TINY HOMES AND BIG MONEY: OPTIONS FOR THE CITY OF OAKLAND, CALIFORNIA TO SUPPORT THE CONSTRUCTION OF ADDITIONAL ACCESSORY DWELLING UNITS

May 25, 2018

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Abstract

This paper explores options for the City of Oakland, California to help its residents finance the construction of Accessory Dwelling Units (ADUs) as a means to boost the supply of affordable housing. This paper finds that private finance options are limited for homeowners with limited incomes and home equity. The Department of Housing and Urban Development’s Section 108 loan program, combined with local funding sources, are the most readily accessible options for Oakland to support ADU construction. More innovative options, such as real estate crowdfunding and ADUs-as-a-service, may one day provide viable alternatives for Oakland to encourage ADU construction.

Keywords: Accessory Dwelling Unit, In-law unit, ADU, laneway house, granny flat, ADU finance, municipal finance, affordable housing finance, Oakland, Bay Area housing crisis, Section 108 loan, real estate crowdfunding, ADUs-as-a-service, real estate innovation, revolving fund, secondary unit.

Acknowledgements: This paper would have been impossible without a great deal of help. First, I am grateful to my client, the Oakland Mayor’s Office, and especially to Joanne Karchmer for suggesting the topic and to Darin Ranelletti for being my main point of contact. I would also like to thank every businessperson, government official, and nonprofit leader who generously shared their time and answered my many questions. My adviser, Bruce Cain, possess great brilliance, patience, and humor. All three proved instrumental in making this work possible. I am also grateful to my program head, Greg Rosston, and to all the Public Policy program staff for the many ways they helped and supported this endeavor. Lastly, I would like to thank my wonderful family, who provided me with constant support, advice, and love while I was working on this project.
1. Introduction

The San Francisco Bay Area, a nine-county region in Northern California, is one of the most economically vibrant regions in the world. If it were a separate country, it would rank among the top 25 largest economies in the world\(^1\). Along with this epic prosperity, however, comes an equally epic shortage of affordable housing for the region’s residents.

Since 1990, the Bay Area has added roughly two new jobs for every new housing unit added to regional supply\(^2\). New housing construction has remained stubbornly low during this time period, even during economic booms, and twice as many new housing units were permitted in the mid-1980s as the most recent year available\(^3\). This shortage of housing construction and raging economic growth have combined to generate some of the most expensive market rents in the country\(^4\). In May 2018, one bedroom apartment rents in San Francisco were estimated to average $3,440, in San Jose to average $2,500, and in Oakland to average $2,100.

Unsurprisingly, these eye-popping rents have sparked great concern among policymakers and ordinary residents alike. According to a January 2018 public opinion survey, 49 percent of Bay Area residents said they were considering moving out of California due to the high cost of living. 77 percent of Bay Area residents said that the cost of housing was a “very serious” problem\(^5\).

Mindful of the issue, in 2017 the California State Legislature approved and Governor Jerry

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\(^1\) (Metropolitan Transportation Council n.d.)  
\(^2\) (Metropolitan Transportation Commission and Association of Bay Area Governments 2017)  
\(^3\) Ibid.  
\(^4\) (Chen 2018)  
\(^5\) (Edelman 2018)
Brown signed a “housing package” of 15 bills to tackle the crisis\(^6\). Although these bills included a variety of new revenue sources and permitting streamlining measures, the general consensus is that they will fall considerably short of resolving the crisis\(^7\). Indeed, one estimate indicated that the measures would together only contribute 14,000 new homes towards an annual 65,000 new home shortfall- if California simply wanted to prevent the problem from getting worse\(^8\).

A key factor in why these new measures only make a limited dent in the housing shortage is the high cost of new construction. A new unit in a purpose-built multifamily affordable housing development in San Francisco in 2016 had an estimated average cost of $425,000 per unit\(^9\). Although San Francisco may be the most expensive city in the Bay Area region, construction costs in other parts of the Bay Area have also been some of the highest in the nation\(^10\). These high construction costs for conventional affordable housing development and the limited availability of both project financing and sites have inspired policymakers to pursue a variety of alternative ways to boost the region’s affordable housing supply.

One of the most promising of these avenues is the conversion of underutilized space in single-family homes or parcels into housing units. These add-on housing units, known variously as in-law units, granny flats, laneway houses, or, in a professional context, Accessory Dwelling Units (ADUs), provide a unique opportunity to add new housing without the expense and difficulty of land acquisition, environmental impact review, or planning commission review. ADUs can be sited in primarily single-family neighborhoods, areas which would otherwise be extremely

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\(^6\) (Kimberlin 2017)  
\(^7\) (Dillon 2018)  
\(^8\) Ibid.  
\(^9\) (Reid and Raetz 2018)  
\(^10\) (Terner Center n.d.)
difficult to locate new affordable housing in. Best of all, ADUs are, compared to traditional multifamily, relatively affordable to construct. Although ADU construction costs vary considerably (due in part to the physical variation - ADUs can involve everything from a basement or garage conversion to installing a brand new cottage in a backyard), a recent study estimated the average cost of ADU construction at $156,000 per unit\(^\text{11}\). That can be less than half the cost of a comparable multifamily unit. Efforts focused on a narrower set of ADU construction, such as basement conversions, often yield even lower per unit construction cost estimates\(^\text{12}\). See Figure 1

**Figure 1: Comparative Cost**

<table>
<thead>
<tr>
<th>Type</th>
<th>New affordable apartment construction estimate(^\text{13})</th>
<th>Average studio apartment purchase estimate(^\text{14})</th>
<th>Average ADU construction estimate(^\text{15})</th>
<th>Typical basement ADU construction estimate(^\text{16})</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost</td>
<td>$425,000</td>
<td>$281,500</td>
<td>$156,000</td>
<td>$80,000</td>
</tr>
</tbody>
</table>

