Joint Informational Hearing
Assembly Banking and Finance Committee
Assembly Housing Committee

Strategies to Finance Accessory Dwelling Unit (ADU) Construction.
Monday, February 7, 2022
9:30 am, State Capitol Room 437

INTRODUCTION

An Accessory Dwelling Unit (ADU) is an additional living quarter that is independent of the primary dwelling on the same lot. An ADU can take many forms but is often a separate backyard cottage or converted garage. Additionally, Junior Accessory Dwelling Units (JADUs) are smaller ADUs built within the walls of a single-family residence that are no more than 500 square feet. ADUs have been identified as an important piece of the solution to California's housing crisis because they can be built on lots traditionally zoned for one single-family residence, thereby expanding the supply of housing and changing how densely housing can be built.

Over the past few years, the legislature has passed a number of bills to ease land use restrictions and expedite the approval processes at the local level. These efforts are contributing to an increased supply of ADUs throughout the state. Recent policy changes on the ADU approval process include:

- Requiring local governments to use a ministerial approval process for ADUs. Ministerial approval removes discretion and much of the uncertainty from the local building approval process. If the proposed ADU meets all the jurisdiction's objective standards (e.g., size, parking, and setbacks) in place at the time the development is proposed then cities and counties must ministerially approve the proposed development.

- Expediting approval timelines by providing that ADUs are automatically deemed approved within 60 days of submitting an application if they meet all objective requirements from the local government.

There have also been a number of measures limiting the costs and extra requirements cities and counties can impose on ADUs including:

- Exempting small ADUs projects (< 750 square feet) from impact fees paid to the local government and limiting the fees that cities and counties can charge for larger ADUs.

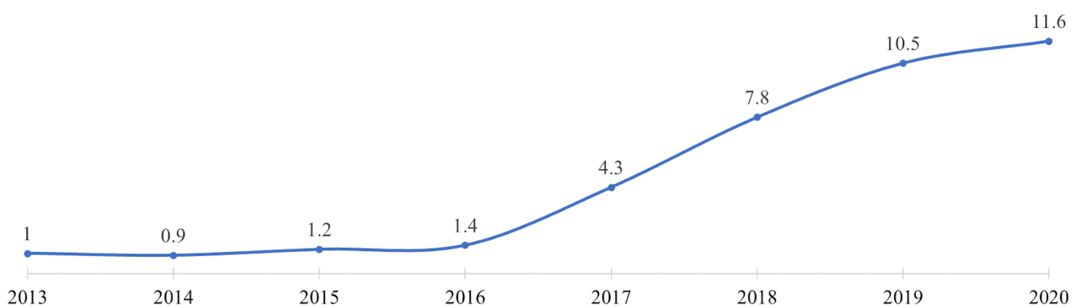
- Banning owner-occupancy requirements for ADUs approved between January 1, 2020 and January 1, 2025 and providing a 5-year grace period for homeowners to fix certain substandard ADU issues.

- Requiring local ordinances to allow ADUs of at least 850 square feet (or 1000 square feet for ADUs with more than one bedroom) and limiting the amount of parking that can be required for an ADU.

In addition to the steps the Legislature has taken to simplify the local ADU approval process, it also directed local governments to update their housing element to promote and incentivize affordable ADU development. The housing element is one of seven required parts of a city's or county's General Plan that acts as a "blueprint" for the jurisdiction. When local governments update their housing element they must include plans to incentivize production of ADUs that can be offered at rents affordable to very low, low-, or moderate-income households. Additionally, the Department of Housing and Community Development (HCD) is also required to maintain information on state grants and financial incentives in connection with the planning, construction and operation of affordable ADUs.

These recent policy changes to facilitate ADU production have helped make ADUs an important segment of housing production amidst the ongoing housing crisis. According to HCD data, ADUs have gone from less than 1% of newly permitted housing units in 2013 to 11.6% of new units in 2020 with 12,813 new ADUs permitted that year (see figure 1). There still remains untapped market potential for ADUs: a 2020 report from the UCLA Lewis Center for Regional Studies determined that there is economic feasibility for at least 1.5 million new ADUs in California.[1] However, homeowners seeking to build ADUs often face challenges around finding financing to pay for the design, permitting, and construction of an ADU.

Figure 1. ADUs as a Percentage of Newly Permitted Housing Units (2013 - 2020)



Source: HCD APR Dashboard. Accessed Jan 25, 2022: https://www.hcd.ca.gov/community-development/annual-progress-reports.shtml

[1] Monkkonen, P., Carlton, I., & Macfarlane, K. (2020). One to Four: The Market Potential of Fourplexes in California's Single-Family Neighborhoods. UCLA: The Ralph and Goldy Lewis Center for Regional Policy Studies. Retrieved from https://escholarship.org/uc/item/8gh2x0tj

FINANCING OPTIONS

While the Legislature has taken significant action in recent years to make it easier and cheaper to build an ADU, property owners still face significant financial barriers in doing so. An ADU can cost hundreds of thousands of dollars to build, and most households do not have the cash or personal resources to do this without borrowing. And while an ADU is likely to increase the value of the property and provide additional income to the owner, the suite of existing mortgage products does not often take this into account and is therefore not well-suited to financing ADU construction.

