Overcoming Financing Barriers to Accessory Dwelling Units

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Accessory Dwelling Units (ADUs)

- *ADUs are small second housing units on the same lot as a single-family home. They can include backyard cottages, basement apartments, or garage conversions.*
- *Historically, most single-family residential zones in the US prohibited ADU construction. But today, cities and states are increasingly permitting ADUs to be built on single-family lots.*
- *The problem - Financing ADU construction is proving to be a major hurdle*

Four Related Questions:

1. *What ADU Financing options are available for homeowners ?*
2. *Why is ADU financing so difficult?*
3. *What role does the Federal government play in renovation financing ?*
4. *What can be done to improve financing ?*

How can homeowners finance ADU Construction ?

- *Homeowners can finance ADU construction in a few ways:*
  - *Cash, personal loans, and short-term loans*
  - *Home equity extraction – Home equity loans, lines of credit, cash-out refinance*
  - *Renovation financing*
    - *Federal-agency backed renovation financing from Fannie Mae, Freddie Mac and FHA*
    - *Non-federal financing from banks, credit unions and State HFAs*
  - *All are limited in scope and have other drawbacks*

Tapping home equity to finance ADU construction is best suited for wealthy households

- *Home equity lending:*
  - *Underwriting standards for home equity lending are very strict:*
    - *Average FICOs for HELOCs are in excess of 760; high income requirements*
    - *Home equity lending is capped at 80% of the current market value of the property.*
    - *Doesn't consider future rental income the ADU will generate*
  - *Home equity lending is based on property value at the time of loan application; i.e. it doesn't consider value of improvements. Appraising how much value new construction will add isn't easy.*
  - *Best suited for wealthy property owners with lots of equity, substantial savings or income*
  - *To get financing based on "after-repair value", one needs renovation financing*

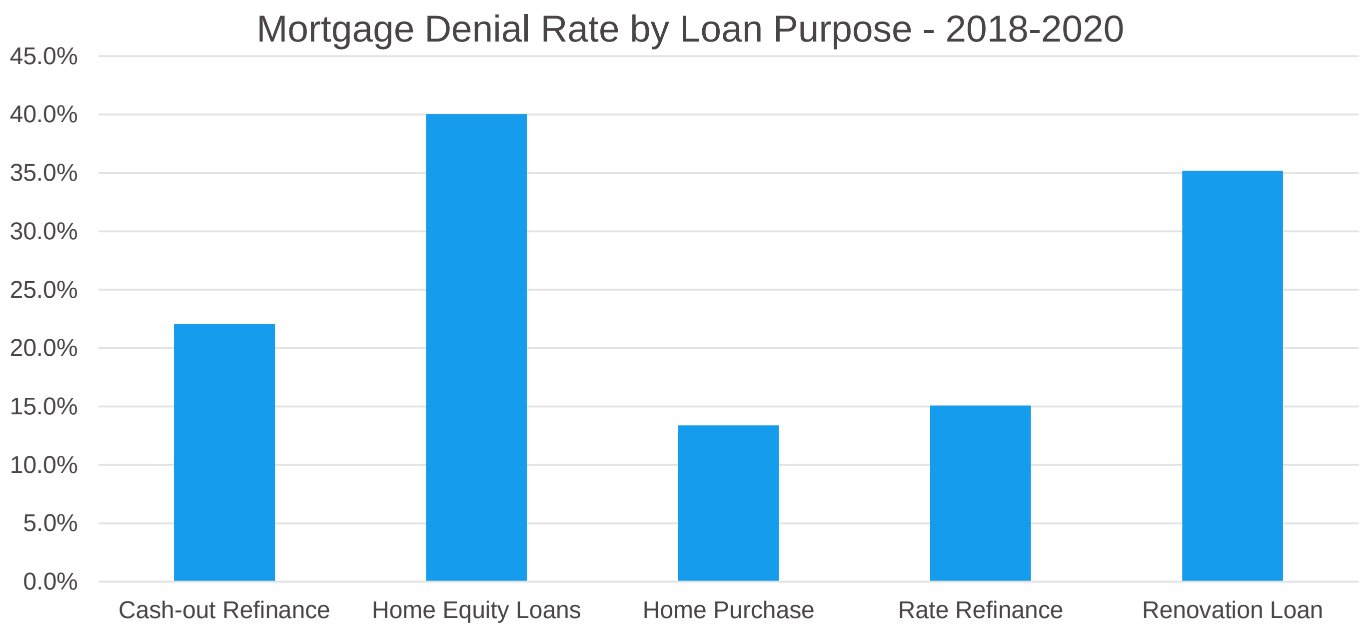
Federal renovation financing is cumbersome and expensive for lenders

