HCMP Law Offices | Hillis Clark Martin & Peterson P.S.

MEMORANDUM

Date: January 5, 2024

To: Washington REALTORS®, c/o Mary Hull-Drury and Bill Clarke

CC: Interested Parties

From: Hillis Clark Martin & Peterson, P.S. (Holly Golden, Josh Friedmann, and Alaura Valley)

Subject: Effects of Upzones on Conforming Financing for Single Family Homes

A. Introduction and Short Answer.

Throughout Washington and across the country, single-family parcels are being upzoned and accessory dwelling units (ADUs) are steadily being built. This results from many factors, including state legislation like 2023's HB 1110 and HB 1337, local officials' planning and policy priorities, updates to Growth Management Act comprehensive plans, infrastructure changes, and simple supply and demand. These zoning changes, whether driven by state legislation or decisions at the local government level, will require many industry sectors to adapt and innovate.

Question: Will upzones driven by 2023s HB 1110 and 1337, or locally-adopted zoning changes, cause existing single-family properties to lose eligibility for conforming financing or FHA- and VA-backed loan products on a widespread basis?

Answer: No. *Any* upzone can cause some homes to lose eligibility for certain loan products, either by increasing the property value to require borrowing beyond "conforming" limits, or if an appraiser writes that the upzoned land is no longer in its "highest and best use." **However, a single-family property will not lose eligibility for these loan products just because it has been upzoned.**

B. Background and Analysis

1. Conforming Loans, Guaranteed Loans, and Housing Innovation.

In 2022, approximately 53% of originated mortgages (first lien) were "conforming" loans, meaning that they satisfied various terms set forth by Fannie Mae, ("Fannie"), Freddie Mac ("Freddie"), and their regulator, the Federal Housing Finance Agency ("FHFA") and were purchased by Fannie or Freddie.[1]

[1] Fannie (formally known as the Federal National Mortgage Association) and Freddie (the Federal Home Loan Mortgage Corporation) are both stockholder-owned, government-sponsored enterprises. As directed by Congress, Fannie and Freddie use private funds to purchase mortgages from lenders and banks (i.e., in the "secondary market"). This allows lenders and banks to make more loans, reducing overall costs to borrowers. The primary difference between the two entities is that Fannie may purchase mortgages from larger, commercial banks, while Freddie generally purchases mortgages from smaller and local banks.

Conforming loans are an important product for many homebuyers. Because these loans are fairly standardized, and Fannie and Freddie support a strong secondary market, these loans are easier for banks and lenders issue. This drives costs and interest rates down for homebuyers.

Federally-guaranteed loans are another important type of mortgage product. For these loans, a federal agency subsidizes the borrower by guaranteeing the borrowing. Such loans are available to veteran and moderately creditworthy families through the Veteran's Administration ("VA"), and Federal Housing Administration ("FHA"), respectively. The FHA guarantees loans for low- and moderate-income borrowers with lower credit scores than conventional lenders will accept, and the VA guarantees loans for veterans and their families. In 2022, 19.8% of originated mortgages were secured by the VA or the FHA. Additional loans, for modest rural housing, may be available through the U.S Department of Agriculture, but substantially different standards apply.[2]

To help Fannie, Freddie, FHA, and the VA manage risk, there are limits to the amounts a homebuyer can borrow through these federally-regulated programs. The 2024 threshold for single-family mortgage loans purchased by Fannie or Freddie or guaranteed by the VA is $766,550 in most areas, though this ceiling increases to $1,149,825 in certain high-cost areas. The 2024 threshold for single-family mortgage loans guaranteed by the FHA varies from $498,257 to $1,724,725 depending on the cost of living where the home is located.

Homebuyers seeking to borrow beyond conforming limits may seek "jumbo" loan products from banks, credit unions, and other financial institutions, often through a third-party mortgage broker. Jumbo products may carry higher fees or interest rates, in part because the loans are not subsidized or supported by federal programs. For a sense of scale, jumbo loans are a subset of the approximately 27% of first-lien mortgages originated in 2022 that were not federally-insured or purchased by Fannie or Freddie.

