LA Project REACh
ADU Financing Subcommittee White Paper
September 1, 2022

I. Overview

In July 2020, the Office of Comptroller of the Currency (OCC) launched the Project Roundtable for Economic Access and Change (REACh), a national initiative to identify ways that financial institutions can address racial inequity and systemic barriers to economic opportunity in the areas of Small Business Growth, Minority Depository Institutions (MDIs) and Expanding Home Ownership. Project REACh brings together leaders from the banking industry, national civil rights organizations, business representatives, and technology firms and seeks to eliminate the specific barriers that prevent full, equal, and fair participation in the nation's economy.[1] Project REACh was initiated in the aftermath of George Floyd's murder and during the Covid-19 pandemic which disproportionately impacted people of color.

To further the goals of the national Project REACh initiative, in October 2020 the OCC created the Greater LA Project REACh initiative encompassing a five-county area (Los Angeles, Orange, Ventura, San Bernardino, and Riverside). Like its national counterpart, LA Project REACh focuses on Small Business Growth, MDIs and Expanding Home Ownership.

Through a series of meetings, LA REACh's Homeownership Workgroup (HWG) identified key areas of focus: (1) make progress in closing the homeownership gap between white and non-white homeowners by expanding homeownership for minority

[1] See occ.gov/REACh: https://www.occ.treas.gov/topics/consumers-and-communities/minority-outreach/project-reach.html

and low-and moderate-income (LMI) homebuyers[2] and (2) promote homeownership preservation. In addition, the HWG was concerned that homeowners may be experiencing financial hardship with the end of foreclosure moratoria established during the pandemic and that a large group of homeowners could potentially be at risk of losing their homes to foreclosure. Thus, the HWG decided to first focus on homeownership preservation efforts.

As the HWG explored the challenges facing minority and LMI homebuyers, it identified the lack of affordable inventory as a key challenge in the Los Angeles market.[3] In light of the limited inventory, the HWG looked to other models to expand homeownership and housing opportunities such as Accessory Dwelling Units (ADUs). ADUs have gained much attention as a potential vehicle to help alleviate some of the inventory issues in the region. However, barriers to financing emerged as one of foremost challenges to taking ADUs to scale, particularly for lower income households. In furtherance of LA Project REACh's homeownership efforts, the OCC created an HWG subcommittee to focus on the challenges of ADU financing in July 2021. [4]

The ADU Subcommittee was comprised of representatives from the OCC, financial institutions and housing experts and heard from a variety of speakers on ADU issues such as Government Sponsored Enterprises (GSE) financing, appraisals and related issues.[5] The subcommittee determined that developing a White Paper would be an effective way to advance ADU financing strategies. This White Paper reflects the Subcommittee's analysis and recommendations following this review. The ADU Subcommittee drew on the excellent research conducted by the Casita Coalition, Terner Center for Housing Innovation, the Urban Institute and USC Lusk Center for Real Estate among others.

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[2] *Reducing the Racial Homeownership Gap*, Urban Institute https://www.urban.org/policy-centers/housing-finance-policy-center/projects/reducing-racial-homeownership-gap
[3] https://www.nar.realtor/newsroom/record-high-prices-and-record-low-inventory-make-it-increasingly-difficult-to-achieve-homeownership-particularly-for-black-americans
[4] For description and definition of ADUs see: https://www.hcd.ca.gov/policy-research/accessorydwellingunits.shtml
[5] A complete list of speakers who joined ADU Subcommittee meetings is attached as Appendix A.

The goal of this White Paper is to build on and add to this work with a specific focus on ADU financing. **The views and positions expressed in the document reflect the individual perspectives of ADU Subcommittee participants and may or may not reflect the views of their respective employers.**

II. Discussion

A. ADUs Potential to Increase LA's Housing Supply

In recent years, as California continues to face an acute housing shortage, ADUs have become increasingly popular as a means of increasing the state's housing supply. It has been estimated that ADUs have the potential for creating nearly 1.5 million new housing units statewide.[6] Most notably, since 2016, ADUs have gained traction in California after the state legislature passed a series of bills which eased permitting, parking and other regulations.[7] Similarly, at the local level, cities throughout California have adopted measures which facilitated ADU production. Through these efforts, the number of permits for ADUs accelerated significantly and reached 33,881 in 2020.[8] In the City of Los Angeles, a total of 6,747 permits were issued for ADUs and account for approximately 20% of all housing permits issued.[9] However, a significant percentage of the permits did not yield completed projects. Moreover, of the ADUs completed, the majority were in higher income communities, primarily with cash resources. [10]