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\(^\text{11}\) (Chapple, et al. 2018)  
\(^\text{12}\) (Bailey 2018)  
\(^\text{13}\) (Reid and Raetz 2018) San Francisco estimate used as an Oakland estimate is not readily available.  
\(^\text{14}\) Specific data was not available, so an estimate was calculated by assuming 500 square feet for the average size and $563/square foot, which is the average cost for all kinds of housing in Oakland. This is likely an underestimate of the actual average studio cost. See (Trulia 2018) and (The San Francisco Chronicle n.d.). This statistic was included as a comparison in case Oakland was considering spending the funds on acquisition and rehabilitation instead.  
\(^\text{15}\) (Chapple, et al. 2018)  
\(^\text{16}\) (Bailey 2018)
Critics of ADUs have primarily focused their concerns on the alleged parking, affordability, and tourism impacts of ADU infill. Such critics\(^\text{17}\) claim that the applicable state law exemptions from parking minimums near transit contributes to a shortage of residential parking. However, the available research on the subject suggests that ADU residents are about as likely as residents of transit-oriented multifamily units to own a car\(^\text{18}\). This low rate of car ownership, and the low overall prevalence of ADUs in even the most ambitious of scenarios, suggest that actual parking impacts will be trivial. ADU critics also claim that ADUs will drive up home prices, making it harder for residents to buy a home. No empirical evidence exists to support this claim\(^\text{19}\). Some ADU critics also claim that most ADUs will be rented out on platforms such as Airbnb, introducing tourism-related impacts (noise, parking, etc.) to quiet residential neighborhoods without doing anything to alleviate the housing shortage. The best available research suggests that only about 12% of ADUs are used for short term rentals even where such a use is permitted\(^\text{20}\), and local governments are free to ban such short-term usages. Currently, Oakland prohibits the rental of any single family or duplex unit for less than 7 days\(^\text{21}\). Therefore, it is reasonable to conclude that the fears of ADU critics are generally unfounded.

The Office of the Mayor of Oakland, California, has recognized the potential ADUs have for helping to alleviate Oakland’s considerable affordable housing challenges and decided to incorporate increased ADU construction into the city administration’s plan to bolster affordable housing.

\(^{17}\) (Moran 2017)  
\(^{18}\) (Brown 2014)  
\(^{19}\) The intuition is unclear. Adding an ADU (and its rental income) to a house might drive up that specific home’s value. However, the added housing supply from ADUs in general drive down rents, which in turn might drive down overall demand for home purchases- which would drive down home prices. The relative magnitude of these effects is difficult to measure due to the rarity of ADUs, and in most places are likely near zero.  
\(^{20}\) (Chapple, et al. 2018)  
\(^{21}\) (Oakland Community Economic Development Agency 2016)
housing supply\textsuperscript{22}. Although Oakland’s leadership has been a state-wide leader in streamlining the permitting process for ADU construction\textsuperscript{23}, it remains concerned about the accessibility of capital for homeowners with limited funds or housing equity to build ADUs. This concern has a strong empirical foundation, as a recent Terner Center report found that securing a loan or paying for the cost of ADU construction were among the most commonly cited obstacles by homeowners\textsuperscript{24}. The report also found that only less than five percent of survey respondents were able to borrow against the income from the ADU to pay for the unit’s construction. For Oakland residents with limited cash or home equity to tap, it may be impossible to finance the construction of a legal ADU even when the circumstances favor construction. Helping these residents, many of whom may be able to use ADU-derived income to help age in place or avoid housing displacement, could play a useful role in furthering Oakland’s equity and economic goals.

Therefore, at the request of the Oakland Mayor’s Office, the author has researched a variety of options that might be used to finance the construction of ADUs. This report contains an overview of the various options considered as well as analysis of the advantages and disadvantages of the potentially viable options the City of Oakland may consider adopting. Based on a review of government documents, academic reports, media reports, and interviews with both finance and government practitioners, Oakland faces various opportunities and challenges with helping Oakland residents finance the construction of ADUs. Although retail banks appear to be generally unable to assist with extending credit to ADU builders due to

\textsuperscript{22} A Roadmap Toward Equity (Rose and Lin 2015)
\textsuperscript{23} (BondGraham 2016)
\textsuperscript{24} (Chapple, et al. 2018)
Dodd-Frank consumer protection regulations, the Department of Housing and Urban Development’s (HUD) Section 108 loan program is a promising opportunity to raise nearly $30 million in capital to loan to certain kinds of ADU construction. This loan program would allow Oakland to take out low-interest loans from HUD, re-loan the funds to builders of attached ADUs, and then pay back HUD with the loan payments derived from the ADU rent. Oakland also faces ready opportunities to use existing affordable housing funding streams to support a broader array of ADU construction. Finally, although the landscape remains highly unsettled, private investors and investment banks may be a potential unconventional source of funds worth further investigation. While previous municipal attempts to support ADU finance have had a shaky start due to capitalization and program design challenges, Oakland has a distinct opportunity to serve a key role in supporting the construction of new ADUs to bolster the city’s affordable housing supply and broaden access to ADU loans to help long-time residents keep up with the cost of living.

2. Background

*The Current Process for Approving ADUs in Oakland*

Oakland has elected to approve ADUs under two somewhat different sets of requirements based on the characteristics and location of the new unit. “Category One” ADUs are located within the existing building envelope of a single-family home as of January 1st, 2017 and meet
certain fire setback requirements. “Category Two” ADUs are either constructed as standalone structures or involve adding to the footprint of the existing house.25

“Category One” ADUs face minimal substantive requirements26. They require no new parking, no new utility connection, no architectural review, no size restriction, and no height restriction.

“Category Two” ADUs face more substantial requirements27. New parking is normally required for units that are not within ½ mile of transit, one block of car sharing, or where on-street parking permitting is in place but is not available to ADU residents. The specific requirement varies by zone. ADUs may not exceed the lesser of 800 square feet or 75 percent of the main house floor area. The ADU must be subordinate in size and location, and have conforming exterior materials. Height restrictions are in place and vary by zone. Various setback requirements are in place, including that no more than 50 percent of a required rear yard may be covered by an ADU. A new utility connection (and fee) may be required but must be proportionate to the burden of the unit on water and sewer systems.

