ADU Construction Financing: Opportunities to expand access for homeowners

USC Lusk
Center for Real Estate

Terner Center for Housing Innovation
UC Berkeley

TERNER CENTER FOR HOUSING INNOVATION
UC BERKELEY

USC Lusk
Center for Real Estate

Authors

Richard K. Green | Director and Lusk Chair in Real Estate | USC Lusk Center for Real Estate

Ben Metcalf | Managing Director | Terner Center for Housing Innovation | UC Berkeley

David A. Garcia | Policy Director | Terner Center for Housing Innovation | UC Berkeley

Eric Valchuis | Principal | Eric Valchuis Consulting

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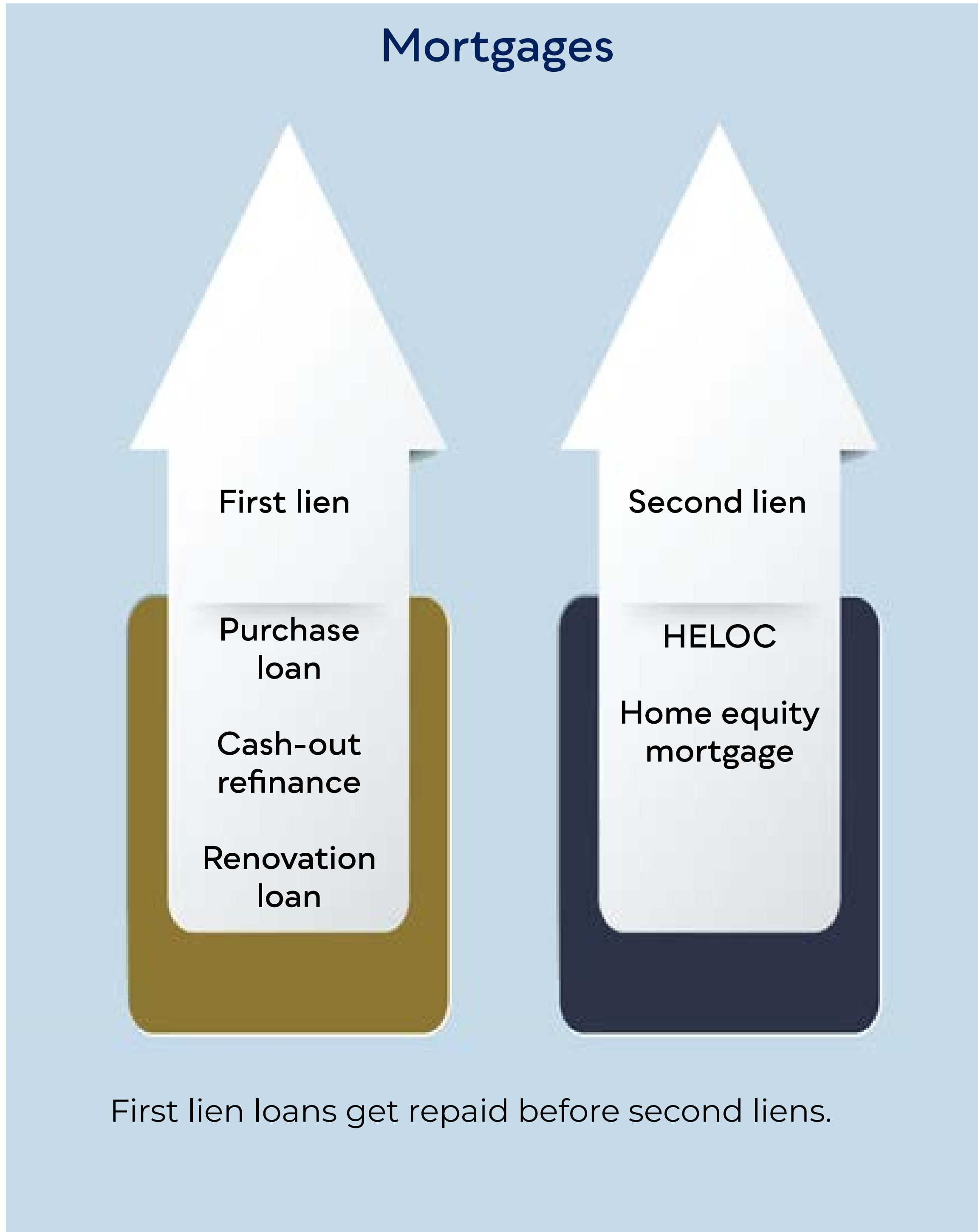
Executive Summary

When a homeowner adds an accessory dwelling unit ("ADU") to their property, they not only gain financial and lifestyle benefits, but they also help close the housing shortage in the United States with homes that typically rent at prices below the median. Though many homeowners want to build an ADU, they are often prevented from doing so because they have difficulty financing the upfront costs. While ADUs have potential to be a tool to bridge the racial wealth gap and add financial stability for lower- and moderate- income homeowners, to date, comparatively affluent and, in many regions, whiter, homeowners have disproportionately built ADUs.

Informed by a literature review and interviews with 30+ experts in the field, this paper maps the existing ADU construction financing landscape and identifies promising financial products, barriers to their utility, and recommendations to help ensure that the benefits of ADUs are realized by all homeowners.

Of homeowners who have built an ADU, most have leveraged a combination of cash and a mortgage to finance construction. Mortgages, loans backed by real estate, are popular as they are widely available, feature relatively low interest rates, and have the potential to produce substantial cash for the homeowner to cover the cost of ADU construction. There are a few main mortgage products that homeowners typically use: 1) first lien products such as purchase loans, cash-out refinance, or renovation loans and 2) second lien products such as home equity lines of credit (HELOCs) or home equity loans. Homeowners who hold significant equity in their home are generally well served by purchase loans, cash-out refinances, and second lien loans. Renovation loans, which are sized based on the expected post-renovation value of the home, are theoretically well suited to help homeowners without significant equity but remain relatively unused.

Type of Product Examples



We found that renovation loans, with reforms, may be a useful tool to enable some homeowners who are currently excluded from the financing market to build an ADU. Our team investigated renovation loans backed by government agencies, such as Fannie Mae and the Federal Housing Administration, to identify issues that reduce their efficacy for the construction of ADUs. We found three specific inhibitors:

- first, that agencies do not recognize income that an ADU may produce;
- second, that appraisals often undervalue ADUs;
- and finally, that agencies have constrictive guidelines which limit where and who can build an ADU.

Further, we identified other issues with renovation loans which help explain why they are a generally unpopular mortgage product including that they tend to be expensive for borrowers, can take a long time to close, have relatively high rates of denial, and often make finding a qualified contractor more difficult as contractors tend to disfavor projects funded by renovation loans.

Finally, we found other non-government-backed products for financing an ADU such as bridge financing, ground leases, personal property loans, and shared appreciation models that hold promise for the longer term and could be scaled up to better serve homeowners. This paper highlights these financial instruments to encourage further research and policy discussion.