B. Community Stabilization

In addition to providing critically needed housing supply, ADUs potentially provide an important tool for stabilizing communities as LA faces increased gentrification. ADUs can provide critically needed income allowing families to purchase a home, to remain in

[6] Chapple et al, *"Reaching California's ADU Potential: Progress to Date and the Need for ADU Finance,"* Terner Center for Housing Innovation, August 2020.
[7] In 2016, California passed statewide ADU reform in SB 1069 and modified in 2017 by SB 229 and AB 494 which require cities to permit one ADU per single family home; streamline ADU permitting by using a ministerial rather than discretionary process, and other provisions to facilitate the construction of ADUs.
[8] www.aducalifornia.org
[9] California Department of Housing and Community Development; ladbs.org/adu
[10] Chapple et al, *"Reaching California's ADU Potential: Progress to Date and the Need for ADU Finance,"* Terner Center for Housing Innovation, August 2020.

their homes or allow for multi-generational housing. Accordingly, ADUs could potentially preserve or build generational wealth accrued through homeownership. [11]

C. Market Opportunity

As the California Legislature continues to address land use issues to promote housing supply, the potential for ADUs will continue to increase. For example, California Senate Bill 9[12], California Housing Opportunity and More Efficiency (HOME") Act, approved in September 2021 allows for two unique opportunities: duplexes and lot splitting.

- Duplexes: Most CA homeowners will now be able to build two homes on single family zoned lots.
- Lot-splitting: Under SB 9, homeowners now have the option to sell a portion of their lot and allow property owners to construct up to two units on the newly created lots.

SB 9 has the potential to create over 700,000 new homes.[13] In addition, the Terner Center for Housing Innovation found that SB 9 could enable the expansion of smaller-scaled housing in higher-resourced, existing single-family communities.[14]

Importantly, SB 9 contains significant principles to promote Black Indigenous and People of Color (BIPOC) community protections including:

- Provisions in the legislation are designed to benefit homeowners rather than investors.[15] Prior to the approval of a lot-split, SB 9 requires that the homeowner live in one of the existing units for a minimum of three (3) years. The same

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[11] Ibid., p.2; ADU Subcommittee discussion with Lori Gay, CEO, LA Neighborhood Housing Services, Sept. 13, 2021
[12] Senate Bill 9: Housing development approvals, April 27, 2021. https://leginfo.legislature.ca.gov/faces/billVersionsCompareClient.xhtml?bill_id=202120220SB9
[13] "Will Allowing Duplexes and Lot Splits on Parcels Zoned for Single-Family Create New Homes?" Terner Center for Housing Innovation, UC Berkely, 2021 https://ternercenter.berkeley.edu/wp-content/uploads/2021/07/SB-9-Brief-July-2021-Final.pdf
[14] Ibid.
[15] Ibid.

individual cannot split a lot that is adjacent to the subject property. The requirement is intended to prevent a potential investor from buying up a neighborhood to split and develop.

- Safeguards in the legislation prevent current renters from being displaced. Housing that has been occupied for three years by a tenant are excluded. In addition, homes that are housing moderate-, low- or very-low-income households and/or under rent-control – cannot be demolished because of a lot split.

SB 9 provides an important advance in utilizing residential lots with an occupied single family home. Under this law, a lot can be split to allow one single family home and an ADU on one half of the lot and two additional ADUs on the other part of the parcel. [16]

D. Challenges to ADU Financing

While interest in constructing ADUs has intensified, there remains a fundamental challenge of the absence of a widely available sustainable and flexible lending products to finance ADUs. ADUs can be a part of the solution to address the shortage of affordable housing, but only if low- to moderate- income, credit worthy borrowers can finance the construction of an ADU. In order to address the challenge of ADU financing, municipalities throughout CA, such as LA County and the cities of Oakland, Los Angeles and Pasadena have developed programs to facilitate ADU construction. Some programs have been designed with an affordable housing component by which an ADU tenant's rent is capped, or the tenant holds a Section 8 voucher. However, while providing needed affordable housing units, such an approach does not further the goal of providing a maximum income stream to the homeowner. Accordingly, these models are limited in their efficacy of getting to scale with ADU production.