Many of the loan options on the market today are subject to a range of underwriting standards set by federal government-sponsored enterprises (GSEs) such as the Federal Housing Administration (FHA), Fannie Mae, and Freddie Mac. These GSEs back a majority of all outstanding mortgages and impose various standards and limits to promote a safe and healthy mortgage market. In practice, these limits and restrictions on so-called "conforming loans" can limit the usefulness of these financing options to fund ADU construction. As explained by the Urban Institute's Dr. Laurie Goodman and Solomon Greene:

> There is no major mortgage product from the government or government-sponsored enterprises that considers both after-repair market value and potential rental income generated from a new ADU.[2]

Moreover, these borrowing options can often exclude low- and middle-income homeowners with lower credit scores or who have limited equity. Typically, a household chooses from the following financing options when financing an ADU:

- **Cash-out refinance.** A cash-out refinance replaces a borrower's current mortgage with a new mortgage that is greater than what the borrower currently owes. The borrower then receives in cash the difference between the two mortgages. The amount that can be cashed out depends on the value of the home and the borrower's equity, and lenders typically require the borrower to maintain at least 20% equity in the home. As a result, this option is most useful to a homeowner with significant equity in their home.

- **Home-equity loan or home equity line of credit (HELOC).** A home equity loan allows a homeowner to borrow a lump sum that is then paid back at a fixed rate. A HELOC is an ongoing line of credit that allows the homeowner to borrow against the home's equity over a set period of time. Similar to a cash-out refinance, the amount of a home equity loan or HELOC is limited based on the home value, and eligibility restrictions such as credit score can limit availability to some potential borrowers.

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[2] https://www.urban.org/urban-wire/unleash-housing-supply-allow-and-finance-accessory-dwelling-units

- **Construction or renovation loan.** A construction loan can be used to build a home or a structure from the ground up and can take into account the future value of the home. Unlike a cash-out refinance, home equity loan, or HELOC, the loan is directly tied to the construction process. The borrower receives the loan in installments as the project reaches completion, and the borrower typically refinances when the project is finished. A construction loan generally has a higher interest rate than the equity-based options discussed above and can be more work for lenders, but the loan can take into account the after-market value of the construction project.

  Moreover, a homeowner can access a number of federal renovation loan products that take into account the future value of the property. Like a construction loan, a renovation or rehab loan requires the use of a contractor and approved project details. For example, the Fannie Mae HomeStyle Renovation loan provides funds (either through a purchase mortgage or a refinance of the current mortgage) to remodel and repair a house. The amount of the loan is limited to 75% of the after-repair value of the home, not to exceed specified amounts (for example: in 2021, the conforming limit was $822,375 for a single-family home in a high-cost metro area).

In addition to the above types of common financing tools, there are also a variety of more tailored mortgage-based financial products as well as new types of financing or investment relationships. A non-exhaustive list of these options include:

- **Reverse mortgage.** A senior over the age of 62 may use a reverse mortgage – a type of mortgage product that allows the borrower to borrow against the equity that is then repaid upon the borrower's death – to receive a lump sum amount.

- **Co-investing.** A co-investing arrangements allows a homeowner to cash out a share of the home's value in exchange for a portion of the home's future value. For example, Unison allows a homeowner to cash out up to 17.5% of a home's appraised value, and in exchange Unison receives a portion of the home's change in value when the home is eventually sold.[3]

- **Fintech partnerships with lenders**. A range of financial technology firms have developed partnerships with lenders to offer ADU-friendly lending options. For example, Renofi partners with credit unions to offer a modified equity-based loan that allows the borrower to borrow up to 90% of the home's after-renovation value (compared to a traditional home equity loan that can be worth up to 90% of the current value).[4]

- **Other private options tailored to ADUs.** A number of newer companies offer specialized ADU financing options as part of an overall ADU construction package. For example, United

[3] https://www.unison.com/how_it_works_homeowner/
[4] https://www.renofi.com/how-it-works/

Dwelling helps a property owner design and build an ADU and manage the property as a rental in exchange for a portion of the monthly rent.

