GSE Guideline Updates: Rental Income & Self-Employed Borrowers

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The Government-Sponsored Enterprises (GSEs), Fannie Mae and Freddie Mac, continually review their guidelines to ensure they meet the requirements of today's market. While both GSEs rolled out new guidelines, they do not become effective on the same date, nor are they the same updates.

Rental Income Requirements: Fannie Mae

Starting with Fannie Mae, their new guidelines for rental income requirements come into effect for all applications on or after January 1st, 2024. These changes were made in response to numerous questions from lenders about how to support borrowers who use rental income as a source of their earnings.

Qualifying Rental Income for Non-Subject Rental Properties

The first significant change pertains to non-subject rental properties that have become rental properties within the last year. These could be single-family investment properties or a 2 to 4 unit primary residence. Under the new guidelines:

- The borrower must have a primary housing expense.
- The borrower must have at least one-year history of property management experience.
- Without these, the amount of rental income that can be used towards qualifying may be limited.

DTI Calculation Using Rental Income from Multiple Properties

The second update is related to Debt-to-Income (DTI) calculation when using rental income from multiple properties. According to Fannie Mae's Selling Guide:

- The income or loss is calculated on a per property basis.
- The total amount across all non-subject rental properties is then combined.
- This combined figure is used in calculating the borrower's total debt-to-income ratio.

To illustrate this, consider a borrower who owns three rental properties plus their own 2-unit primary residence that receives rental income. If two of these properties incur losses while one gains profit, you would combine the losses and gains across all three non-subject properties when calculating DTI.

Documentation Requirements for Lease Agreements

Fannie Mae has also updated its documentation requirements for lease agreements:

- Appraisal Form 1007 or Form 1025 must support the income reflected on the lease agreement.
- Alternatively, there should be evidence that terms of the lease have gone into effect with proof of receipt for at least two months' worth of rental payments.

This change aims to establish more stable payment history and consistency across different types of documents provided by borrowers.

Rental Income Requirements: Freddie Mac

Freddie Mac's updates are effective for mortgages with settlement dates on or after April 1st, 2024 but sellers may implement them immediately. Their updates focus more specifically on documentation for rental properties.

Changes in Lease Agreement Requirements

The changes include:

- Removing the requirement that a lease must have an original term of at least one year.
- Specifying that for newly executed leases, the first due date must not be later than the first payment due date of the mortgage.

Documentation Requirements for Receipts

Freddie Mac also updated its requirements concerning proof of two months' worth of received rent:

- Evidence is required showing that payments were cashed or deposited into borrower's depository account at a financial institution or transferred into a third-party money transfer application account owned by them.
- The funds must be in the borrower's personal accounts for the income to be considered valid for qualifications.

However, Freddie Mac is now allowing documentation of receipt of the security deposit plus first month's rental payment, instead of two months' rental payments. This could offer flexibility when timing the receipt of funds from the rental property.

Rental Income from Accessory Dwelling Units

Freddie Mac also provided additional guidance on rental income from an accessory dwelling unit (ADU):

- They removed the appraisal requirement that at least one comparable sale must have a rented ADU when using rental income generated from an ADU on a subject 1-unit Primary Residence to qualify the borrower.
- They reformatted the documentation requirements table for rental income generated from an ADU on subject 1-unit Primary Residence "no cash-out" refinance transactions.

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Self-Employed Borrowers: Fannie Mae

Lastly, we turn to Fannie Mae's recent changes for self-employed borrowers. These changes are effective January 1st, 2024 for all DU loan casefiles and manually underwritten loans.

Use of Self-Employment Income with Less Than Two-Year History

Historically, Fannie Mae required a two-year history of prior self-employed earnings. While this remains a requirement in most cases, certain circumstances identified by Fannie Mae may allow for a shorter verified history:

» The signed personal and business federal income tax returns must reflect at least 12 months of self-employment income from the current business.

Documentation Needed When Loan is Underwritten Through DU

Fannie Mae updated its policy to allow one year of personal and business tax returns when:

» All self-employed businesses have been in existence for five years.

» The borrower has had a 25% or greater ownership interest for the last five consecutive years.

This policy applies to both DU and manually underwritten loans. For instance, if a borrower has been a 50% owner of a restaurant for seven years and can provide proof via public records and an account letter, they only need to provide their most recent year's personal and business tax returns according to Fannie Mae's new guidance.

Example Scenarios

Let's review some scenarios related to these updates:

Scenario One: Rental Income Calculation

Assume a borrower owns three rental properties plus their own two-unit primary residence that receives rental income:

» The subject property receives $6300 per year in rental gains or $525 per month.

» Rental Property 1 has an annual loss of $2100 or $175 per month

» Rental Property 2 has an annual gain of $5600 or $466.67 per month

» Rental Property 3 has an annual loss of $2600 or $216.67 per month

Under new guidance, you would combine non-subject rental properties' incomes or losses. In this case, there are losses totaling $391.67 per month but offset by property two's gain of $466.67 monthly.

Therefore, you should show combined amount reflecting $75 as income in borrower's total DTI calculation.

Scenario Two: Self-Employment Documentation Requirement

During loan application process, let's say your borrower notifies you they've been 50% owner of a popular pizza restaurant in their neighborhood for seven years. They tell you while pandemic years were tough; they came out stronger over the past three years.

During your review of the business, you confirm via public records that the borrower is listed as an owner since 2016. You also receive the borrower's K1 that shows 50% ownership, verified via public records and an account letter.

Given these details, based on Fannie Mae's new guidance, the borrower only needs to provide their 2023 personal and business tax returns.

Resources

GSE Guidelines

→ Freddie Mac Selling Guide Bulletin 2023-19

→ Fannie Mae Selling Guide Announcement (SEL-2023-09)

→ Fannie Mae Selling Guide B3-3.1-08, Rental Income (10/04/2023)

→ Fannie Mae Selling Guide B3-3.2-01, Underwriting Factors and Documentation for a Self-Employed Borrower (12/13/2023)

→ Freddie Mac Cash-Out Refinance

→ Fannie Mae Selling Guide B2-1.3-03, Cash-Out Refinance Transactions (02/01/2023)