nonconforming. Fannie Mae considers ADUs falling into this category legal if they conform to the current zoning code for the subject property. However, you must verify the ADU won't jeopardize any future property insurance claims.

When current zoning doesn't allow an ADU, you must meet additional conditions for the loan to be eligible for sale to Fannie Mae. These are found in the Fannie Mae Selling Guide, sections B2-3-04 and B4-1.3-05.

Appraisers play a crucial role in determining whether an ADU complies with zoning regulations and report their opinion in the Highest and Best Use section of the appraisal. Encourage appraisers and borrowers to collaborate to document all zoning details accurately, including separate utility meters, unique postal addresses, and legal rentability.

Fannie Mae ADU Guidelines

Key Takeaways:

- One ADU per parcel is allowed.
- ADUs not permitted with multi-unit dwellings (two to four units).
- Must have its own ingress/egress, kitchen, sleeping, and bathroom facilities.
- Borrower must qualify for the mortgage without considering rental income from the ADU.
- Can be site-built or factory-built. Must comply with HUD if manufactured.
- Legal nonconforming ADUs may be considered legal.
- If not allowed under zoning, additional conditions apply for eligibility.



Freddie Mac ADU Guidelines

Freddie Mac defines an ADU as an attached or detached independent living space on the same parcel as a primary dwelling. It must have a separate entrance and living, sleeping, cooking, and bathing facilities. However, a separate bedroom is not required, making it possible to finance an efficiency ADU.

Freddie Mae's guidelines distinguish between one-unit properties with an ADU, a two- and three-unit property with ADU, and a four-unit property. A four-unit property with one or more ADUs is not eligible.

ADUs are often conversions of existing spaces, attached or detached, while multi-unit properties are typically constructed simultaneously. Differences in zoning regulations and land use requirements are also critical factors. ADUs may share utilities and addresses, but multi-unit properties have separate utilities and unique postal addresses.

Borrowers can use Freddie Mac's CHOICERenovation® mortgage to renovate their existing residence to add an ADU or make an ADU renovation part of a home purchase transaction.

Zoning Challenges

Freddie Mac highlights the importance of complying with zoning rules. In cases where ADUs may be legal nonconforming or face restrictions, confirm property insurance claims won't be jeopardized.

Properties with ADUs that don't comply with zoning may be eligible:

- For one-unit properties, eligibility is maintained if two comparable sales, each with an illegal ADU, are included in the appraisal report.
- Two- or three-unit properties with noncompliant ADUs are ineligible for sale to Freddie Mac.

ADU Rental Income

Freddie Mac's guidelines distinguish between primary residences with ADUs and other configurations. ADU rental income can be considered for one-unit primary residences. However, rental income is not allowed for two- or three-unit properties with ADUs, nor can rental income from illegal ADUs be used to qualify.

The documented rental income can't exceed 75% of the lease amount, and it can't count toward more than 30% of the income the borrower uses to qualify. The appraiser must cite at least one comparable sale with an ADU and one comparable rental ADU.

Borrowers must take a landlord education class unless they have at least one year of experience managing investment property or ADU rentals.

Illegal ADUs and Mortgage Eligibility

Freddie Mac provides options for mortgages secured by properties with ADUs that don't comply with zoning. For one-unit properties, eligibility is maintained if two comparable sales, each with an illegal ADU, are included on the appraisal report. However, two- or three-unit properties with noncompliant ADUs are ineligible for sale to Freddie Mac.

Freddie Mac ADU Guidelines

Key Takeaways

- ADUs must be self-contained with a separate entrance.
- No Bedroom Requirement: Efficiency units are financeable.
- Illegal ADUs: Certain conditions allow for financing despite non-compliance with zoning.
- Rental income can be used to qualify for one-unit properties with ADUs.

Documentation and Appraisal Insights

Lenders play a pivotal role in ensuring proper documentation and appraisal processes. The appraiser's analysis of comparable data, including ADUs, must be documented in the appraisal report. Freddie Mac accepts Form 1000 for ADU rent schedules, supporting the rental analysis.

Moving into the ADU financing niche offers correspondent lenders the opportunity to increase local housing inventory and origination volume and to help borrowers overcome the challenge of high home prices. By understanding and embracing the FHA, Fannie Mae, and Freddie Mac dynamics, lenders position themselves at the forefront of catering to diverse housing needs, ultimately fostering robust community development and sustainable homeownership.

ADU Best Practices

Key Takeaways

- Ensure ADUs meet size, independence, and feature requirements.
- Confirm zoning compliance or understand conditions for non-conforming units.
- Accurately document and evaluate rental income when applicable.
- Maintain adequate reserves in line with FHA requirements.
- Consult with appraisers to ensure proper valuation and compliance with guidelines.



NMLS ID# 17022

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