Accessory Dwelling Unit Program Evaluation

Pursuant to Health and Safety Code Section 51532, the **California Housing Finance Agency** is pleased to submit this report to the Legislature providing an evaluation of the **CalHFA Accessory Dwelling Unit Grant Program**.

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Please call (916) 326-8000 to request a hard copy of the report.

Summary

The 2020-21 State Budget (Senate Bill [SB] 115, Skinner) provided the California Housing Finance Agency (CalHFA) with $81 million to fund a program to assist homeowners in qualifying for loans to construct accessory dwelling units (ADUs) and junior accessory dwelling units (JADUs) on the homeowners' property and increase access to capital for homeowners interested in building ADUs and JADUs.

Pursuant to Section 51532 of the California Health and Safety Code, this report provides an evaluation of CalHFA's ADU Grant Program, including key demographic and geographic outcomes and the impact of the program on the ADU lending and construction environment.

Introduction And Overview

In September 2021, CalHFA introduced the CalHFA Accessory Dwelling Unit (ADU) Grant Program, which provides funding for predevelopment (i.e., any activities to get the site ready for construction) and other costs necessary to build an ADU. CalHFA had a total of $125 million available for the ADU Grant Program over two phases.

Phase 1 of the ADU Grant Program was funded by $81 million in State General Funds from the Fiscal Year 2020-21 State Budget. CalHFA supplemented this amount with an additional $19 million in discretionary Assembly Bill (AB) 101 (2019, Ting) funds for total Phase 1 funding of $100 million.

The 2023-24 State Budget (SB 104, Skinner) provided CalHFA with a one-time appropriation of $25 million to be used for a Phase 2 of the ADU Grant Program.

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Program Parameters

Phase 1

When first established in September 2021, the ADU Grant Program offered a $25,000 grant to fund ADU predevelopment costs (e.g., architectural designs, permits, impact fees, soil tests, property surveys, energy reports, utility hookups, etc.). Eligible homeowners included lower income households (i.e., under 80% Area Median Income [AMI]); moderate-income households (i.e., up to 150% AMI) located in a Socially Disadvantaged Area (e.g., homeowners with high or highest vulnerability as defined in UCLA's CA COVID-19 Owner Vulnerability Index); and moderate-income households with low equity.

In response to a volatile interest rate environment as well as rising material and labor costs, CalHFA increased the grant amount from $25,000 to $40,000 in March 2022. In addition, CalHFA expanded the definition of eligible costs to include all non-reoccurring closing costs associated with the construction financing, which would include costs to buydown the interest rate. Finally, CalHFA expanded income eligibility to include low- to moderate-income homeowners regardless of location or home equity level.

Phase 2

Consistent with legislative expectations and CalHFA Board of Directors approvals, Phase 2 maintained the same program parameters but reduced income eligibility to lower-income homeowners seeking to build an ADU.

Delivery System

Because CalHFA is not a direct lender (i.e., it does not provide loans or funds directly to homeowners), the ADU Grant Program was deployed through CalHFA's network of ADU partners, including lenders, credit unions, nonprofits, and local government agencies qualified to manage the grant funds in accordance with the ADU Grant Program guidelines.

CalHFA's network of program partners prequalified homeowners for the CalHFA ADU grant and reserved the grant in CalHFA's system. When the project was ready for funding, the ADU Grant Program partner submitted the required documentation to CalHFA for review and approval. Once approved, CalHFA wired funds directly to the construction escrow account managed by the ADU Grant Program partner, as described further below.

Construction Escrow Requirements

ADU grant funds were required to be deposited into a construction escrow account, a typical feature of construction lending. Construction lenders rely on construction escrow accounts to ensure that sufficient funds are available to complete the construction project, that the borrower uses a properly licensed and insured contractor, and that project construction milestones are met (among other features and requirements).

For the ADU Grant Program, the grant funds were deposited into a construction escrow account managed by CalHFA's network of participating ADU partners. The lender or partner then releases funds in accordance with CalHFA's program guidelines and their program participation agreement with CalHFA. This ensures that ADU grant funds were only spent on eligible costs.

Grant funds may only be distributed to directly pay vendors or to write down the principal balance on the loan associated with the ADU (e.g., HELOC, etc.). No grant funds may be distributed directly to the grantee.

Due to the varied complexity and duration of construction projects, ADU grant funds do not currently have an expiration date. Lenders are encouraged to manage their pipeline effectively to make sure all grant awardees are in process and working toward completing their project. When the ADU project is complete, the lender/partner is required to submit the Certificate of Occupancy (COO) to CalHFA. If they are not able to produce a COO, the lender must return the grant funds to CalHFA.