In both cases, an ADU is processed through the City of Oakland’s Design Review Exception Process. ADUs require this planning review (which is mandated to conclude within 120 days), as well as building permits. Approval can be granted at the counter, and this is a ministerial review process (i. e., if it fits the requirements it must be approved). Public input is prohibited by state law in order to prevent spurious neighbor concerns from derailing or delaying the approval of ADU construction.

25 The requirements and description of ADUs in Oakland is taken from the following fact sheet: (Community and Economic Development Agency 2017)
26 Ibid.
27 Ibid.
Recent Changes in Oakland City Law

The ADU approval regime described above was put into place by Ordinance No. 13357 on January 5th, 2016 and by subsequent planning commission actions\(^{28}\). The most significant changes made by this ordinance were to establish the new parking exemptions for ADU construction close to transit/ carsharing. Other notable changes made included eliminating the requirement for separate utility connections for ADUs in the existing floorplan of a house and the establishment of the ministerial approval process. The changes also eliminated unnecessary requirements for fire sprinklers in new ADUs where the main unit did not have them, as well as loosened the requirements for new parking where it is required.

Recent Changes in California State Law

California state law recently imposed new requirements on the ADU review process, though these were largely anticipated by Oakland’s voluntary rule changes. SB 1069 and AB 2299 were two successful bills that took effect in 2017. SB 1069 forces cities to evaluate secondary units ministerially, drop parking requirements for ADUs near transit, and prevents cities from unnecessarily requiring new utility connections\(^{29}\). SB 1069 also imposes default rules when there is no local ordinance on ADUs (which doesn’t apply in Oakland as Oakland has adopted an ordinance on ADUs).

AB 2299 more narrowly focuses on parking requirements, and prohibits local governments from requiring parking above and beyond one space per bedroom in new ADUs\(^{30}\). AB 494, which took

\(^{28}\) (The City of Oakland 2016)  
\(^{29}\) (State of California 2016)  
\(^{30}\) (The State of California 2016)
effect in 2018, provides minor technical revisions to the previous two bills and also requires cities to allow ADUs to be rented out separately from the main unit (which was already the case in Oakland)\textsuperscript{31}.

3. Methodology

Following initial discussions with the Oakland Mayor’s Office, the client’s scope of work included:

A) Identifying opportunities for residents, especially low-income and equity-poor residents, to tap existing Oakland financial institutions for credit to construct ADUs,

B) Identifying existing governmental funding streams that could be used to support the construction of ADUs, and

C) Explore innovative options other cities have used to promote ADU construction.

In order to accomplish this objective set, the author began contacting a sample of banks with a physical presence in Oakland. When attempts to contact a bank branch were successful, the author briefly described what an ADU was and asked to talk to someone about financing opportunities that bank might have. As described in the findings section, these inquiries were unsuccessful in finding any offerings besides various kinds of equity loans or personal loans. The author stopped calling banks after it came to light that federal regulations generally prevent retail banks from loaning money to a low-income borrower based only on the anticipated rental income of the future ADU. The author then followed up with the Mayor of Oakland’s Office, and received further guidance to particularly focus on:

\textsuperscript{31} (The State of California 2017)
A) ADUs as a service (an ADU financing structure described further in the findings section),

B) Real estate crowdfunding, and

C) Options for the City of Oakland to operate a loan fund for ADU construction.

Due to the relative obscurity of this particular field of housing finance, the author took a highly iterative search process for information about these various foci of information gathering. This involved web searches, contacting a variety of government agencies such as the Department of Housing and Urban Development, California Department of Housing and Community Development, California Housing Finance Agency, and interviewing or requesting information from a number of nonprofit, business, educational, and local government staff. Due to the low level of previously collated information available on this topic, a major theme in this research process was using information or connections from one source to identify new information or ideas related to another source.

4. Findings

This section includes a discussion of a variety of possible financing alternatives that the City of Oakland might employ or highlight to help Oakland residents finance the construction of ADUs. It includes an overview of the various strengths and weaknesses of each approach considered or encountered in the course of the search for the best possible ADU financing mechanism(s).32

32 The client did not include specific guidance on what an optimum ADU financing mechanism would include, except that it would be available to low-income Oakland homeowners who do not currently have access to equity-based financing. The author took the liberty of assuming that the “best” ADU financing mechanism would likely involve A) minimum cost to the City of Oakland, B) minimum diversion of funds from alternative affordable housing programs, C) minimum financial risk or liability to the City of Oakland, D) is suitable for a broad variety of ADU construction types, and, perhaps most importantly, E) has the potential to provide a substantial amount of money.
The ten funding mechanisms considered in this report are, in no particular order, A) lending by retail banking institutions, B) lending by investment banking institutions or other institutional investors, C) real estate crowdfunding, D) city-banking partnerships, E) the Section 108 loan program, F) other federal funding sources, G) state funding sources, H) Alameda County funding sources, I) City of Oakland funding sources, and J) ADU-as-a-service or other alternative ADU ownership schemes. This findings section concludes with a brief discussion of other findings from two other cities that considered or engaged in an ADU loan program. A summary of the characteristics of the different options is found in Figure 2.