When the ADU Subcommittee began its work, the use of ADU rental income was only available as a means for a home buyer to qualify for a loan in very limited instances. However, in June 2022, Freddie Mac announced new guidelines for ADU rental income

[16] Ibid.

that are a significant departure from past GSE policies.[17] These policy changes represent a significant advance in ADU financing and a new receptiveness by a GSE to consider ADU income for loan qualification purposes. Under these guidelines, Freddie Mac now allows one ADU on 1,2 or 3 unit properties and rental income generated from an ADU on a 1-unit primary residence can be used to qualify when certain requirements are met (e.g. appraisal, current lease or rental analysis).

While the recent advances are very positive, there are a variety of reasons for the current challenge in ADU financing:

Lenders

- Standard conventional and government financing offer limited opportunities for prospective rental income from an ADU to be factored as part of loan qualification.
- Appraisers are not provided with or are unaware of consistent policies for assigning value to an ADU. Without an effective valuation, the financing will not provide sufficient funds to build or renovate an ADU.
- Construction and renovation loans carry additional risks that can be addressed but requires a lender to create full scope loan origination, fulfillment, construction management and loan sale process designed for this type of financing.
- Most investors require lenders to hold recourse, meaning they have the obligation to buy back a loan if the construction or rehab goes into default related to a construction issue.
- There are relatively few lenders offering these types of products. Major financial institutions have exited FHA 203k and conventional Single-Family (SF) construction programs.

[17] Guide Section 5306.3 (freddiemac.com);

- For depository institutions, there may be additional risk management and reserve requirements that banks would need to consider related to construction lending.

Consumers

- Homebuyers, and in particular LMI homebuyers, may need to rely on the ADU income to qualify for a mortgage. However, as noted above until June 2022 most current financing products either do not allow the ADU rental income to be included for credit qualification or impose risk parameters that may be difficult to meet. For example, the property appraiser may have a difficult time finding data on property comparables ("comps") with ADUs.
- Most homeowners and homebuyers are not experienced in the construction/rehab management process.
- Homeowners and homebuyers may not be experienced in rental management.
- Interested consumers may not know where to start and how to locate resources.
- Even with substantial home equity, some homeowners may be wary of taking on additional debt.
- As interest rates rise, fewer homeowners will seek refinancing as a way to finance ADUs, particularly if they benefitted from the historically low rates of the last few years.

While most ADUs are currently financed by cash derived from a cash-out refinance of an existing property, cash from a Home Equity Line of Credit or cash savings, we need to consider additional scenarios, where the right financing can boost affordable inventory.[18] Addressing all of the scenarios will be a meaningful advance in getting to scale in ADU development, however, not all the scenarios are equally in need of development and innovation. The focus of the OCC Project REACh ADU Subcommittee

[18] Casita Coalition, ADU finance Guide for Homeowners, March 18, 2021, https://www.hcd.ca.gov/policy-research/accessorydwellingunits/docs/cc%20adu%20finance%20guide%20for%20homeowners%20v5%203.18.21_ada.pdf

is on LMI communities and closing the racial homeownership gap while providing expanded opportunities for all families to gain generational wealth. While the expansion of ADU financing will benefit all the scenarios, there is a particular need for a focus on providing financing for the potential homeowners described in scenario 6 below.

Scenario 1: A current homeowner wants to build an ADU without changing their first mortgage financing

Financing in this scenario is often accomplished with a Home Equity Line of Credit, an amortized second mortgage or the homeowner may have cash resources. To date, this has been an advantageous situation, particularly as borrowers in California take advantage of the relaxed statewide zoning changes combined with the strong equity growth, where existing borrowers can use the cash available to build an income- producing unit.