- *Renovation financing:*
  - *FHA 203 K program has two forms:*
    - *Limited form: Max $35,000 loan; minor remodeling and nonstructural repairs.*
    - *Standard form:*
      - *Lenders must review contractor credentials, experience, work plans, cost estimates etc. Must ensure quality workmanship and timely completion (adds substantial cost, uncertainty and risk)*
      - *Repairs to start within 30 days of closing and completed in 6 months. Delays/cost overruns require lender involvement*
      - *Borrower must hire a HUD consultant to oversee the renovation process.*
      - *10-20% of the total loan amount be set aside as a contingency.*
      - *Median renovation loan amount in 2020 - $75,000*

Federal renovation financing is cumbersome and expensive for lenders

- *Fannie Mae Homestyle Program, Freddie Mac CHOICE Renovation:*
  - *Repairs must be completed within 12 months*
  - *A contingency must be set aside for cost overruns.*
  - *No consultant is required, but the GSEs have recourse to the lender during the construction period.*
  - *Essentially, lenders are on the hook for any delays, cost overruns and poor-quality workmanship; most are unwilling to take the risk*

Over 1 in 3 renovation loans in denied



- *Key takeaways:*
  - *Most homeowners lack expertise needed to efficiently manage construction projects, a prerequisite for renovation financing*
  - *Federal agencies require mortgage lenders to monitor entire construction and ensure on time completion*
  - *This reduces risk to taxpayers, but increases risk to lenders, limiting participation*

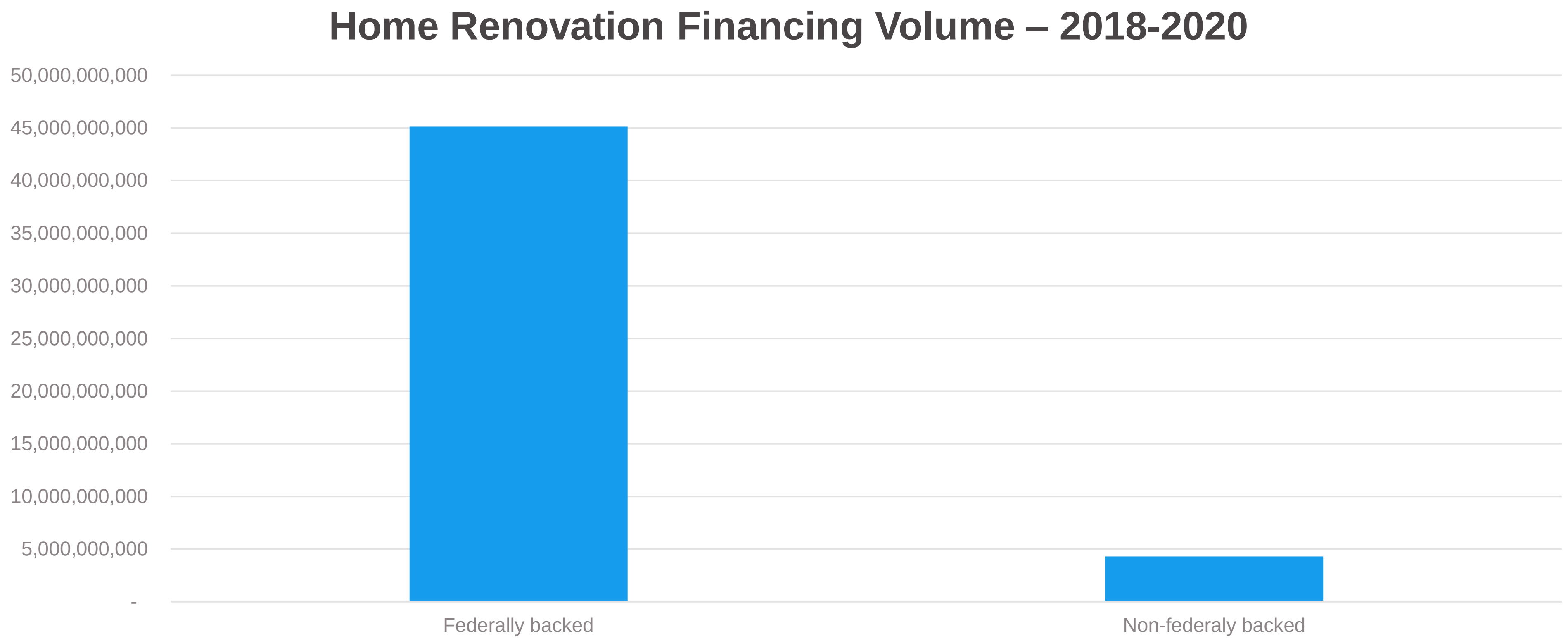
Source: 2018-2020 Home Mortgage Disclosure Act and Urban Institute