Figure 2

<table>
<thead>
<tr>
<th>Option</th>
<th>Source</th>
<th>Amount available</th>
<th>Who qualifies</th>
<th>What ADU uses qualify</th>
</tr>
</thead>
<tbody>
<tr>
<td>Traditional retail banking</td>
<td>Retail and neighborhood banks</td>
<td>Varies. Up to several hundred thousand dollars.</td>
<td>Individuals with acceptable credit, low debt, substantial home equity</td>
<td>Any ADU-related purpose</td>
</tr>
<tr>
<td>Institutional banking</td>
<td>Investment and commercial banks</td>
<td>None currently. Unknown in future.</td>
<td>No one currently. Unknown in future.</td>
<td>Unknown.</td>
</tr>
<tr>
<td>Real estate</td>
<td>Individual and</td>
<td>Probably low</td>
<td>In this case,</td>
<td>Any ADU-related</td>
</tr>
<tr>
<td>crowdfunding investors via crowdfunding websites</td>
<td>institutional investors via crowdfunding websites</td>
<td>millions to tens of millions of dollars.</td>
<td>probably the City of Oakland, which then loan funds back out to homeowners.</td>
<td>purpose</td>
</tr>
<tr>
<td>---</td>
<td>---</td>
<td>---</td>
<td>---</td>
<td>---</td>
</tr>
<tr>
<td>City-banking partnerships</td>
<td>Local credit union + state funds</td>
<td>None currently. Historically, loans were granted of $100,000. Size of loan fund unknown.</td>
<td>No one currently. Historically, homeowners.</td>
<td>Unknown. Historically, ADUs must accept affordability covenant.</td>
</tr>
<tr>
<td>Section 108 Loan Program</td>
<td>Department of Housing and Urban Development</td>
<td>$29,604,740</td>
<td>The City of Oakland. Oakland can relend the funds to ADU builders if so desired.</td>
<td>“Rehabilitation.” Therefore, conversion of existing rooms or outbuildings to ADU are acceptable. Building a new ADU from the ground up is not</td>
</tr>
<tr>
<td>Community Development Block Grant (CDBG)</td>
<td>Department of Housing and Urban Development</td>
<td>Unknown. Oakland already dedicates CDBG funds to other purposes, making availability questionable.</td>
<td>The City of Oakland. Can loan funds to ADU builders if so desired.</td>
<td>“Rehabilitation.” Therefore, conversion of existing rooms or outbuildings to ADU are acceptable. Building a new ADU from the ground up is not acceptable.</td>
</tr>
<tr>
<td>---</td>
<td>---</td>
<td>---</td>
<td>---</td>
<td>---</td>
</tr>
<tr>
<td><strong>Federal Housing Administration Section 203(k) loan program</strong></td>
<td>Private lenders</td>
<td>Up to $680,000 per loan. No program limit</td>
<td>Homeowners or home buyers</td>
<td>Rehabilitation/ADU construction</td>
</tr>
<tr>
<td>Fannie Mae HomeStyle Mortgage</td>
<td>Private lenders</td>
<td>$680,000 per loan, up to 75 percent for rehabilitation. No program</td>
<td>Homebuyers (and homeowners) or investors with credit scores of</td>
<td>Any ADU related purpose.</td>
</tr>
<tr>
<td>Fannie Mae HomeReady Mortgage</td>
<td>Private lenders</td>
<td>$680,000 per loan. No program limit.</td>
<td>Homebuyers/homeowners with credit scores of 620, and either A) incomes up to 100 percent of AMI in all neighborhoods or B) any income in specific high-poverty tracts.</td>
<td>Can buy homes with ADUs. May be paired with HomeStyle loans for rehabilitation.</td>
</tr>
<tr>
<td>-------------------------------</td>
<td>----------------</td>
<td>-----------------------------------</td>
<td>---------------------------------------------------------------------------------------------------------------------------------</td>
<td>---------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>State-funding sources</td>
<td>None</td>
<td>None</td>
<td>No one</td>
<td>None</td>
</tr>
<tr>
<td>County-level funding (such as Innovation and Opportunity fund)</td>
<td>Alameda County</td>
<td>Possibly $35 million. More if rental housing funds can be tapped.</td>
<td>City of Oakland</td>
<td>Unclear.</td>
</tr>
<tr>
<td>Oakland City Funds</td>
<td>Oakland General Fund and Oakland Affordable Housing Trust Fund</td>
<td>Unknown. Both accounts have considerable competing demands.</td>
<td>Homeowners interested in building ADUs.</td>
<td>Any ADU related purpose.</td>
</tr>
<tr>
<td>-------------------</td>
<td>-------------------------------------------------</td>
<td>-------------------------------------------------</td>
<td>--------------------------------</td>
<td>-----------------</td>
</tr>
</tbody>
</table>

**A) Lending by retail banking institutions.**

An important part of this project was determining the state of retail banking for ADUs in Oakland. In order to do this, the author planned to contact every banking institution with a physical presence in Oakland\(^{33}\). However, this plan was discontinued after about 15 bank contacts when a loan officer informed the author about rules related to the Dodd–Frank Wall Street Reform and Consumer Protection Act\(^{34}\). As subsequently verified by the author, Dodd-Frank has a rule that “Qualified Mortgages” - which receive a variety of special benefits - must be issued with a debt-to-income ratio of less than 43 percent\(^{35}\). ADU income does not consistently

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\(^{33}\) Based on locations identified through Google Maps.  
\(^{34}\) (Loan Officer at a Regional Bank n.d.)  
\(^{35}\) (Shatz n.d.)
meet bank underwriting standards as a reliable source of income and therefore loans with such income may fall afoul of this rule\textsuperscript{36}.

Prior to this realization, the author made an attempt, whenever possible, to speak to a loan officer for both residential and business lending practices at a bank. In none of the banks where contact could be established with a residential loan officer would the bank make any kind of second loan except as a cash-out refinancing or as a home equity line of credit. In none of the banks where contact could be established with a business loan officer would the bank make any kind of business loan to a development of less than 4 units\textsuperscript{37}. Therefore, while retail lending based on home equity remains a promising way for some homeowners to capitalize the construction of an ADU, this option remains closed to low-equity borrowers for the foreseeable future. At some future point underwriting standards may well change\textsuperscript{38}; at that point it may make sense to revisit the wider use of retail lending.

\textit{B) Lending by investment banks or other institutional investors}

Based on guidance from the client, research into financing options from investment banks and other institutional investors was not a major focus of the author’s research. However, it appears that there has been at least some preliminary institutional interest in ADU finance. The community development arm of a major commercial bank has contributed funding to community partner groups in the southern San Francisco Bay Area and Los Angeles area for

\textsuperscript{36} (Chapple, et al. 2018)

\textsuperscript{37} Loaning to add a unit to a 4 (or more) unit building is considered multifamily lending and might qualify for business loans at some institutions.