> Of homeowners who have built an ADU, most have leveraged a combination of cash and a mortgage to finance construction.

Introduction

The US has a housing deficit of 3.8 million units.[1] This deficit has resulted in a rapid run-up in home prices and rents, and decreased housing affordability for many Americans. The median sales price of homes sold in the United States increased 24% between January 2020 and October 2021 alone.[2] Between 2000 and 2019, the share of renters who are rent-burdened, or whose housing costs account for more than 30% of their income, increased from 39 to 49%.[3] The crisis requires tackling the problem from multiple angles–preserving existing affordable housing, protecting vulnerable individuals from eviction, and producing new housing.

ADUs are a means of producing a meaningful amount of new housing units, by some estimates up to 1.8M in California alone.[4] ADUs, often incorporated inside existing homes or on existing parcels, are not given the same community scrutiny as larger apartment buildings, and are often politically insulated from neighbors' objections that otherwise successfully block larger scale housing projects. When rented, ADUs often are leased at rents that are affordable to households earning below the area median income; for example, in the high property-value areas of Alameda, Marin, and San Mateo counties, between 29-67% of ADUs are affordable to a family of two making 80% of the area median income.[5]

Beyond increasing the supply of housing, ADUs provide benefits to homeowners. ADUs often house family members, allowing children to care for aging parents or grandparents to help with childcare.[6] Other homeowners opt to rent out their ADU to earn supplemental income as renting an ADU can provide an outsized financial return to homeowners compared to other investments.[7] Finally, ADUs can provide income diversification that can help homeowners remain housed during an income shock, such as a loss of employment. ADUs can provide homeowners lifestyle flexibility and can help them to increase financial stability, making them an especially powerful tool for low-income / wealth and BIPOC homeowners, the latter of which are at the highest risk of losing their homes in a short sale or foreclosure after purchase.[8]

Recognizing the benefits of ADUs, lawmakers across the country in states such as California and Oregon, and cities such as Seattle; Boston; Minneapolis; Washington, DC; Salt Lake City; among many others, have legalized second (and sometimes third or fourth) units. Many of these localities have also enacted reforms that promote project feasibility such as lowering or eliminating parking requirements, reducing impact fees, liberalizing size and occupancy requirements, among others.

The appetite for future reform also appears to be high, even from the top of the federal executive branch: in May 2022, the White House released a 5-year strategic plan aimed at making rent more affordable and homeownership more attainable, especially for low- and moderate-income families. ADUs are key to the White House's plan: they assert that ADUs can account for 1 million of the 1.5 million housing units needed in the United States and recommend new financing mechanisms to cover gaps in the ADU market.

ADUs, though less expensive than other forms of housing, require significant financial resources to construct—the median cost to build an ADU in California in 2018 was estimated at $150,000 while 13% of ADUs were estimated to cost more than $300,000 to build.[9] For lower-income and lower-wealth individuals, ADU construction requires financing. For many of these homeowners, though, there is limited access to adequate financing to construct an ADU.[10] Perhaps, as a result, to date, ADUs have disproportionately been built in high-income, high home-value, and, oftentimes, whiter areas.[11]

To better understand the opportunities to expand credit for low- and moderate-income households to build an ADU, we conducted a literature review, one-on-one interviews with ten subject matter experts, and group roundtable discussions with 20+ government regulators, local government professionals, loan originators, ADU advocates, appraisers, ADU startup executives, academics, and real estate agents (the "interviewees"), all of whom have various perspectives on the challenges and the opportunities in the ADU construction financing space. In particular, we sought to understand:

- **The current ADU financing landscape for homeowners.**[12]
- **The government-backed loans with the highest potential to facilitate ADU construction.**[15]
- **The specific barriers built into each of these loan products for their use towards ADU construction.**
- **The opportunities for improving utilization of these loan products for ADU construction.**

In addition, we sought to identify promising ADU financing solutions outside of government-backed loans that might warrant further research.