Summary: Key Barriers to ADU Financing

- *Federal agencies and lenders can’t easily mitigate the risk that the construction will get delayed, incur cost overruns, or never be completed.*
- *Most lending programs don’t consider the rental income the ADU will generate. Key hurdle for lower-income homeowners who may want to construct ADUs*
- *Most home equity lending programs won’t lend more than 80 percent of the appraised value of the home*
- *Appraisals don’t take “after-repair” value into account*
- *Small loan sizes are less profitable for lenders; discourage participation*

We have to address issues with Federal renovation financing

- *Despite these drawbacks, federally-backed renovation financing is the most viable path forward.*
- *$45 billion out of the total $50 billion in total renovation lending in 2018-2020 was federally backed by Fannie Mae, Freddie Mac, FHA and VA*



Source: 2018-2020 Home Mortgage Disclosure Act and Urban Institute

Renovation financing: We need to get it right because the housing stock is aging

- *Half of the nationwide housing stock is more than 43 years old; A quarter is more than 60 years old*
- *Efficient renovation financing is critical for home preservation - A housing unit kept from becoming obsolete is a unit added to the housing stock*

	Number of units	Share of the housing stock	Cummulative Share
1939 and earlier	17,219,141,	12%	12%
1940-1959	20,762,454	15%	27%
1960-1979	35,536,349	25%	53%
1980-1999	37,725,172	27%	80%
2000-2009	18,434,989	13%	93%
2010 or later	10,008,104	7%	100%
Total	139,686,209	100%	

Source: Census Bureau and Urban Institute

How can we improve availability of renovation financing to spur ADU construction ?

- *Overcoming the risk of cost overruns and delays:*
  - *Federal agencies and lenders need reasonable assurance that construction will be completed on time and within budget.*
  - *This risk can be mitigated a couple of ways:*
  - *Partner with a reputed entity to oversee construction. Case Study: The City of Detroit teamed up with Home Depot during the last foreclosure crisis to repair thousands of abandoned homes. Advantages:*
    - *Home Depot deployed contractors from its approved vendor list. Contractors on this list are subject to quality standards, background checks and other vetting to ensure a level of quality.*
    - *Repairs were standardized to minimize labor and materials costs. Large economies of scale*
    - *Financing was philanthropic, but it proved that the model works*
  - *Provide tax incentives to homeowners that install factory built ADUs. Standardized product, much lower cost, built to HUD code; would largely eliminate risks that accompany site-built ADUs.*
  - *Encourage rental use - Provide incentives/rebates to homeowners that rent ADUs to section 8 voucher holders*

How can we improve availability of renovation financing to spur ADU construction ?

- *Overcoming barriers to ADU Lending:*
  - *Homeowners are unfairly penalized by lending rules:*
    - *ADU underwriting should provide at least 50 percent credit for future rental income; this will help qualify lower income and senior homeowners living on fixed incomes*
    - *Appraisals should be completed on an "after-repair" basis. This is difficult today due to lack of comps.*
    - *Raise the maximum 80% LTV cap for home equity lending as long as funds are used to finance ADUs*
    - *Incorporate alternative credit scoring to improve approvals (bank cash-flow data, utility, telecom.)*
  - *Half of ADUs nationwide are financed using cash and high-interest debt such as personal loans, and short-term loans. We should make it easy to pay off these loans via a refinance product.*

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