\textsuperscript{38} ADU construction has been rising in California in recent years. As it becomes more common and more banks become exposed to ADUs and their risk profile, it seems probable that they may become more willing to extend credit for ADU construction.
them to help identify possible funding models for ADU construction. According to an official with the bank in question, they had no particular ADU lending practices in mind and hoped the community partner groups would develop models. This official identified the cash flow from ADU investments and the ability to provide collateral on the investments as major factors their bank would consider when deciding if they should include ADU finance in their portfolio. The official anticipated having a better understanding of ADU finance options as early as the end of 2018.

C) Real estate crowdfunding

One interesting development in capital markets in the past few years has been the rise of various crowdfunding websites dedicated to real estate investment. Although models vary considerably, a typical such website collects and vets real estate investment opportunities and then invites investors to purchase a small participation share (such as $5,000 in a $500,000 deal). While a few crowdfunding sites feature a broad variety of real estate types, many funds invest in a particular niche such as commercial real estate, housing rehabilitation, or a specific geographic market. Advantages of real estate crowdfunding include the use of private capital, the broad pool of potential investors, and the possibility of avoiding certain fees associated with a private placement. Disadvantages of real estate crowdfunding include unpredictable or limited volume (many platforms have limited deal turnover), high expected interest rates (Platforms commonly advertise 7-11 percent IRRs), and the difficulty of working

39 (Chalifour 2018)
40 (The Real-Estate Crowdfunding Review 2018)
41 (Realty Shares n.d.)
42 (CrowdStreet n.d.)
43 (Fund That Flip n.d.)
44 (Prodigy Network n.d.)
with partners unused to collaborating with government agencies. The high rates of return expected by real estate investors corresponds to the high anticipated risk associated with these kinds of investments. Until ADU portfolio loans are a sufficiently proven investment that private lenders will be willing to lend at a lower interest rate, real estate capital markets may be the only viable source of private sectors financing.

The author attempted to contact several appropriate crowdfunding platforms, but these attempts did not develop any solid leads. Though these prospects did not work out, it may make sense for the City of Oakland to continue investigating real estate crowdfunding as an option. The market for real estate crowdfunding is currently highly fractured and is characterized by high entry and exit. Thus, the best partner for this investment opportunity may not have been founded quite yet.

Even if existing crowdfunding websites are not willing to partner with Oakland, Oakland might wish to consider developing its own real estate crowdfunding option, possibly in tandem with other Bay Area cities. The City of Oakland would likely encounter certain obstacles if it were to attempt to raise funds through a crowdfunding platform (among other things, most crowdfunding sites feature specific information about the properties being invested in, while Oakland probably wouldn’t want to feature the addresses of each loan for privacy reasons). Nonetheless, the successful launch of the crowdsourced microloan program Kiva Oakland suggests that Oakland residents might be willing to invest in local concerns, and the existence of a prominent crowdfunding platform in the city may have helped familiarize residents with

45 (The Real-Estate Crowdfunding Review 2018)
46 (Kiva 2016)
the concept of crowdfunding. Furthermore, the Securities and Exchange Commission 
regulations about forming a crowdfunding site are quite liberal\textsuperscript{47}. Anyone who has not 
previously violated SEC regulations and can convince the SEC that they have the capacity to 
successfully operate a crowdfunding platform can receive a license. The SEC does have rules 
that say the owner of the platform cannot manage the investor funds (ergo cannot be the 
recipient of the investment), but this could likely be sidestepped by having a third party (such as 
a partner non-profit or possibly the Oakland Financing Joint Powers Authority\textsuperscript{48}) host the 
crowdfunding website. Alternatively, other Bay Area cities might be interested in trying to tap 
crowdfunding to support ADU construction, in which case it might make sense to seek the 
creation of a regional ADU crowdfunding site.

\textit{D) City-banking partnerships}

Although it seems likely that most if not all retail lending institutions will not be willing to make 
ADU loans based on future rental income due to Dodd-Frank regulations, the author did 
encounter an interesting historical example of a credit union making ADU loans supported by 
its home municipality. In the mid-2000s, the City of Santa Cruz partnered with the Santa Cruz 
Community Credit Union to offer construction loans up to $100,000 ($133,760 in 2018 dollars) 
at interest rates of 4.5 percent for ADUs rented to tenants with an income of 80 percent of AMI

\textsuperscript{47} (U. S. Securities and Exchange Commission n.d.)
\textsuperscript{48} The Oakland Financing Joint Powers Authority, is, like many similar bodies throughout the state, a legally distinct 
but heavily city-influenced body that is used to issue debt. Although California cities are not allowed to issue debt 
without voter approval, they sometimes work around this challenge by having a Financing Authority like this one 
officially borrow the money and then “rent” a physical asset back to the city to pay off the debt. This, although 
essentially the same as a city borrowing money, fulfills the requirements of state law. When the debt is paid off, 
the Authority turns over the physical asset to the city on a permanent basis.
or less. According to the current Santa Cruz Housing and Community Development Manager, the program was discontinued due to low demand. In her opinion, the program was less competitive than private loans at the time due to a combination of easy lending practices prior to the Great Recession making home equity loans widely available and the comparatively limited returns imposed by the 80 percent of AMI affordability restriction. The current Housing and Community Development Manager said that if she was to resume the program, she would likely give residents the ability to buyout the affordability covenant. She reported that the 2000s era program was capitalized by a combination of credit union and grant funds. She said that the grant was a one-time grant for pollution control and that she had not seen it re-advertised through a Notice of Funding Availability since then. The author of this report checked funding availability through the California Air Resources Board and Bay Area Air Quality Management District websites. Neither website had any grant currently offered that seemed similar to the one Santa Cruz utilized, nor did any other grant offered through the two agencies seem suitable for supporting the finance of ADU construction. A final lesson Santa Cruz’s Housing and Community Development manager shared was that the credit union’s return requirements resulted in the 4.5 percent interest rate.