Housing innovations like zoning changes and ADU development are advancing across the country, and issuers and regulators of federal loan programs are working hard to keep their products compatible with market changes. For example, as recently as October of 2023, Freddie and FHA each eased certain appraisal and financing requirements for ADUs.[3]

2. Analysis: Impact of Upzones on Common Federal Loan Products.

Any upzone can cause some homes to lose eligibility for certain loan products, either by increasing the home's value beyond the limits of a "conforming" loan product, or if an appraiser writes that the upzoned land is no longer in its "highest and best use." Upzones driven by HB 1110 and 1337 are no exception. However, a single-family property will not lose eligibility for federal loan products just because it has been upzoned.

---

[2] This memo will not cover USDA loans, which are subject to geographic limits, regulated according to household size, and in many cases restricted to the purchase of "modest" homes. USDA HB-1-3550 at 2.12; HB-1-3555 at 7.1. Because of these major differences in policy, some USDA loans will no longer be available to properties that have an ADU. However, like the other loan products discussed in this memo, we were not able to find any evidence that USDA loans would become unavailable as a result of an upzone alone.

[3] *See* Freddie Bulletin 2023-19, issued 10/4/2023; HUD Press Release 23-237, issued 10/16/23.

Conforming and USDA loan products are all limited in the number of units they can finance through a given loan, because they are designed to support individual and family homeownership, not investment in apartment buildings. However, these limits apply to the number of housing units that ***actually exist*** on a site, not the number of housing units that ***could exist*** under current zoning or a future upzone. Please see below for applicable guidance and regulations, with italics provided in each instance.

- **Fannie**: Selling Guide: Fannie Mae Single Family (Dec. 13, 2023) at B2-3-01 (describing eligibility to mortgages only "when the dwelling ***consists of*** one to four units").

- **Freddie:** Freddie Mac Single Family Seller/Servicer Guide at Glossary (defining "home mortgage" as a mortgage "on real estate on which ***there is located*** a structure designed principally for residential use by one to four families.")

- **FHA:** 24 C.F.R. 203.38 ("At the time a mortgage is insured there ***must be located*** on the mortgaged property [dwelling(s) designed] for not more than four families.").

- **VA:** 36 C.F.R. 4301 (defining "residential property" to include, among other things, "any improved real property . . . ***consisting of*** not more than four units . . ." and limiting an eligible "dwelling" to "not more than four family units" in most cases).

In other words, eligibility for conforming mortgage products through Fannie, Freddie, FHA, and the VA is based on the building ***that exists (or is planned) at the time of lending.*** It is not based on hypothetical redevelopment potential under zoning and land use rules. ***We are not aware of, and were not able to find, any regulation that would cause a single-family home to lose eligibility just because an upzone theoretically would allow redevelopment to a greater density.***

Note that some homes could lose eligibility *indirectly*, where an upzone causes the property to increase dramatically in market value, *see* Section B.1 above, or where the upzone causes an appraiser to write that the property's "highest and best use" is in redevelopment of the site for more than four units.[4] The highest and best use would be impacted by a number of factors including legal restrictions on height, lot size, setbacks and parking requirements. This is probably because federal programs do not aim to support or subsidize the purchase of luxury homes, nor incentivize land uses that are very clearly inefficient. But in such instances, buyers and borrowers will still have access to a multitude of mortgage products, like jumbo loans and other types of portfolio loan products.

C. About Us.

Hillis Clark Martin & Peterson P.S. is qualified to review these questions based on our experience providing private and public clients with a full range of land-use, development and other real estate services (extending from pre-purchase feasibility analysis to entity formation, entitlements and transactions) together with our lender services and finance group's experience assisting clients in every facet of commercial and public finance matters.

[4] *See*, *e.g.*, Fannie Selling Guide at B4-1.3-04 ("Fannie Mae will only purchase or securitize a mortgage that represents the highest and best use of the site as improved. . . . The appraiser determines highest and best use of a site as the reasonable and probable use that supports the highest present value on the effective date of the appraisal."); Freddie Seller/Servicer Guide at 5605.4 ("For the Mortgage to be eligible for sale to Freddie Mac, the appraiser must report that the [premises'] present use represents the highest and best use of the property as improved . . .").