STATE AND LOCAL PROGRAMS

The state government and a number of local governments in California have started programs designed to promote ADU construction through direct financial assistance or partnership with local financial institutions. Programs include:

- **CalHFA's ADU Grant Program.** CalHFA's program provides a grant of up to $25,000 to reimburse pre-development costs associated with ADU construction.[2] An eligible borrower must meet certain income limits and must apply for a construction loan with an approved lender. The lender includes the predevelopment costs as part of the loan and sends the relevant information to CalHFA. CalHFA then wires funds to the lender to lower the ADU construction loan principal that the homeowner must pay. CalHFA's program is in its early stages, and the Governor's proposed 2022-23 budget includes an additional $81 million one-time General Fund to expand the program for a total of $100 million in available financing for ADUs.[5]

- **HCD's CalHome Program**. State money to local public agencies and nonprofits for first-time homebuyer mortgage assistance including a home purchase with an ADU or JADU and options for rehabilitation of ADUs/JADUs. Also includes certain predevelopment, construction, repair, and reconstruction costs for ADUs and JADUs.

- **San Diego Housing Commission (SDHC).** SDHC, the housing authority for the City of San Diego recently released a report from its ADU Pilot Program. Through the pilot program SDHC constructed five varying types of ADUs on properties it owns and issued a report documenting costs, predevelopment processes, and permitting for various types and sizes of ADUs. In their October 2021 report, SDHC provides lessons learned and key takeaways for San Diego homeowners considering building ADUs. [6]

- **Permit Ready Plans**. A number of local governments provide homeowners with "permit ready plans" for ADUs which can reduce the cost and time required for homeowners considering building an ADU on their property. Some of the jurisdictions with permit ready ADU plans include: San Jose, Stockton, Chico, Clovis, and Del Mar.

- **Incentive programs for affordable ADU development.** Santa Cruz County has a forgivable loan program which provides up to $40,000 for homeowners who rent ADUs to low-income households at affordable rents for up to 20 years. Additionally, Habitat for Humanity

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[5] https://www.calhfa.ca.gov/homebuyer/programs/adu.htm

[6] https://www.sdhc.org/housing-opportunities/adu/

Monterey Bay operates a program to create affordable ADUs for low-income senior homeowners.

RECENT ADU FINANCING LEGISLATION

A number of proposals to create a state-run program to support ADU financing have been introduced in the Legislature. These proposed programs would have been structured differently than CalHFA's program discussed above, had they gone into effect. Those proposals are:

- AB 69 (Ting), of the 2019-20 Legislative Session, would have established a new program, the Help Homeowners Add New Housing Program (Program), in the State Treasurer's Office to help finance ADUs and JADUs. The proposed program would have provided partial loan guarantees and other credit enhancements in order to induce private lenders to issue loans for ADU and JADU construction. Initial capitalization of the Program will be provided through the issuance of revenue bonds. AB 69 was vetoed by the Governor, whose veto message stated:

  > This bill would establish the Help Homeowners Add New Housing Program within the State Treasurer's Office to finance the construction of Accessory Dwelling Units (ADUs) and Junior Accessory Dwelling Units (JADUs) and would require the California Housing Finance Agency (CalHFA) to issue revenue bonds to fund the program. ADUs and JADUs are a critical tool for increasing the housing supply in California, and access to construction financing remains one of the major hurdles in unlocking their full potential. I was proud to sign three bills last year that built on the state's strongest-in-the-nation ADU streamlining laws. Access to ADU financing - especially for lower-income California homeowners - is an issue that should be addressed, but the financial structure proposed in this bill would negatively impact affordable housing production, as it could harm CalHFA's credit ratings. Therefore, I am directing the Business, Consumer Services and Housing Agency to continue departmental efforts to provide increased access to capital markets and opportunities to encourage broader adoption of ADUs and JADU

- AB 1074 (Diep), of the 2019-20 Legislative Session, would have authorized the issuance of up to $500 million in bonds to finance the Accessory Dwelling Unit Construction Program (Program). Under the Program, HCD would enter into a contract with a homeowner to provide financing for eligible ADU construction costs. AB 1074 died in the Assembly Committee on Housing and Community Development.

- SB 1400 (Umberg), of the 2019-20 Legislative Session, was nearly identical to AB 1074. That bill died in the Senate Committee on Rules.

ADDITIONAL RESOURCES

This background document is meant to provide a broad overview of key issues around ADU financing. For additional detail, see:

- Karen Chapple, David Garcia, Julian Tucker, Eric Valchuis, Reaching California's ADU Potential: Progress to Date and the Need for ADU Finance, (UC Berkeley Terner Center for Housing Innovation, August 28, 2020), available at https://ternercenter.berkeley.edu/research-and-policy/reaching-californias-adu-potential-progress-to-date-and-the-need-for-adu-finance/

- Laurie Goodman and Solomon Greene, "To Unleash Housing Supply, Allow and Finance Accessory Dwelling Units," (Urban Institute, February 3, 2020), available at https://www.urban.org/urban-wire/unleash-housing-supply-allow-and-finance-accessory-dwelling-units

- Casita Coalition, "ADU Best Practices Webinar Series: ADU Finance Update & Panel," (September 24, 2021), available at https://www.youtube.com/watch?v=wa6vcCXGbIo&list=PLRPPog7f6IzVUuadN9ED5HztZGU_tgY32&index=9