Although this program appears to be an idiosyncratic incident, it may provide some useful insights for Oakland’s consideration. First, it suggests that simply putting together an ADU loan program will not necessarily lead to a flood of loan applications. Loans and marketing must be properly targeted to ensure that those who will benefit most from a city-backed loan program

49 (City of Santa Cruz 2004)
50 (Berg 2018)
51 (California Air Resources Board n.d.)
52 (Bay Area Air Quality Management District n.d.)
receive proper information about the opportunities at their disposal. Second, it is important for municipalities partnering with banks to make sure that the bank’s return considerations are a good fit for the municipalities’ goal and fit the market demand. Third, in some situations, municipalities may have to adopt a buy-out clause or other concession to the borrowers on affordability if the municipality wants its loan to compete with private equity offerings. This may be an issue with some ADU applicants, but, if Oakland wants to try to spur additional housing supply growth, it will likely try to target less-affluent borrowers instead. Finally, Oakland may wish to consider exploring partnerships with agencies such as the California Air Resources Board if ADUs can be demonstrated as an effective pollution reduction investment.

E) Section 108 Loan Program

Although there are several programs offered by the U. S. Department of Housing and Urban Development (HUD) or other federal agencies detailed in more depth in a later section, the Section 108 Loan Guarantee Program is singled out here for special attention because of its potential. Section 108 is a HUD program that offers recipients of Community Development Block Grants (CDBG) the opportunity to borrow as much as five times their annual CDBG allocation from the federal government at a low interest rate. Section 108 borrowers (states, counties, and municipalities) have the opportunity to use their borrowed funds to set up a loan program to lend the Section 108 money to non-governmental actors (developers, non-profits, homeowners, etc.). The government agency is then in effect an intermediary between HUD and the people who actually use the money. However, a government agency that loans out its Section 108 allocation to other parties must pledge security against the loan. A theoretical last

53 (The Department of Housing and Urban Development n.d.)
resort for HUD to recoup its money is for it to seize future CDBG allocations (hence the five times the annual allocation of CDBG funds limit on Section 108 lending). Happily, this has never actually been necessary. So long as a government agency repays its Section 108 debts on time, there is no impact on the commitment of CDBG funds (there is no loss recovery pool set-aside or any similar sequestration of funds). Although Oakland has already borrowed $6,981,948 of its Section 108 limit for purposes this author was unable to determine, Oakland has $29,604,740 of borrowing capacity available\(^54\).

Section 108 could be used to support a city-operated ADU construction loan fund, as confirmed by a HUD program officer\(^55\), but there are several important factors that merit careful consideration. First, Section 108 loans can only be used for rehabilitation. According to the HUD program officer, this could include the construction of ADUs in basements, garages, and existing outbuildings. It would, however, preclude such loans from financing stand-alone ADUs in backyards from the ground up\(^56\). Second, Section 108 loans must be used to benefit low-income persons. Therefore, the first tenants of any ADU built through this program would have to be low-income. Oakland could and likely would impose a defined period of affordability for the newly built units, but this would not be a HUD requirement. Third, Oakland would have to pledge security on the loans to HUD. Second liens on existing single-family homes would be acceptable security, but it is conceivable that Oakland might also have to pledge a small amount of city assets as security. Fourth, Section 108 lending could serve as a source of money for traditional multifamily acquisition and rehabilitation affordable housing activity, so the use

\(^{54}\) (The Department of Housing and Urban Development 2018)
\(^{55}\) (HUD Program Officer 2018)
\(^{56}\) These ADUs built from the ground up are among the most expensive on offer, so it seems likely that a cost-conscious loan program might seek to avoid them anyway.
of Section 108 funds on ADUs may directly compete with other affordable housing opportunities.

Despite these considerations, Section 108 lending is a very promising opportunity for Oakland to help its residents finance the construction of ADUs. Beyond an obligation to use reasonable underwriting standards, Oakland has considerable flexibility in how it would operate a hypothetical ADU lending program. Oakland could impose as long or as short an affordability provision as it deems appropriate, and it could set eligibility to target populations as it sees fit. Although the first tenants of the program-funded ADUs would have to be low-income, the program is flexible enough to allow the city to lend to high-income residents who wish to build ADUs. Perhaps most critically, Section 108 has over $29 million available—enough money to potentially fund the construction of 300 ADUs. Few other programs could hope to compete with this volume.

F) Other federal funding opportunities

Unfortunately, alternative federal grant opportunities for ADU construction are limited. CDBG funds could be used for ADU construction in the existing footprint of a home, similar to Section 108 loans, but the City of Oakland has many competing priorities for this funding that make CDBG expenditure on ADU construction unlikely. Besides Section 108 lending, three other federal opportunities exist which may realistically help some homeowners and homebuyers finance the construction of ADUs. Federal Housing Administration (FHA) 203(k) loans and

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57 (Center for Community Innovation—University of California, Berkeley 2017)
Fannie Mae’s HomeStyle and HomeReady loans are all loan offerings available directly to the public which some segments of Oakland’s population would likely qualify for.

FHA 203(k) loans are loans available to fund the acquisition or refinance of a house as well as substantial rehabilitation work (anything up to and including levelling the house and rebuilding it on the same foundation)\(^58\). On the plus side, there are no minimum or maximum income limits. Downsides of this loan include the strong creditworthiness requirements, employment requirements, and the private origination of the loan (which can lead to considerable fees). FHA 203(k) loans are also subject to the same “ability-to-pay” requirements as “prime” housing loans in general. FHA loans also have a limit on the size of the mortgage: the total balance borrowed cannot be more than roughly $680,000 in Alameda County\(^59\). Nonetheless, these loans may be well-suited for Oakland residents already intending to refinance their mortgage or buy a house. The HUD website includes a look-up tool where borrowers can see which approved lenders have recently originated any 203(k) loans.