Findings

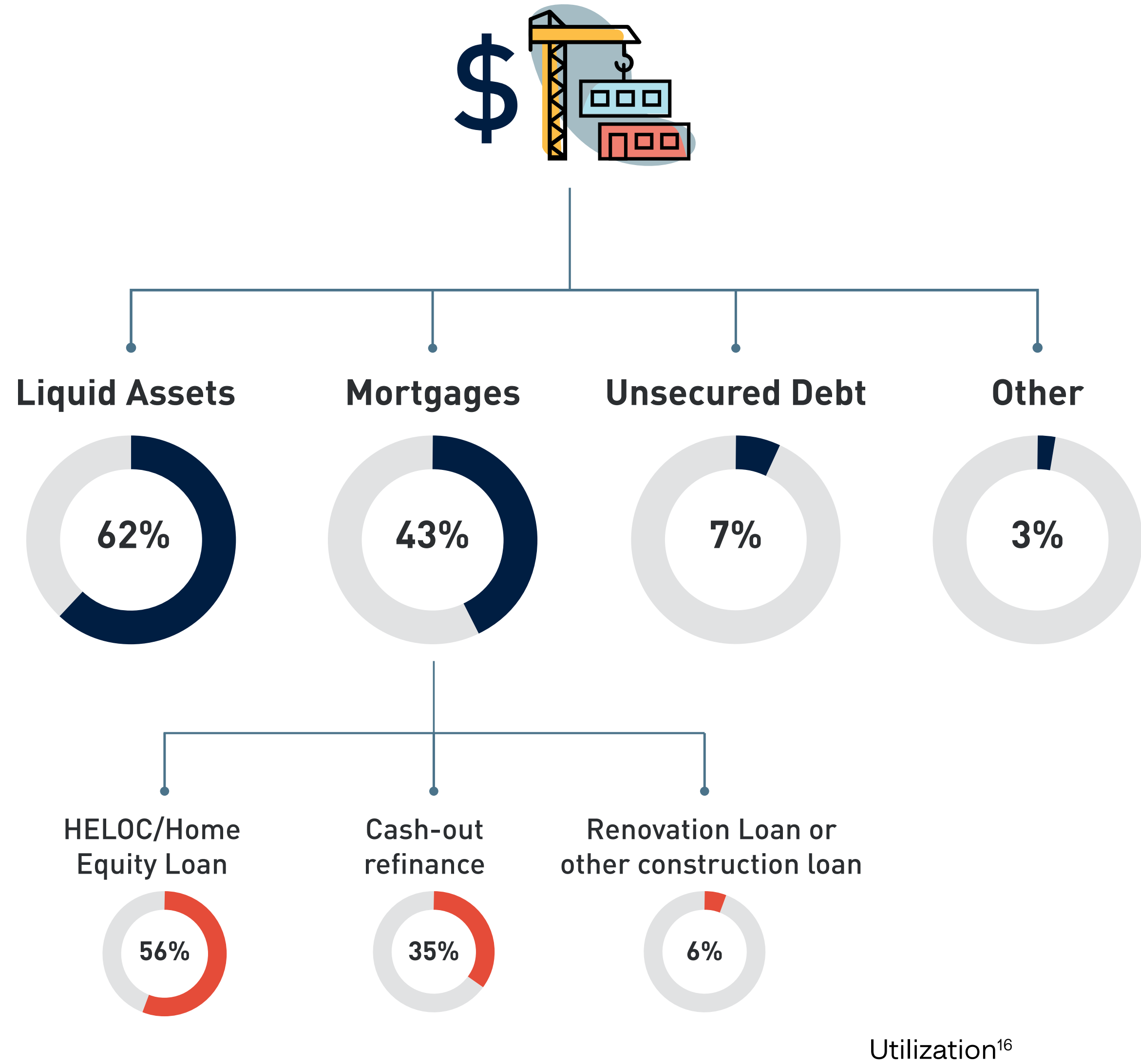
Existing ADU Financing Landscape

In a 2021 UC Berkeley survey of 800+ homeowners in California who built a permitted ADU, respondents were asked how they financed the cost of ADU construction. Their responses fell into four broad buckets: liquid assets, mortgages, unsecured debt, and "other" as shown in Figure 1. Most homeowners use, at least in part, cash or other liquid assets to build their ADU. Those who do not have enough liquid assets to finance the full cost of ADU construction require other sources of funds. Mortgages–loans secured by real property–are the most frequently utilized source of debt for ADU construction as they have wide availability, relatively low interest rates, and borrowing limits are typically high enough for the homeowner to borrow enough money to cover most or all of the cost of ADU construction. Homeowners less frequently use other forms of debt, including credit card loans and personal loans which carry high interest rates and can generate a limited amount of cash. Other non-debt sources of funds–government grant programs, ground leases, and equity share models–are as of yet a small piece of the ADU financing landscape.

Survey respondents were further asked about the type of loan that they took out. The three main types of mortgages used for ADU construction are cash-out refinances, home equity lines of credit/home equity loans, and renovation loans.

Figure 1

How do homeowners finance the cost of ADU construction?



Home equity lines of credit ("HELOCs") and home equity loans (collectively, "second lien loans") are loans collateralized by real property but are subordinate to a homeowner's first mortgage (hence they are in the second lien position). The main difference between a HELOC and a home equity loan is that a borrower can draw the funds of a HELOC down as desired whereas, with a home equity loan, all of the funds are disbursed to the borrower at loan closing. Being in the second lien position makes second lien loans riskier for lenders than first lien loans, and therefore, they carry higher interest rates. Second lien loans are attractive to homeowners who have an interest rate on their first mortgage which is lower than one they could obtain through a cash-out refinance. As mortgage interest rates have sat at historic lows for much of the recent past, these second lien loans have represented a small portion of the overall mortgage market in the United States; of the 14.5 million mortgages originated in the United States in 2020, only 850,000, or 5.9% were second lien loans.[18] Second lien loans are, however, the most common method for homeowners who have built an ADU to date.

A cash-out refinance is a first-lien mortgage which a homeowner uses to replace their existing, smaller, mortgage. Cash-out refinances are available to people with existing equity in their home (which is built by paying off principal over time or through home appreciation). Interest rates on cash-out refinances are generally higher than those on non-cash-out refinances and purchase loans but lower than those on second lien loans and renovation loans.

In order for a borrower to take out a second lien loan or a cash-out refinance, they need to have equity in their home which is not the reality for many, including those who have recently taken on a new mortgage. Though rising home prices have increased home equity for many, similar appreciation in the future is not certain.

A renovation loan is a first lien loan that is designed to provide homeowners with the cash they need to purchase a home or refinance an existing mortgage, plus cash to complete a home renovation such as fixing a roof, remodeling a kitchen, building an ADU, among other types of eligible improvements. Renovation loans work similarly to other types of mortgages with a few exceptions. When originating any loan, an appraiser values the property to determine the maximum loan that a borrower can borrow. In the case of a renovation loan, an appraiser determines the value "as-if" the renovation project has already been completed. By contrast, for other types of loans, an appraiser determines the value of the home "as-is." By using a renovation loan, then, a borrower can typically borrow a greater sum of money than with other products such as a purchase loan or cash-out refinance. At loan closing, the borrower receives a certain portion of the loan and other money is held back for the renovation. The lender will release the renovation funds to the borrower once an inspector comes to ensure that the required work has been completed as agreed. Once the renovation is completed, then the loan functions like other first lien mortgages. FHA, VA, Fannie Mae, and Freddie Mac all offer renovation products. Renovation loans are, at present, a comparatively small share of the ADU financing landscape: only 6.3% of the homeowners surveyed who used a mortgage to finance their ADU construction used a renovation mortgage.

Having identified the ADU financing landscape, our team sought to understand how government-backed mortgages could better facilitate ADU construction. We heard in our initial one-on-one interviews that none of these mortgages will be a silver bullet for ADU construction financing. We also heard near-unanimous agreement from the interviewees that renovation loans have the potential to be a far stronger tool in the ADU financing toolkit.[19]

Government-Backed Renovation Loans

There are four renovation government-backed loans available in the market: Fannie Mae HomeStyle renovation; Freddie Mac CHOICERenovation, FHA 203(k) Rehabilitation, and the VA renovation loan. As detailed in the sections below, we found from our interviews that there are three main issues that impede utilization of renovation loans by homeowners who want to build an ADU. First, while an ADU generates rental income, agencies generally do not allow ADU rental income to count towards a borrower's income, therefore limiting the amount of funds they can borrow. Second, appraisals often undervalue the ADU, again limiting the amount of the loan. Finally, agencies limit the types of properties on which an ADU can be built, what the ADU looks like, and the characteristics of the borrower. Outside the context of ADUs, there are various reasons for the lower market share of renovation loans: they are often more costly than other forms of debt, they have high denial rates, are administratively burdensome for lenders and contractors, and they are often impractical for borrowers when purchasing a home.

Some of the experts we interviewed, including ADU advocates and mortgage originators, tended to lean towards more expansive reforms to address these impediments while other interviewees, including those from the agencies, tended to lean towards more modest reforms due to wanting to balance greater access to credit with ongoing robust consumer protection. The recommendations presented herein are ones that were generally agreed upon by participants along the risk spectrum.

> Only 6.3% of the homeowners surveyed who used a mortgage to finance their ADU construction used a renovation mortgage.

Consideration of ADU Rental Income

One of the criteria that lenders use when underwriting a loan is the borrower's "stable" income–income that one can reasonably expect to continue into the future. They do so because they want to ensure that the borrower has enough income to service their anticipated mortgage payments for the entirety of the loan term.