Lender, Nonprofit, and CDFI Participation

At the outset of the ADU Grant Program, construction escrow management services were only offered by traditional lenders that offered construction and renovation financing. Because construction lending is very complex and financially risky for the lender, and because construction financing for ADUs was a fairly new consumer market, lender participation rates were somewhat low at the beginning of the program.

Interest rates began to rise in early 2022, significantly impacting the market for construction and renovation financing. Construction and renovation financing generally requires the homeowner to refinance their first mortgage at current interest rates. However, with many homeowners locked into historically low interest rates, traditional construction financing was not an attractive approach to funding their ADU construction project.

In response to these dynamics, CalHFA worked to establish new partnerships with nonprofit organizations that could provide the managed construction escrow feature as a third party to the construction financing. These partnerships offered significant financing flexibility that allowed for different types of financing (e.g., home equity line of credit, second mortgage, cash-out refinance). Borrowers could use the type of financing that worked best for their unique situation and deposit those funds with the third party managed construction escrow provider, who would then oversee the construction of the project and offer CalHFA the needed assurances that the ADU will ultimately be constructed.

Traditional lenders could also partner with the third-party construction escrow provider to offer additional financing opportunities to their borrowers.

CalHFA also worked with various local government programs that offered ADU construction financing conducive to the ADU Grant Program. **Figure 1**, below, lists the lenders, credit unions, nonprofits, and local governments that participated in the ADU Grant Program.

Figure 1: ADU Grant Program Partners

Lenders

1. Academy Mortgage
2. American Financial Network
3. American Pacific Mortgage
4. Bay Valley Mortgage Group
5. Benchmark
6. Caliber Home Loans
7. Castle & Cooke Mortgage
8. CMG Mortgage
9. Envoy Mortgage
10. Evergreen Home Loan
11. Fairway Independent Mortgage
12. First Northern Bank
13. Flagstar Bank
14. Guaranteed Rate
15. Guaranteed Rate Affinity
16. Guild Mortgage
17. Homebridge Financial
18. JMJ Financial
19. Land Home Financial
20. LoanDepot
21. The Money Store
22. Mortgage Management Consultants
23. New American Funding
24. NewRez, LLC
25. One Trust Home Loans
26. PFN Lending Group
27. Platinum Home Mortgage
28. Primary Residential Mortgage
29. Priority Financial Network
30. Supreme Lending

Credit Unions

1. Patelco Credit Union
2. Redwood Credit Union
3. Self-Help Credit Union

Nonprofits

1. California Community Economic Development Association (CCEDA)
2. Hello Housing
3. HPP Cares
4. Neighborhood Housing Services of LA County (NHSLA)
5. Neighborhood Partnership Housing Services, Inc. (NPHS)
6. Self-Help Enterprises

Local Governments and Public Agencies

1. City of Oakland
2. City of Pasadena
3. City of West Hollywood
4. San Diego Housing Commission

Program Outcomes to Date

ADU construction projects are challenging and complicated, and durations for project completion vary greatly. Design and permitting often remains a protracted process for many, sometimes taking multiple years for homeowners to navigate. In addition, many homeowners begin the process of planning their ADU only to find that their project is not feasible due to the high interest rate environment, site constraints, costs, timelines, family circumstance, or myriad other factors. For that reason, ADU Grant Program activity is fluid and changes regularly.

Snapshot of ADU Grant Program activity, current as of November 20, 2024:

- Phase 1 = 1,996 Grant Reservations
- Phase 2 = 585 Grant Reservations
- Total = 2,581 Active Projects
- Nearly 560 ADUs completed
- Roughly 1,900 grant recipients have commenced the ADU project in earnest (i.e., submitted enough documentation to lender to reserve grant and start predevelopment activities)

It is important to note that these figures are snapshots in time and will change as homeowners continue to work through their projects.

The remainder of the projects have a reservation for the grant, but have not yet requested the grant funds, meaning the project remains in initial feasibility and evaluation stages. Lenders are encouraged to make sure all grant awardees remain in process and working toward completing their project (i.e., projects must remain in process of some predevelopment or construction activity to remain active).

Construction Status

ADU Grant Program administration underscores the complex and protracted nature of ADU construction projects. Of the projects that are in progress, CalHFA estimates that nearly 50% remain in early stages of architecture, design, and permitting. Construction is underway for another roughly 35%, with 12% completed but waiting on occupancy permits. CalHFA has observed that these projects often take several years to complete and is actively working with our ADU partners to monitor and manage the construction pipeline. Many external factors — such as state law and local practices — have the potential to expedite the process. CalHFA continues to identify other streamlining opportunities that could align with existing resources.