Scenario 2: A homeowners who owns free and clear (without a mortgage) taking out a new first mortgage to build an ADU

Although, not often mentioned, almost 30% of homeowners in Los Angeles County have paid off their homes.[19] Some are described as house-rich and cash-poor. This segment may benefit from using a financing mechanism that allows the proposed rent to be used for credit qualifying and uses the "after-improved" value.

In this scenario, Fannie Mae will treat the loan as a Limited Cash-Out Refinance under their HomeStyle Renovation where an ADU is an eligible improvement. Freddie Mac also offers this option with CHOICERenovation. Both HomeStyle Renovation and CHOICERenovation could provide the cash required to build an ADU through the recognition of the "after-improved" value to calculate the maximum loan amount. Finally, FHA offers the 203k loan program which allows the funds derived from the "after improved" value to be used to build an *attached*

[19]According to the U.S. Census American Communities Survey, 29.5% of all owner-occupied housing units in Los Angeles County are owned free and clear.

ADU. A lender who offers the industry's renovation products will have the infrastructure required to collaborate with the consumer through the build process.

Scenario 3: A current homeowner will use a cash-out refinance to build ADU

Cash-out refinances in the past few years have allowed existing owners to lower their mortgage interest rate, while borrowing cash to build an ADU. In some cases, an increase in their monthly mortgage payment could be more than covered from the income produced by the ADU. Freddie Mac's June 2022 changes to their product guidelines provide homeowners with the opportunity to use their CHOICERenovation product for a refinance where the funds are used to pay off debt incurred by the construction or renovation of an ADU. With 2022 increases in mortgage interest rates, there will be fewer borrowers who can take advantage of this option and they will choose to fall into scenario number one.

Scenario 4: The construction of a new home along with the construction of an ADU

The most likely borrower in this scenario is one with strong resources and excellent credit to qualify for a construction loan. Construction lending is considered a niche product and a borrower in this scenario is most likely to obtain their loan from their existing banking partner or a commercial lender.

Scenario 5: Purchase of an existing home with an ADU that is rented

In this scenario, there are existing mortgage products that may work, although more challenging for a first-time homebuyer with lower cash resources. The credit qualifying guidelines may allow some of the ADU income to be included in the buyer's monthly income for purposes of qualifying. However, the purchase loan guidelines are not consistent across conventional or government loan investors, guarantors, or mortgage insurance companies. Counting the income or a percentage of income from an ADU may be impacted by how the lender and/or appraiser identifies the property, as either an ADU or 2-unit, as well as the type of product and the lender's underwriting and credit risk overlays.

Scenario 6: Purchase of an existing home with the intent to build an ADU

This is the most challenging scenario and involves a borrower who wants to buy a home and build an ADU to provide future income that can help cover their monthly mortgage payment. This is the scenario where the industry needs to bring new ways of financing to reach borrowers who can benefit from an income source of a two unit but constructed as a main home with an attached or detached ADU. It is recognized that this type of financing would be most effective if it allows some percentage of the future income of the ADU to be used for credit qualifying and uses an "after improved" appraisal to determine the maximum loan amount. It will take research, risk weighting, policy changes and credit enhancement, but the requirements already exist as elements of existing mortgage finance products.

In order to address these scenarios, stakeholders need to come together to develop and conduct a pilot where there would be a partnership with lenders, a local housing department with pre-approved ADU plans, a targeted communication within the appraisal community and the GSEs allowing some percentage of the proposed ADU rental income. There would have to be offsetting risk parameters, but this step forward can test the model and begin making a difference for low-to moderate-income families who could benefit from this homeownership and generational wealth building opportunity.

The primary components of a potential pilot are illustrated below and include 10 critical features. The ADU Subcommittee can continue to serve as a platform to ensure the development of a pilot, but there is a need for an entity to take on leadership to manage the pilot as a concept test. The results of this proof of concept, and changes as may be identified can be leveraged to create a more widely distributed source of financing; that is, if the financing product that is tested proves to be accepted by lenders, investors and consumers. The proof of concept will also require the collection of data and the establishment of success factors to ensure an effective launch, as well as the ability to quantify the results.

Pilot Components

1. Identify a geographic area within the scope of LA REACh where favorable zoning can be leveraged to offer an innovative ADU financing pilot.