For many loans, agencies consider some or all of the rental income generated by a property as stable; for example, on a mortgage for a duplex where one or both sides are rented, part of the rental income is considered stable. Despite the widespread nature of this practice, government-backed loans either prohibit ADU income from being considered stable or make it so that ADU income can only be considered stable income in limited situations:

- **Fannie Mae's** selling guidelines state that "a borrower must qualify for [a] mortgage without considering any rental income from the ADU.[20] A limited carveout exists for low-income borrowers.[21]
- **Freddie Mac**, as of June 1, 2022, allows rental income from an existing ADU to count as stable for an ADU within a single-family, owner occupied property, granted the ADU is legal and the loan is either for a purchase or a non-cash out refinance. However the rental income can account for no more than 30% of the borrower's total stable income and the borrower must either have landlord experience or have taken a landlord training course. Finally, Freddie Mac requires an appraisal that shows a comparable property with a rented ADU that has recently sold as well as three comparable rentals, including one that is an ADU. Freddie Mac will also consider income from an ADU as stable for investment properties–either if the entirety of the subject property will be an investment property or if the borrower has ADU income from another investment property.[22]
- While the **VA** does not have any specific limitations on ADU income, the lender's handbook states that, when considering rental income on a single family property (the only type of property that can have an ADU per their guidelines), it can only be considered stable if the borrower has two years of rental history documented on their tax returns.[24]
- **FHA** features similar guidelines as the VA, though they may consider ADU income from a different property without income documented on the borrower's tax returns if the borrower has 25% equity in the property and obtains specific appraisal reports.[24]

These rules are not only a constraint for borrowers who want to build an ADU with a renovation loan, they can limit the potential loan amount for borrowers of other types of mortgages who either already have an ADU at their property or who are going to purchase a home with an existing ADU. Interviewees suggested that agencies consider three types of ADU income as stable:

1. **Income from an existing ADU with an in-place lease.** Agencies today consider income from a rental unit on a 2-4 unit property for which there is an in-place lease, as stable. The interviewees suggested that income from an ADU with an in-place lease should be treated no differently than a unit on 2-4 unit property. For loans on 2-4 unit properties, to compensate for the risk of non-professional leasing and property management, agencies discount the value of the rental revenue stream–a practice that could be replicated for ADU income. With the recent changes it made to its selling guide, Freddie Mac has gone the furthest in allowing income from an existing ADU to be considered stable for up to 30% of the borrower's stable income.
2. **Income from an existing ADU without an in-place lease.** Agencies today consider income from a unit on a 2-4 unit property that is currently vacant as stable–discounting the value of the rental revenue stream to take into account the risks associated with leasing-up the unit. Again, the interviewees suggested that income from an existing ADU without an existing lease should be treated no differently than a vacant second unit in a 2-4 unit property.
3. **Income from a yet-to-be built ADU.** Agencies today do not consider rental income from a yet-unbuilt unit on a 2-4 unit property as stable. For properties with 5+ units, however, agencies will consider the value of rental income of a yet unbuilt unit. There are risks with lending against the rental income of a yet unbuilt unit; from loan closing, the borrower must successfully build the unit and find a qualified tenant who will begin paying rent. With loans on 5+ units construction, lenders underwrite the future rental income of a yet-unbuilt structure at a discounted amount, taking into consideration defensible assumptions on vacancy and operating expenses and only funding the loan after the borrower obtains necessary entitlements and construction permits from local jurisdictions, a guaranteed price contract from a licensed contractor, and a property management agreement from a qualified property manager. Inter-

viewees suggest that agencies enact similar guidelines for renovation loans, discounting the potential revenue from a yet-unbuilt ADU based on comparably defensible assumptions.

Several interviewees conjectured that considering some or all ADU income as stable could improve the underlying ability of a borrower to repay a loan. Further research should be conducted to evaluate the relative safety of mortgages backed by ADU rental income–specifically, default prediction modeling that includes ADU income as an explanatory variable for greater financial resiliency. This work may be done internally at the agencies or by outside researchers. Currently, default models include such characteristics as loan-to-value ratios, a borrower's credit score, length of time in a job, among other factors. If having income from an ADU reduces default probability, it will be evidence of the safety of loans backed in part by ADU income. Even if the addition of an ADU has a marginally positive impact on the likelihood of default, this risk might be reasonably priced into the loan pricing which could result in a loan that is still less expensive to borrowers than other non-government backed loan options.

As previously noted, some homeowners do not treat an ADU as a rental unit, instead using it as additional living space for themselves or a family member. If, and as, future research on loan performance indicates that ADUs, no matter the tenure, increases the safety of a loan, the agencies may choose to have borrowers certify as a condition of their mortgage that they plan to lease their ADU for a minimum period of time after loan closing to help ensure that the ADU will, in fact, generate rental income.[25] Alternatively or additionally, the agencies may require that the homeowner contract with a third-party property management firm that professionally leases and manages the unit for a certain period of time after closing.

Changing if and how ADU income is underwritten can be done by the agencies through updates to internal underwriting, policies, and guidance and does not require statutory change nor action by the Federal Housing Finance Agency or other regulatory body).

> The interviewees believe that considering the income of a yet-unbuilt ADU as stable would go the longest way in making renovation loans more useful to borrowers.

Appraising ADUs

Another criterion that lenders use when underwriting a loan is the loan-to-value ratio which is calculated by dividing the loan amount by the appraised value of the property. For a renovation loan, an appraiser will value the property as if the ADU has already been built (the "as-if complete appraised value"). As a lender will not lend above certain loan-to-value ratios (typically 80%), for the borrower to receive the right sized loan to build the ADU, it is important appraisals are accurate. However, interviewees reported that some appraisers lack appropriate data and others lack experience in the specific nuances of evaluating the contributory value of an ADU.

Most appraisers of residential properties use the sales comparable approach of appraising homes–the method by which the value of the subject property is arrived upon by comparing it to similar nearby homes that have recently sold. In some geographies, there are few properties with ADUs that have transacted in the market, making it challenging to appropriately assess the added value of the ADU. In other markets, while properties with ADUs might have transacted, appraisers might not be able to find them as multiple listing services (MLS') across the country do not have a standardized method to identify if a property includes an ADU. The MLS' that do identify if a property has an ADU do not always indicate if an ADU is legal per local zoning and do not always report other pertinent ADU information, such as number of bedrooms, square footage, or whether or not the ADU is a conversion or new construction. Complicating matters, no centralized body exists to regulate MLS', leaving it to entities like HUD or the National Association of Realtors to provide the necessary technical assistance to MLS' across the country to incorporate standardized ADU data inputs, which to date has not been done.

Agencies also allow appraisers to use the income approach–whereby the rental income of the property is analyzed–to help value a property. Though agencies do allow appraisers to use rental income from an ADU in the income approach calculation, we heard that many appraisers erroneously believe that they are prevented from doing so. The interviewees suggested that the agencies explicitly clarify this point in their guidelines. In addition, the interviewees suggested that the appraisal forms provided by the agencies be updated to accommodate the unique needs of appraising a single family home with an ADU. Whereas 2-4 unit appraisal forms allow the appraiser to arrive at rental rates for each unit, the single family appraisal forms only allow the appraiser to come up with the rental rate for the whole property–that is, it does not allow the appraiser to break out the ADU and the primary home rental rates. Freddie Mac, in their recent selling guide update, provides some guidance to appraisers by suggesting that ADU comparable data can be provided either in narrative form or as a separate schedule.