Geographic Distribution

Figure 2, below identifies the distribution of ADU grant funds by region. At 54%, Los Angeles County is the largest recipient of grant funds. According to the California Department of Housing and Community Development's (HCD)Annual Progress Reports data, Los Angeles County has led the state in ADU production, accounting for nearly 60% of all ADUs produced statewide since 2018. The nine-county Bay Area region also accounts for a significant level of ADU grant activity, bolstered by low housing inventories, high rental rates, and higher incomes. ADU grant activity in these regions helps to bolster CalHFA programmatic assistance in these high-cost regions that are very challenging to serve with traditional CalHFA down payment assistance programs.

While areas like the Inland Empire, Capital Region, and Central Valley have received smaller shares of ADU grant funds, these regions are receiving a higher proportion of grant funds than they have contributed to ADU production over the last several years. This may suggest that the ADU Grant Program is incentivizing increased ADU production in those regions.

Figure 2: Geographic Distribution of ADU Grant Reservations

Region	CA Households	Statewide ADU Permits (2018-2022)	Phase 1 ADU Grants (2022)	Phase 2 ADU Grants (2024)
				To date - current as of 1/2/2024
Los Angeles/Orange County	33%	63%	49%	65%
Bay Area	21%	15%	19%	11%
San Diego	9%	7%	10%	7%
Inland Empire	11%	5%	8%	5%
Central Coast	6%	6%	6%	5%
Capital	6%	2%	5%	3%
Central Valley	10%	1%	2%	2%
Rural	4%	1%	1%	1%
Grand Total	**100%**	**100%**	**100%**	**100%**

Note: Net of cancellations includes completed ADUs.
Source: U.S. Census 2022 5-Year American Community Survey (ACS); HCD's Annual Progress Reports Data Dashboard and Downloads; CalHFA's ADU Grant Program

Distribution by Race/Ethnicity

The geography of ADU Grant Program recipients also drives program demographics. Because the ADU Grant Program serves existing homeowners, **Figure 3**, below, compares the race and ethnicity of ADU Grant Program recipients to the race and ethnicity of existing California homeowners. Nearly 55% of ADU Grant Program recipients self-identified as belonging to a community of color. Notably, 9% of ADU grantees identified as Black or African American, well outpacing the Black or African American composition of California homeowners (4%). Lower ADU construction activity in the Central Valley and Inland Empire, driven in part by more affordable housing prices and higher inventory in those regions, somewhat depresses the composition of grantees that identify as Latino or Hispanic.

Figure 3: ADU Reservations by Race & Ethnicity

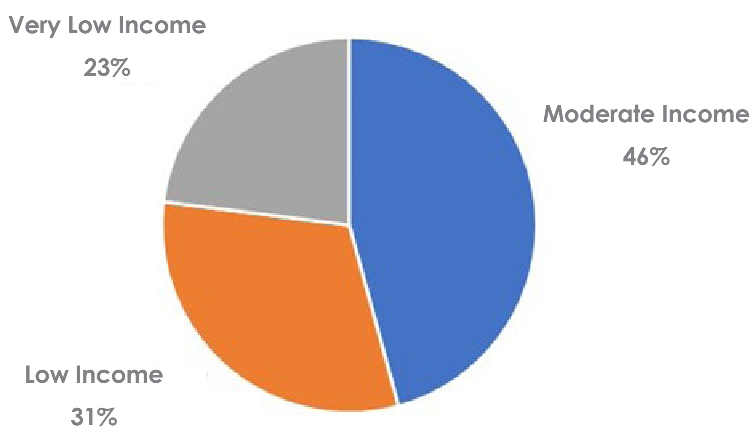
Race & Ethnicity	CA Homeowners	ADU Grant Reservations*
		*As of 11/20/2024
American Indian or Alaska Native	0.3%	1%
Asian	16%	20%
Black or African American	4%	9%
Hispanic or Latino	25%	23%
Native Hawaiian or Other Pacific Islander	0.2%	1%
Not Provided	3%	3%
White	53%	44%
Grand Total	**100%**	**100%**

Note: Net of cancellations includes completed ADUs.
Source: U.S. Census 2022 5-Year American Community Survey (ACS); CalHFA's ADU Grant Program

Income Levels

More than half (54%) of ADU grant recipients were lower income, earning less than 80% AMI (as defined by the Fannie Mae HomeReady AMI Lookup Tool). Almost a third (31%) of Phase 2 grant recipients identified as Low-Income (i.e., households earning between 50-80% AMI) while 44% identified as Very Low-Income (earning between 30-50% AMI). The remaining 46% identified as Moderate-Income (earning between 80% AMI and CalHFA county income limits — on average, roughly 150% AMI).

Figure 4: Distribution by Income Level



Impact on Lending Environment

In 2023, CalHFA conducted a working group process that provided significant feedback from industry partners regarding the impact of the ADU Grant Program. Working group discussions revealed that the ADU Grant Program not only helped individual homeowners to build an ADU, but also catalyzed significant innovations in the ADU lending ecosystem.