2. Identify 3-5 pilot mortgage lenders interested is testing the ADU financing product for origination. These could be mortgage bankers, commercial bankers, Community Development Finance Institutions (CDFIs) or nonprofits. To participate in the pilot, a lender may need to obtain a variance from their loan investor. The pilot will test new guidelines and policies not yet approved for all lenders. The variance process requires a lender to make a formal request and lay out the business case for testing the new guidelines. If approved, the variance language is a legal agreement and specific to each lender.

3. Lenders often rely on warehouse lines of credit to fund or purchase mortgage loans. The warehouse lender may restrict the type of loans that are funded. For a pilot, we would need to ensure the lenders warehouse lines will allow participation.

4. Identify a take-out lender willing to buy the mortgage loans once closed. This could be one of the originating lenders or a named master servicer or housing finance agency.

5. Partner with a mortgage insurance agency to create acceptable risk variances.

6. Gain support from local appraisal oversight team to issue guidance on how to determine the "after improved", and with ADU value using the income approach as one component of a comparison appraisal.

7. Create guidelines, checklists, policies, procedures, audit and loan servicing practices specifically for ADU financing.

8. Identify a loan servicer(s) (or outsourced provider) with the willingness and ability to manage the construction process, providing contractor approval, property inspections, fund disbursement, change order review and approval, process a loan modification (if needed) and convert the loan upon completion.

9. Identify potential GSE or private investors of whole loans, or Mortgage Backed Securities (MBS) backed by a specific percentage of ADU loans in the mortgage loan pool.

10. Partner with non-profit housing counselors who will provide crucially needed landlord education to homeowners.

Other partners that can support success of an ADU pilot include localities that offer pre-approved ADU models, down payment assistance programs funded by eligible sources and providers of home buyer education and credit counseling.

To ensure the scalability of this type of financing, it is critical to consider ways of encouraging more lenders to participate in construction lending. Construction loans require technology support throughout the loan origination and construction process. Even if loans are sold prior to construction completion, the lender holds representation and warrant risk until construction is complete. The risk and business issues are complex, but they can be mitigated with construction loan technology, including loan origination, construction management and servicing systems. In addition, the process must include builder reviews, construction project underwriting, property inspections and comprehensive draw disbursement policies. ADU builds require unique borrower construction support related to renovation or construction financing. Currently, there are not enough lenders with this expertise.

The most scalable construction loan product would be one that encourages non-banks, as well as banks to participate in ADU construction financing. This can be accomplished by offering an interest rate risk transfer by selling the loan prior to construction completion, much like 203k, GSE renovation and some One Time Close construction programs operate today.

Even a city pre-approved ADU plan requires construction loan servicing through the build process. The process of adding an ADU requires construction loan financing. However, though small ADUs have many of the same pressure points of larger scale construction projects such as cost-overruns and supply-chain issues.

The California Housing Finance Agency (CalHFA) has demonstrated their commitment to being a catalyst to supporting ADU financing. CalHFA is offering a grant program that is entrepreneurial and available to lenders throughout CA. CalHFA offers a grant for up to $40,000 to cover predevelopment costs, non-recurring closing costs, including rate buydowns. It is a true grant that does not require repayment. To apply for the grant, the borrower must apply for a construction loan with a CalHFA-approved lender. The lender provides a list of costs and invoices to apply for the grant. The funds for the grant are added to their construction loan amount, which will lower their loan principal by the amount of the grant. Currently, the participating lenders are mortgage companies and there is only one participating depository bank.[20]

Appraisal Issues

The current challenge facing the appraisal of an ADU is that most appraisers do not capture the total value of an ADU property. An ADU adds value to a home, but it typically does not stack up to the total cost of construction. [21] Appraisers do have access to the tools they can leverage for the valuation of the ADU but lack industry/regulatory adoption. In addition, there is often little comparable neighborhood data on ADUs to facilitate the appraisal of an ADU. This appraisal issue adds to other appraisal issues now being looked at such as racial disparity in appraisals. [22]

E. Recommendations

- GSE's should allow at least 75% of ADU income to be factored in a borrower's loan qualification. Risk related to proposed ADU income can be mitigated by assessment of two-four unit performance and a requirement for appraisers to assign a value to market rate rental income for the area and size of the unit. Freddie Mac has incorporated important risk offsetting factors in their June 2022 guidelines: They will allow up to 75% of the ADU rental income to be counted