As ADUs are a relatively new and geographically limited phenomenon, we heard that many appraisers are unfamiliar with the ADU-specific appraisal guidelines set forth by the agencies. Appraisers have considerable latitude in determining the contributory value of an ADU, but conversations with appraisers suggest that appraisers often err on the side of caution and value the ADU overly conservatively. Lenders or the agencies could require that appraisers (or at least those appraisers who value ADUs) complete certain trainings or certifications to ensure that they have the necessary tools to appropriately value them. These trainings already exist: for example, the Appraisal Institute, a national association of real estate appraisers, offers a continuing education course, "Valuations Overview of Accessory Dwelling Units," that teaches the techniques for appropriately valuing ADUs. Similarly, the Northern California Chapter of the Appraisal Institute offers a continuing education course to navigate appraising ADUs in California specifically (which could be used as a model for similar courses nationwide to help appraisers align local land use laws and patterns with the appraisal standards).

Renovation Loan Eligibility

Each agency has different guidelines which specify the characteristics of mortgages that they will purchase. These guidelines are the result of many influences, including the vagaries of enabling statutory authorization, regulatory mandates, market conditions, and agency responsibility to reduce the risk of the loans on their balance sheet. This section details key barriers to ADU uptake for each of the mortgage product and spotlights whether changes could be made through agency updates to guidelines vs. statutory or regulatory change.

Single-family dwelling only. Fannie Mae, FHA, and VA define an ADU as a dwelling on a parcel improved with a single family home (i.e., a one unit property). A borrower who owns a two or three unit property, then, could not use a renovation loan to build an ADU, even though single family loan programs allow for financing of structures with up to four units. Freddie Mac, as of June 1, 2022, stands alone in purchasing loans secured by two and three-unit properties that are improved with an ADU.[26] The interviewees believed that there is no indication that an ADU on a property improved with two to three units is any riskier for lenders than an ADU on a property improved with a single family home. Several states, such as California and Oregon, have recently expanded their ADU laws beyond single family properties to allow them on multi-unit properties, suggesting a mismatch between local efforts to expand supply and existing definitions.

One ADU only. All four agencies state that only one ADU is permitted per property, limiting those who seek to build a second or third ADU, as is increasingly being allowed by state and local jurisdictions. Interviewees noted the absence of any evidence suggesting that multiple ADUs on a property decrease the safety of the loan. Agencies may wish to consider a pilot to study the loan performance of mortgages on properties containing up to three ADUs (four being the maximum number of units on a property eligible for agency financing).

Attached only. FHA, under its 203(k) guidelines, states that any addition of a unit must be attached to an existing housing unit–which means that detached ADUs and certain garage conversion ADUs are not financeable under the 203(k) program.[28] Per interviewees at the FHA, this regulation stems from FHA's historic interpretation of the 203(k) enabling statute which states that acceptable uses of funds are for "the rehabilitation of an existing one- to four-unit structure which will be used primarily for residential purposes."[29] FHA is reportedly reexamining their interpretation of this passage to determine if a detached ADU may be applicable under the 203(k) program. If it turns out that the existing interpretation holds, the interviewees recommend that Congress amend section 203(k) of the National Housing Act (12 U.S.C. 1709(4k)) to allow for the addition of a detached ADU.

Limited funds for manufactured homes. Fannie Mae and Freddie Mac limit the loan amount from a renovation loan for properties for which the primary residence is manufactured (i.e., factory built to HUD specifications). For these properties, the loan amounts are the lesser of $50,000 or 50% of the 'as completed' appraised value. For all other properties, the loan amounts are 75% of the 'as completed' appraised value.[30] However, if the borrower would like to build an ADU on their property that has a primary residence that is manufactured, their eligible loan amount would be lower than a neighbor in the same position with a site-built primary residence. Interview respondents said that there does not appear to be a clear rationale for this rule. As of June 1, 2022, Freddie Mac updated their guidelines to clarify that the lower loan proceeds do not apply to ADUs that are manufactured.

Owner occupied only. Except in very limited circumstances, FHA and VA loans, including renovation loans, require that the borrower occupy the property for at least one year after loan closing. The reason for this is that one of FHA's and VA's mandates is to help borrowers achieve homeownership, not necessarily to help borrowers build an investment portfolio. In the case of FHA, changing this requirement would require an amendment to the National Housing Act which states that mortgage can be insured "only if the mortgagor is to occupy the dwelling as his or her principal residence or as a secondary residence." Similarly, for VA loans, changing this requirement would require an amendment to 38 U.S. Code § 3704(c) which states that "the veteran intends to occupy the property as the veteran's home."[31]

In addition, as agencies update their guidelines or seek statutory changes, some interviewees emphasized the importance of keeping language broad to accommodate local zoning that permits additional units but does not call them "ADUs". For example, California's SB9 legislation allows for "two residential units" within a single-family residential zone. Though the second unit is not called an ADU under local law, in physical and practical form, there is no distinction. Given this, some interviewees advocated for agencies to replace the term ADU in favor of more generalizable terms such as "additional unit[s]."

Figure 2 summarizes restrictions imposed by the guidelines which the interviewees believe limit the applicability of renovation loans for would-be ADU builders without increasing the loan risk for the agency. Figure 2 summarizes which agency guidelines feature the limitation and with whom the power to amend the guideline rests.

Non-ADU related challenges with renovation loans

Beyond the specific use case of ADU construction, issues remain with renovation loans generally which may also limit their usefulness to borrowers. Specifically, interviewees told us that these products are often more expensive for borrowers, can take a long time to close, have relatively high rates of denial, and often make finding a qualified contractor more difficult.

All of the interviewees noted that the process for originating and servicing a renovation loan is administratively onerous for lenders, requiring a significant amount of paperwork and coordination with HUD inspectors, contractors, and homeowners. The requirements mean that the loans require more staffing than is needed for other types of mortgages and lenders will often charge additional points or higher interest rates on renovation loans than on purchase loans to compensate themselves for this additional work. Other lenders, given the challenges, opt to not offer renovation loans. The interviewees suggested that the agencies review the origination process to determine areas for streamlining. For example, instead of basing the loan amount off of plans and specifications that are unique to each project, lenders could be permitted to offer a standardized amount based on the type of work that will be completed (e.g., a kitchen remodel generates loan proceeds of a certain set value). Alternatively or additionally, and more targeted towards ADUs, agencies can work with ADU manufacturers to determine a standardized loan amount for adding a specific ADU model to a property. Finally, one interviewee suggested that updates to the underwriting software, including allowing HUD consultants to directly input information into underwriting portals, would save significant lender and contractor time and effort by removing the need for significant paperwork and manual input of data.