Fannie Mae’s HomeStyle mortgages are a way for homebuyers and investors to buy or refinance a 1-4 unit property and spend as much as 75 percent of the assessed value\(^60\) on rehabilitation or reconstruction. This program requires very good credit ratings (660 for individuals, 680 for investors)\(^61\) and similarly only goes up to loan amounts of $680,000. Unlike 203(k) loans, HomeStyle mortgages can be used for the construction of a stand-alone ADU.

\(^{58}\) (The Department of Housing and Urban Development n.d.)
\(^{59}\) (Federal Housing Administration n.d.)
\(^{60}\) Defined as the lesser of purchase price+ renovation costs or the final assessed value.
\(^{61}\) (Center for Community Innovation—University of California, Berkeley 2017)
However, this mortgage suffers from the similar defect of facing private origination fees and requiring the creation or refinancing of a mortgage.

Fannie Mae’s HomeReady mortgages are a mortgage lending product targeted more narrowly towards low- and middle-income borrowers. For low-poverty neighborhoods in Oakland (most neighborhoods in Oakland north of Interstate 580), the maximum income for a borrower to qualify for this loan is 100 percent of AMI (in 2018, $97,400). For low-poverty neighborhoods, there is no restriction on maximum income. This loan offering has somewhat relaxed credit requirements (620 or above), as well as the ability to explicitly count ADU-related income towards the borrowers income. While these are considerable advantages, the income-related restrictions limit access to this offering in certain parts of Oakland.

**G) State funding sources**

The author contacted the California Department of Housing and Community Development (HCD) to inquire about the suitability of existing state grant or loan programs to support the construction of ADUs. According to the program officer interviewed for this report, no existing state grant or loan projects were an appropriate fit for ADU construction. However, the program officer reported that HCD is interested in expanding opportunities to finance ADU construction. HCD is also potentially interested in supporting a pilot project involving a city-administered ADU loan program.

**H) Alameda County funding sources**

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62 (Fannie Mae 2018)  
63 (Center for Community Innovation—University of California, Berkeley 2017)  
64 Interview with HCD Program Officer
In 2016, over 70 percent of Alameda County voters approved a plan to issue $580,000,000 of bonds, supported by property tax revenues, to tackle the county’s affordable housing crisis.

Most of these funds are dedicated to rental housing development and a sizable portion of the remaining funds are dedicated to homebuyer assistance. However, $35 million are set aside for an Innovation and Opportunity Fund to seize emerging opportunities to bolster the county’s affordable housing supply and/or prevent displacement. This Innovation and Opportunity Fund set-aside is a promising opportunity to source funds for grants or loans to encourage ADU construction. Although a closer examination of the bond restrictions with County staff will likely be required, it might also be possible to use the rental housing development funds for ADU construction. A significant drawback of diverting funds from the rental housing development fund to ADU construction is that each city, including Oakland, has a set allocation of these funds. Therefore, any attempt to fund ADU construction with these funds may negatively impact other affordable housing construction activity in Oakland. The Innovation and Opportunity Fund revenue stream, however, is not geographically limited in such a way and the crowding-out effect of using that Fund is likely smaller.

1) City of Oakland funding sources

In addition to the external funding sources listed above, the City of Oakland could tap various funding sources it controls to support ADU construction though grants or loans. The two most logical candidates for such an investment would be the General Fund, the unrestricted base

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65 Of which Oakland is a member.
66 (Ballotpedia 2016)
67 (Alameda County n.d.)
68 However there may still be some crowding-out as the money will end up being used for something, and Oakland is such a large city in Alameda County that it is quite probable that some of the money would have found its way to Oakland anyway.
budget of the city, or the Affordable Housing Trust Fund, a special fund used to assemble and spend a variety of funds for affordable housing purposes (including but not limited to affordable housing impact fees). While these funds are legally the most easily accessible of any discussed in this report (a vote from the City Council would be sufficient to reallocate them), there are serious drawbacks that likely preclude their use from supporting ADU construction. The many competing needs for General Fund revenues, such as time-sensitive homelessness services, make the availability of funds for ADU construction unlikely. The Affordable Housing Trust Fund would pose crowding-out issues, as any funds dedicated to ADUs would not be dedicated to other affordable housing projects in Oakland. As Oakland carefully schedules its Affordable Housing Trust Fund allocations in such a way that they help affordable housing developers access state and federal funding contributions, every dollar diverted to ADUs could in turn cost other affordable housing development in Oakland considerably more than a dollar.

J) ADU-as-a-service and other alternative ADU ownership schemes

In recent years, a number of companies have helped consumers reimagine how to pay for various amenities (such as how Zipcar has changed attitudes towards and payment models for the use of a car). Under a conventional model, as discussed throughout this paper, a homeowner or homebuyer borrows money, builds an ADU or hires a contractor to build an ADU, and then the homeowner owns the ADU. If financing is involved, the homeowner collects rent (in some cases) and then pays back the loan. However, new models may be emerging that would challenge this traditional system.
One intriguing idea is “ADU-as-a-service.” Under this proposal, a company would take a prefabricated unit and install it in the backyard of a house. The company would collect rent from the renter and pay in effect a land rent to the homeowner (making profit by pocketing the difference after costs). Although no major construction player has implemented this idea and arranged the financial backing needed to support the up-front cost, this idea has been mentioned repeatedly by experts in the ADU field to the author as an up-and-coming solution. While this could potentially eliminate the need for a homeowner to demonstrate creditworthiness or even borrow any money, it is unclear if it will be practical to contain the costs of modular construction and installation to economical levels. Installing modular ADUs also leaves untapped the relatively inexpensive option of ADU conversions within the existing footprint of a building.

One alternative change in the ADU finance landscape might be equity/return participation in ADU construction. One idea (also mostly on the drawing board) would be for a company to build an ADU at no initial cost to the homeowner, but then have the company collect a portion of the monthly rent generated by the ADU and a portion of the home sale price (attributable to the ADU) when the home is eventually sold. This would have the advantage of potentially supporting all kinds of ADU construction for all kinds of homeowners without the risk associated with debt, but it once again remains to be seen if the legal and financial obstacles to this idea can be overcome.