[20] Mortgage companies participating in this program as of 8/29/22 are: Academy Mortgage Corporation, Art-La-Tex Financial Services, Inc. dba Benchmark, CalCon, Inc., Envoy Mortgage Ltd., Evergreen Home Loans, Guild Mortgage, LLC Renovation Specialist Financing Team, Homebridge Financial Services, Inc., LoanDepot, MLD Mortgage, Inc. dba The Money Store, Mortgage Management Consultants, Inc. dba MMC Lending, Platinum Home Mortgage Corporation, Primary Residential Mortgage, Inc. and Flagstar Bank.

[21] Terner Center for Housing Innovation and USC Lusk Center for Real Estate ADU Construction Finance Webinar (June 7, 2022).

[22] Action Plan | PAVE (hud.gov); *"Increasing Diversity in the Appraisal Profession Combined with Short-Term Solutions Can Help Address Valuation Bias for Homeowners of Color*," Urban Institute, Urban Wire, July 2021, https://www.urban.org/urban-wire/increasing-diversity-appraisal-profession-combined-short-term-solutions-can-help-address-valuation-bias-homeowners-color

toward credit qualifying income, not to exceed 30% of the total qualifying income. If available, the lender must use a lease to determine the net rental income and the appraiser is required to provide a rental analysis. If a lease is not available, the ADU rental analysis must be used to determine the net rental income.

- Revise GSE appraisal forms to note ADUs on a property.
- More consistency in appraisal process for valuing ADUs as well as training is needed.
- Include education on the ADU process, ADU construction loans and landlord training as part of a borrower's financing offering.
- Expand other existing tools such as 203k, which is currently limited because the ADU must be attached to the existing home, as well as other renovation tools.
- An ADU appraisal valuation study for the Greater LA REACh area is needed as part of a plan to generate more consistency in the appraisal process.[23]
- Home improvement second mortgages are needed for ADU construction.

III. Conclusion

Piloting a scalable financing option and allowing sufficient time for the program to yield results will be a major step forward in advancing ADUs as a resource to combat the affordability and inventory issues faced by California and the nation. ADUs have the potential to fundamentally alter the landscape of housing availability in Los Angeles and help promote community stabilization. To accomplish these goals, new models of home financing are needed to fully realize the potential of this housing solution. Addressing the challenge of ADU financing will take innovation and new approaches to mortgage lending.

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[23] See: Appraising ADUs, Leading Research on Valuing Contributory Value of ADUs

Appendix A

Members of the LA Project REACh Subcommittee

- Beth Castro, District Community Affairs Officer, Office of the Comptroller of the Currency

- Cristian Correa, Senior Vice President, Caliber Home Loans

- Carmel Sella, Senior Vice President, Government Relations and Public Policy, Wells Fargo

- Dottie Sheppick, Founder, Specialty Mortgage Product Solutions, LLC

Appendix B

Guest Speakers at ADU Subcommittee meetings

- Professor Richard Green, Director, USC Lusk Center for Real Estate

- Mike Smeltzer, Senior Vice President, Non-QM Products, and Neil Merritt, Vice President of Product Strategy, Newrez LLC

- Loran Sharp, President of Accelerated Appraisal Group

- Sarah Gerecke, Jung Choi, Gideon Berger, John Walsh, Urban Institute

- Lori Gay, CEO, Los Angeles Neighborhood Housing Services

- Ben Metcalf, Terner Center for Housing Innovation at UC Berkeley

- Sharyl Silva, Single Family Production Manager, California Housing Finance Agency

- Dan Hardcastle, Special Assistant for Special Projects, Office of the Secretary, U.S. Department of Housing and Urban Development

- Mike Hernandez, Engagement and Impact Team, Fannie Mae; Jeffrey Zitelman, Product and Policy Development, Fannie Mae

- Sharon McLendon, Affordable Lending Manager; Kelly Noonan Marrocco, Director, Affordable Credit & Policy; Mark Spates, Director Strategy and Policy; Jeremiah Cruzan, Client Credit Management; and Scott Douglass, Director Collateral Policy, Freddie Mac