The administrative requirements of renovation loans also make them imperfect products for borrowers purchasing their home, particularly in competitive markets, as renovation loans can take a long time to close. According to interviewees,

Figure 2

Interviewees reported that these agency restrictions limit the applicability of renovation loans for ADU builders.

	FANNIE MAE HOMESTYLE	FREDDIE MAC CHOICE RENOVATION	FHA 203(K)	VA RENOVATION	REFORM AREA
SINGLE-FAMILY DWELLING ONLY	X		X	X	Agency
ONE ADU ONLY	X	X	X	X	Agency
ATTACHED ONLY			X		Congress
LIMITED FUNDS FOR MANUFACTURED	X	X			Agency
OWNER OCCUPIED ONLY			X	X	Congress

Note: An “x” indicates that the agency does impose the limitation.

it takes at least 30 days to close a renovation loan in a best-case scenario, but achieving that quick time frame requires a savvy borrower and doesn't allow for unexpected hiccups. Typically, according to our interviewees, renovation loans take 60-90 days to close, whereas conventional purchase mortgages close in 45 days or less. The process of closing requires the borrower to secure plans from a licensed contractor before an appraiser values the property so the lender can determine the maximum loan amount. In hot housing markets, buyers often offer short closing timelines in order to increase the appeal of their bids. Those relying on renovation loans are put at a distinct disadvantage.

In addition to streamlining origination procedures, housing counselors could help homeowners ready the necessary permit, design, and other required application materials to be more competitive in this process. Research indicates the general usefulness of housing counselors; they are especially effective in steering homeowners towards less risky and more affordable loan products.[32] Housing counselors could more broadly identify the right financing options for homeowners and also think through the financial implications of building an ADU–including identifying the additional operating expenses associated with managing the additional unit. In 2021, Congress appropriated $78 million to HUD for homeowner counseling, very little of which appears to be specifically targeted for homeowners intended to purchase homes with ADUs or those intending to use renovation loans.[33] ADU-specific homeowner counseling does exist and could be scaled up, however. For example, HPP Cares, a Community Development Entity, helps homeowners with the financing as well as the construction and leasing of an ADU. This could be used as a model for other HUD-approved housing counseling agencies to replicate.

Another major issue with renovation loans is that they have a high rate of denial: 45% of applicants who apply for a renovation loan are denied compared to 18.4% of borrowers who are denied when applying for a cash-out refinance.[34] Per our interviewees, this denial rate may be higher because the as-completed value determined by the appraiser often does not justify the cost of the proposed renovations. More research is needed to understand why the rate of denial is so much higher for renovation loans as high denial rates impose an unnecessary burden on homeowners and create a major cost to renovation loan lenders.

Another major issue with renovation loans is that contractors are often reluctant to take on a project that is being funded through a renovation loan. Prior to closing a renovation loan, the lender and borrower agree to a draw schedule that dictates when money will be released to the borrower for the work completed. Before funds are released, an inspector must ensure the required work has been completed as agreed. The lenders can release some funds to pay for up-front costs, such as materials, design, and permit fees. In the case of Fannie Mae for example, they will release up to 50% of the agreed to material costs upfront. For the remaining 50% of the material costs and for all of the subcontractor costs, the contractor must wait until the work has been inspected and completed in order to be reimbursed. This process, which mitigates risk for the lender and the borrower, places a financial burden on the contractor. When contractors are in high demand, they are more likely to choose a job for which the homeowner is paying them cash rather than paying through a comparatively inflexible renovation loan. Per the interviewees, the agencies could

> “
> 45% of applicants who apply for a renovation loan are denied.

explore ways to release loan funds as the project requires it, for example, by allowing contractors to bypass the draw process if the contractor needs to pay for materials or subcontractors.

For many homeowners who want to build an ADU, especially those with equity in their home, renovation loans will never be the preferred mortgage product. Further, in a rising interest rate environment, borrowers will be increasingly reluctant to replace an existing low-interest rate mortgage with a renovation loan. However, given other options currently available in the market, renovation loans can be a good option for many homeowners who want to build an ADU: they carry the benefits of being government-backed, including low costs and borrower-friendly protections, and offer amounts that can fund most (if not all) of the cost of ADU construction. By enacting some or all of the reforms outlined above, renovation loans can be further optimized in the near-term to help lower- and moderate- income homeowners to participate in the growth of ADUs.

State and local governments, of which California and Boston are but two examples, have set aside grants and/or soft loans to help accelerate the construction of ADUs. As lawmakers and administrators create these programs, the interviewees suggested that they be crafted to work within the conventional mortgage system. For example, government programs could pay upfront for development costs that are either not paid for by renovation loans or that are paid only after a draw occurs. Working in tandem with Agency renovation loans, government programs can reduce a homeowner's debt load or help bridge the upfront costs of ADU construction.

Non-Government-Backed Loan Recommendations

With time, the private sector may develop and scale other products that could fill the financing gap for homeowners looking to build an ADU. Some of these products–including, but not limited to, bridge financing, ground leases, personal property loans, and shared equity–should be further researched and, given potential feasibility and appropriateness, made more widely available to homeowners. The importance of this work is magnified in a high-interest rate environment when homeowners will be less willing to replace their lower-interest first mortgage with a cash-out refinance or renovation loan.

Bridge Financing

A bridge loan is a short-term, second-position mortgage that can be used to fund the construction of an ADU. Upon stabilization of the ADU, the homeowner would complete a cash-out refinance of their first and second mortgages or would take out another, longer-term, second-position mortgage to pay off the bridge loan. Stabilization occurs once the property shows gains in appraised value or the homeowner establishes rental income at the property and this income can be considered "stable."

For example, San Mateo Credit Union (SMCU) offers an ADU bridge financing product. This loan requires that the homeowner occupies the primary residence and meets certain underwriting criteria. The term of the loan is 12 months and it considers up to 75% of rental income from the future ADU when calculating borrowing limits. SMCU, as a credit union, gets their capital from depositors and the loans are held on the lender's balance sheet. Once enough data has been generated, further research on this program is warranted to determine outcomes such as rates of default and closing rate.

Ground leases

A ground lease is an agreement signed by a property owner and a company whereby the property owner grants the company time-limited control of all or part of the subject property and the company builds, rents, and manages the ADU on behalf of the property owner. During the term of the ground lease, the property owner enjoys part of the rental income and by the end of the ground lease period, the property owner owns the ADU outright. The homeowner is typically spared the challenges of permitting, constructing, and managing the ADU and incurs no upfront costs.

A handful of companies, such as Dweller in Portland and Rent the Backyard in San Francisco, pioneered the ground lease model but have ceased offering it as a means of financing. The primary reason cited is that Fannie Mae and Freddie Mac mortgages state that transferring the property, or any interest in the property, triggers immediate repayment of the loan (known as the "due on sale" or "acceleration" clause). We do not know whether Fannie Mae and Freddie Mac would enforce these due on sale clauses in the event that a homeowner entered into a ground lease for an ADU, but it would clearly create a risk for homeowners. Notably, FHA and VA loans do not feature these due on sale clauses.[35]

> State and local governments, have set aside grants and/or soft loans to help accelerate the construction of ADUs.