For individual ADU grantees, lenders indicated that the ADU Grant Program not only defrayed predevelopment costs but was also an effective credit enhancement tool — i.e., expanded homeowner access to more financing by increasing their value and increasing the economic viability of ADU construction.

In addition, by improving ADU economics and demonstrating the strong market for ADU lending, the ADU Grant Program contributed to significant innovations in ADU financing. At the outset of the ADU Grant Program, ADU financing options for low- and moderate-income (LMI) borrowers were very limited.

LMI and low equity borrowers were particularly challenged as there were few (if any) options available for borrowers to rely on the prospective rental income from an ADU to support their loan. Current federal mortgage underwriting standards do not allow ADU rental income to be counted when qualifying for a home loan. This exclusion limits homeowners' ability to finance ADUs. However, recent updates from Freddie Mac and Fannie Mae signal potential progress. Freddie Mac announced a pilot program to include projected ADU rental income for certain loans, and Fannie Mae has expressed interest in similar initiatives. These changes could pave the way for more accessible ADU financing and encourage broader adoption.

The launch of the ADU Grant Program highlighted the significant consumer demand for ADUs and the need for financing products serving LMI borrowers. The lending ecosystem is very entrepreneurial and responsive to current market dynamics, including consumer appetites for ADUs. Over the course of the ADU Grant Program, several of CalHFA's ADU lending partners developed portfolio loan products that expand access to ADU financing by allowing rental income to be used in the construction loan underwriting process and other products that expand consumer access to financing. These portfolio products include cash-out refinances, second mortgage products, HELOC renovation financing, and other approaches, all with access to a managed construction escrow that meets the ADU Grant Program requirements.

These programs all helped to expand access to financing products not only for ADU grant recipients, but also for other homeowners interested in building an ADU.

Remaining Gaps in the ADU Lending Ecosystem

Despite significant progress in the field of ADU finance, ADU construction financing remains a significant challenge for homeowners. High interest rates and material costs combined with construction labor shortages introduce substantial additional costs. In addition, ADU construction projects are undertaken by individuals who may lack the expertise to navigate complex design and entitlement processes, as well as the actual construction process which can lead to unforeseen challenges and obstacles. Fortunately, innovation and creative local initiatives can help ease some of these challenges for homeowners through preapproved plans and other pro-housing policies that streamline the production of more housing.

Construction and renovation loans continue to be the predominant form of financing for ADU construction, but these vehicles are not attractive to homeowners who have locked in historically low interest rates on their first mortgage that would have to be refinanced to take advantage of this financing. Implementation of the ADU Grant Program underscored the importance of financing flexibility and having a variety of available financing products accessible to LMI borrowers to facilitate ADU construction. Individual borrower circumstances vary widely and there is no "one-size-fits-all" approach.

That said, several recurring themes emerged over the course of the ADU Grant Program that may inform future policy initiatives:

- **Low-Cost Construction Financing.** Construction lending is complex and risky, and subject to prevailing interest rates. Private sector actors must be responsive to current market circumstances, and are limited in their ability to offer low-cost, risk-tolerant financing products. Community Development Financial Institutions (CDFIs) have begun to move into this space, but significant additional funding is needed to build institutional capital and offer these options at scale.
- **Lack of Secondary Market Capital.** Private sector capacity to provide alternative financing options is limited by the absence of a robust secondary market. To the extent that lenders have offered products that expand access (e.g., allowing the use of prospective rental income in underwriting), those lenders generally must hold those loans on their own balance sheet. This limits an individual lender's ability to extend financing at a large scale.
- **Need for Additional GSE-Conforming Construction Lending Options.** Building on the above concept, additional options are needed for construction loans to be eligible for purchase by the Government Sponsored Entities (GSEs), namely Fannie Mae and Freddie Mac. For example, many lenders are seeking products like a one-time close construction loan that allows the borrower to take out a construction loan that rolls over into a permanent loan. If allowed by the GSEs, those products can be sold during the construction phase, helping to

mitigate lender risk and creating more liquidity in the construction lending market. The GSEs are actively working to expand options in this arena, and continued efforts will be important to expanding access to financing opportunities.

Conclusion/Next Steps

CalHFA will continue to process ADU grant reservation files and distribute grant funds over the coming months as ADU Grant Program participants submit files for review and recipients commence and complete work on ADU design, site improvements, and construction. CalHFA will also continue to work with participating lenders, credit unions, and nonprofits to monitor construction activity (including Program fallout) and ensure that the ADUs benefitting from CalHFA grant funding are constructed. Because permitting and construction timeframes can be protracted, this is expected to be a long-term, sustained effort spanning multiple years.