Fannie Mae and Freddie Mac may wish to further study what impact ADU ground leases would have on the value of their collateral and make an official determination on whether or not they are acceptable.

Personal property loans

A personal property loan is a loan secured by non-real property (i.e., not real estate) and is commonly used to finance assets such as automobiles. Personal property loans (formerly referred to as chattel loans) are also used to finance manufactured homes, such as those in a mobile home park. Similarly, an ADU could be eligible for a personal property loan.[36]

The advantages of using a personal property loan in the context of an ADU is that it would not conflict with the requirements of a primary mortgage, including the the due-on-sale clause as discussed above. By separating out the ADU from the real property, if the homeowner were to default on the ADU loan, then they are not at risk of getting their primary residence foreclosed upon. A disadvantage of this model is that interest rates on personal property loans are often significantly higher than mortgage interest rates, likely to account for the fact that repossession of the ADU in the event of borrower default would be challenging.[37] A limitation on personal property loans for the ADU context is they would likely only be feasible as a financing solution for detached ADUs.

We have not found any examples of companies offering personal property loans for ADUs. The most obvious companies to explore offering these loans are the major manufactured home builders–including Skyline Champion, Clayton, and Cavco–as ADU could be a means of expanding their customer base. Absent action by the manufactured home builders, a third party company, perhaps one that provides development and property management services, could offer these loans to homeowners. However, absent a private or governmental secondary market for these loans it is unlikely that they could get to scale.

Shared Appreciation

A shared appreciation contract is one entered into by a homeowner and a company whereby the company will pay the homeowner a sum of cash upfront in exchange for the right for the company to receive an outsized share of the future value of the home. If an interested homeowner qualifies, the property is appraised by a third party appraiser to determine the upfront value of the home. The company–of which a handful exist, such as Point, Unison, and Unlock–will pay a lump sum to the homeowner, typically 10% of the home's value. The homeowner can use that lump sum as they wish and no payments are required during the term of the agreement (though this model was not necessarily designed for the ADU construction, this money can be used to build an ADU). At the end of the term, typically between 10-30 years, the homeowner pays off the company, either through a buyout or by selling the home. The buyout amount varies from company to company; in the case of Unison, the homeowner returns the initial investment made by the company and pays 40% of the difference between the initial appraised value and the final appraised value (or sale price, as the case may be). In the case of Unlock, the homeowner pays 16% of the final sale/appraised price.

Some homeowners may find this model attractive as they do not take on additional monthly payments and they have freedom to spend the money as they wish. This model may be a good option for less creditworthy homeowners as the companies claim that their underwriting criteria, including the debt to income ratios and credit scores, are less stringent than those of loan originators.

Given the novelty of the shared appreciation model, some questions remain. For instance, it is unclear if the cash received upfront to the homeowner is taxable and if these contracts are compatible with the primary mortgage. These contracts should also be further evaluated to ensure that they are not predatory given the lack of regulation in this space

The ADU financing models outlined above hold promise but require time and effort to flesh out business models that work for capital providers and homeowners. As with all new and untested financial products, there are potential pitfalls for borrowers that come with the expansion of these non-government backed and regulated models. As these models expand, watchdogs, regulators, and researchers should continue to monitor their effects on borrowers to ensure that predatory models do not proliferate.

Summary of Recommendations

We recommend the following changes to expand ADU financing options for homeowners:

Government-backed renovation loans: recommendations for agencies

- Research should be conducted on the relative safety of loans backed by ADU income. If ADUs have a positive effect on loan safety, agencies should consider ADU rental income from an existing ADU as "stable," especially for ADUs with in-place leases. Agencies should also explore lending against the income of a yet-unbuilt ADU, perhaps limiting construction and lease up risk in ways that are common in lending on 5+ unit properties.
- Agencies or lenders should require that appraisers who will appraise an existing or future ADU complete an ADU-specific appraisal training.
- Agencies should review their appraisal forms to accommodate the unique situation of appraising a single family home with an ADU.
- Agencies should explore amending their guidelines to allow for ADUs on two- to four-unit properties and allow for up to three ADUs as allowed by local zoning.
- Fannie Mae and Freddie Mac should reconsider their guidelines which limit the loan maximum for homes for which the primary residence is manufactured.
- Agencies should study their requirements for renovation loan origination and servicing to realize efficiencies for lenders, borrowers, and contractors. Agencies should also explore why denial rates are so much higher on renovation loans than rates on other products.

Government-backed renovation loans: other recommendations

- HUD and National Association of Realtors should work together to add standardized ADU information to MLS' across the country.
- If the existing FHA interpretation of the 203(k) enabling legislation holds, Congress should pass new legislation to allow FHA to issue renovation loans for ADUs that are not attached to the primary structure. Congress should also allow FHA and VA to issue loans to investors who wish to build an ADU.
- HUD should prioritize homeowner counseling funding to approved housing counselors that train counselors to help borrowers through the ADU financing process, especially the process to navigate closing a renovation loan.
- State and local ADU grant programs should tailor their programs to work within the conventional mortgage market, not outside of it.

Non-Government Backed Loans

- Researchers should study the success of ADU bridge financing programs and should study the implications of shared appreciation models for homeowners.
- Fannie Mae and Freddie Mac should explore compatibility of the ground-lease model with the due-on-sale clause found in their uniform mortgage instruments.
- Manufactured home builders and startups should explore the feasibility of personal property loans.

Conclusion

Recognizing the potential benefits of ADUs, activists, lawmakers, regulators, and other stakeholders have made significant progress in lowering the barriers of construction: zoning regulations have been eased, permit fees reduced, and resources developed to help homeowners through the process. The call for breaking down barriers to ADU finance has also been heeded to some extent by the government agencies and regulators who have made important strides, most notably and recently, Freddie Mac, in incorporating ADUs into their guidelines.

This paper provides a roadmap for targeted and achievable reforms that can help make government-backed renovation loans more useful for would-be ADU builders. Progress need not stop there; non-governmental actors–private sector, researchers, and even those representing philanthropic sources of capital–can have a role to play in advancing traditional and non-traditional financing products alike. With a more mature ADU financing market, we can unlock increased ADU production throughout the United States and do it in ways that better support the needs of lower- and moderate- income homeowners.

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6. Ibid. 19% of homeowners with an ADU rent to a family member or acquaintance.

7. Valchuis, Eric (2020). “HomeOn: Providing Loans to Homeowners to Construct Accessory Dwelling Units.” Professional Report submitted in partial satisfaction of the requirements for the degree of Master of City Planning at the University of California, Berkeley. An ADU in Oakland, California, rented at market rents, generates a ~12.0% annual return on investment; the S&P 500 has returned 9.6% annually since 1926.

8. Kermani, Amir, and Francis Wong. “Racial Disparities in Housing Returns.” NBER Working Paper Series. National Bureau of Economic Research, September 2021.

9. Chapple, et al., “Implementing the Backyard Revolution”

10. Chapple, Karen, David Garcia, Eric Valchuis, and Julian Tucker. “Reaching California’s ADU Potential: Progress to Date and the Need for ADU Finance.” Center for Community Innovation and the Terner Center for Housing Innovation: University of California, Berkeley, August 2020. http://ternercenter.berkeley.edu/uploads/Reaching_Californias_ADU_Potential_2020_1.pdf

11. In “Reaching California’s ADU Potential,” a study of building permits for ADUs in California shows that ADUs are more likely to be built in neighborhoods with high home values. While in regions such as Los Angeles, ADUs are more likely to be built in areas with a greater percent of Latinx and Black residents, in places like San Francisco and San Diego, the opposite is true. In “Implementing the Backyard Revolution,” a survey of homeowners who have built an ADU showed that homeowners with an ADU are much more affluent and less likely to identify as Hispanic or Latinx than the typical Californian homeowner.

12 We specifically focused on identifying products geared towards homeowners as owner-occupation is the predominant form of tenure in the United States–64% of the homes in the United States are owner-occupied (ACS 2019, Table B25003). Further, compared to investors or corporate landlords, individual homeowners have historically shown greater willingness to build ADUs, having built 92 percent of them in California in 2018 and 2019 (Chapple, et al., “Reaching California’s ADU Potential”)

15. We focused on loans that are secured by government agencies, such as the Federal Housing Administration (FHA) and the Department of Veterans Affairs (VA), or government-sponsored enterprises, such as Fannie Mae and Freddie Mac (collectively “agencies” issuing “government-backed loans”) as, since the foreclosure crisis, government-backed loans have been the predominant form of financing residential real estate in the United States and generally have the lowest interest rates and fees for borrowers with the greatest regulatory oversight.

16. Chapple at al., “Implementing the Backyard Revolution” Respondents, those who have built an ADU in California, were asked to check all of the financing sources that they utilized to fund their ADU construction. The data presented here reflects homeowners who permitted their ADU in either 2018 or 2019 when interest rates for a 30-year fixed rate mortgage were between 3.74 - 4.94% (Primary Mortgage Market Survey, Freddie Mac. Retrieved on March 22, 2022 from https://www.freddiemac.com/pmms). While interest rates are currently in line with these figures (4.16% as of March 17, 2022), the predominant sentiment among interviewees is that interest rates will follow its current trajectory (between August 2021 and March 2022, interest rates for a 30-year fixed rate mortgage have increased by 139 basis points) and continue to increase. The implication is that while this data is instructive, it is influenced by the unique circumstances of the time in which it was captured.

17. Ibid. Respondents, those who have built an ADU in California, were asked what kind of loan they took out and to select all that applied. The options provided were “Home Equity Line of Credit,” “Refinancing,” “Construction Loan,” and “Personal Loan.” Personal loan, as it is not a mortgage product, is not shown in Figure 1. The other category names have been modified to use consistent nomenclature in this paper.

18. Home Mortgage Disclosure Act. 2020 data, all financial institutions. Retrieved March 22, 2022 from https://ffiec.cfpb.gov/data-browser/data/2020?category=states

19. The one participant that did not agree felt that renovation loans have structural issues which will ensure they remain niche products. These structural issues are addressed further in this paper.

20. “Selling Guide: Fannie Mae Single Family.” Fannie Mae, February 2, 2022. https://singlefamily.fanniemae.com/media/document/pdf/selling-guide-march-2-2022?_ga=2.187774895.607046413.1647571128-512140567.1641778380, section B-2-3-04.

21. The limited exception is for the HomeReady mortgage–Fannie Mae’s mortgage product designed for borrowers who earn 80% of area median income. Fannie Mae considers “boarder income”--income received by a non-interested party which has been consistent over the previous 12 month period–as stable income.

22. “Seller/Servicer Guide.” Freddie Mac Single-Family, February 2, 2022. https://guide.freddiemac.com/ci/okcsFattach/get/1002095_2, section 5306.1. Freddie Mac will also consider income from an ADU as stable if the homeowner has a disability and they receive rental income from a live-in aid. They will also consider boarder income as stable for their Home Possible Mortgage product, Freddie Mac’s counterpart to Fannie Mae’s HomeReady mortgage.

23. “Lender’s Handbook VA Pamphlet 26-7, Revised.” U.S. Department of Veterans Affairs, n.d. https://benefits.va.gov/warms/pam26_7.asp,chapter 4.2.n

24. “Handbook 4000.1, FHA Single Family Housing Policy Handbook, Title I Content.” US. Department of Housing and Urban Development, November 9, 2021. https://www.hud.gov/sites/dfiles/OCHCO/documents/4000.1hsgh-112021.pdf.

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25. This certification could be analogous to the one borrowers must make that they plan to live in their home for at least one year to avoid the “investment property” loan-level price adjustment.

26. Freddie Mac will not purchase a four-unit property with an ADU

28. FHA Single Family Housing Policy Handbook, section II, A, 8, a, vi, A, 2, b, page 389.

29 Insurance of mortgages, Pub. L. No. 12 U.S. Code § 1709 (n.d.). https://www.law.cornell.edu/uscode/text/12/1709, section 203(k)

30. “Selling Guide: Fannie Mae Single Family”, page 754.

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33. “Budget in Brief: Fiscal Year 2022.” https://www.hud.gov/sites/dfiles/CFO/documents/2022_Budget_in_Brief_FINAL.pdf, n.d., page 8 (see “Housing Counseling Assistance”)

34. Walsh, John, and Jung Hyun Choi. “California’s New Zoning Law Eases Building Restrictions but Depends on the Financing Industry to Play Its Part.” Urban Institute, January 6, 2022. https://www.urban.org/urban-wire/californias-new-zoning-law-eases-building-restrictions-depends-financing-industry-play-its-part.

35. “Summary of Issues Related to ADU Financing and Due-on-Sale Clause.” Dweller, n.d.

36. In California, per Section 18007 of the Health and Safety Code, a manufactured is a non-site built structure that was built after June 15, 1976, is transportable in sections, is built on a permanent chassis, and is designed to be used as a single-family dwelling with or without a foundation, and includes plumbing, heating, air conditioning, and electric systems. California Health and Safety code states that a manufactured home “may be installed on a foundation system either as a fixture…or…as chattel.”

37. Consumer Financial Protection Bureau’s Offices of Research and Mortgage Markets. “Manufactured Housing Finance: New Insights from the Home Mortgage Disclosure Act Data,” May 2021. Page 25. Median interest rate on a personal property loan for a manufactured home is 8.6% versus 4.9% on other manufactured housing loans.