69 (Hoffman 2018) and (Regan 2018)
70 ADUs as a service is reliant on the idea that an ADU can be removed and re-sited if it is no longer wanted. Basements are notoriously difficult to remove and relocate to another site.
Although these ideas may have future promise and bear watching for closely, it seems unlikely that they will be widely deployable at scale within the next few years. Therefore, it does not seem that they will be a realistic source of funding for the project at hand.

Other Findings

Staff from two cities not previously mentioned in the findings section above were also interviewed for this report. The City of Portland considered implementing an ADU loan program to support the conversion of basements into ADUs, but Portland ultimately did not move forward with the program due to internal disagreements over program priorities. Los Angeles County is currently engaging in a pilot program to loan funds for the construction of ADUs, but the pilot program’s unusual design choices make it difficult to use as an appropriate comparison for what Oakland might consider.

In Portland, city staff considered introducing an ADU construction loan program specifically targeted at basements\(^\text{71}\). Under the proposal they were considering, Portland would use tax increment financing\(^\text{72}\) to offer a zero interest loan of up to $80,000. According to the staffer interviewed for this report, basements were the most affordable ADU opportunity they could find. They set the loan amount at $80,000 based on a consensus from the contractors they consulted that $80,000 should be enough to build a basement ADU in most circumstances. Under their proposed design, the homeowner could use the ADU for anything except short-

\(^{71}\) (Bailey 2018)  
\(^{72}\) Tax increment financing is a common economic development program where a city government will borrow money to improve the quality and value of an economically depressed area. The borrowed money is then (in theory) paid off by diverting the increased property taxes of the newly-revitalized area. Tax increment financing has advantages and drawbacks too complex to explain in a footnote, but the issue is mostly moot as tax increment financing was largely abolished in California along with the redevelopment agencies in 2012.
term rentals and did not have an affordability covenant. Portland considered possibly requiring the use of a property management company to ensure that the ADUs were not used for short-term rentals. The loan program was intended to be paired with a separate loan program of $40,000 offered by Portland to help rehabilitate the homes attached to the ADUs. Despite the level of detail and research they put into their proposal, they ultimately were instructed to not pursue it after several concerns were raised by non-staff. These concerns included the prospect that the construction would raise property taxes\(^{73}\), that the targeting of basements alone was imprudent, that it would be difficult to do effective public outreach over the initiative, and that Radon gas would be an obstacle to basement conversions\(^{74}\).

Los Angeles County staff are currently working on a pilot loan program to loan up to $75,000 per unit to two to three homeowners for them to each construct one ADU and then rent it to a homeless individual or family\(^{75}\). The loan is envisioned to be a “soft second” loan. Despite the availability of funds to only build 2-3 units, Los Angeles County staff report receiving interest from hundreds of homeowners\(^{76}\). The dozens of applications that Los Angeles County received to participate in the program have been screened by a multi-step review process. Although it is laudable that Los Angeles County is actively pursuing a pilot program to promote ADU construction, the decision to only fund 2-3 units in the pilot and subject them to a hard-to-replicate level of scrutiny raises serious questions about whether the conclusions of the pilot

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\(^{73}\) Which is *not* a problem most homeowners in California will encounter, as ADU additions in California generally don’t trigger a property tax reassessment.

\(^{74}\) Radon gas is a natural byproduct of uranium decay and can contribute to lung cancer when inhaled. Basements are, as the bottom part of the house, a place at particular risk of exposure. See (Simon 2017)

\(^{75}\) (Los Angeles County Department of Regional Planning 2017)

\(^{76}\) (Tran 2018)
are externally valid77. Having to turn prospective borrowers away also raises concerns about reducing future interest in ADU lending products. However, the large interest expressed by Los Angeles County residents for a program of ADU loans linked to renting to the homeless is an encouraging sign to other jurisdictions interested in similar programs. The short construction time periods associated with ADUs could help rapidly scale up the supply of housing Oakland has available to house homeless or at-risk residents78.

Los Angeles County may also develop valuable insights over the next 12-18 months on how best to publicize ADU loan programs and design forgivable loans. If the City of Oakland was to embrace an ADU loan program, it may wish to consider periodically checking in with Los Angeles County staff.

5. Conclusion

After carefully analyzing a wide variety of possible ADU financing alternatives, a few key trends and takeaways appear clear. First, many existing funding opportunities, including the very promising Section 108 HUD loan program, are limited only to ADU construction that takes place within the existing footprint of a house due to “rehabilitation” requirements. Second, although a few private lending offerings backed by the federal government can support ADU construction, existing private lending is almost exclusively contained to those buying a house, tapping home equity, or refinancing a mortgage. Those with limited credit or income face limited opportunities to access these private lending opportunities. Third, existing county,  

77 Funding the two of the most intensively vetted ADUs in the history of ADUs may lead to better outcomes than less heavily vetted ADUs if and when ADU lending is conducted at scale.

78 Through the expenditure of city and federal funds. This is not intended to claim that ADUs are affordable to the average homeless citizen without some kind of financial assistance towards rent.
state, and federal funding opportunities for affordable housing do not have any dedicated set-asides to support ADU construction and many existing grant programs do not fit the needs of ADU construction. A silver lining is that the program staff at all three levels of government seem to be mindful of ADUs’ potential and are looking for ways to help support their production. Further cause for hope is the prospect of new models such as “ADUs-as-a-service” that could help radically reshape the financial relationships that underpin ADU construction. While current indicators suggest that these unconventional financing ideas are still in an early stage, the recent proliferation of other disruptive technologies show how unwise it can be to bet on the slow spread of new ideas.

Oakland, however, does not need to wait for a disruptive technology for it to begin helping its residents afford the construction of ADUs. HUD’s Section 108 program is a readily available source of low-cost loans that have historically been used by other municipalities to lend money. With almost $30 million available, it would be a strong foundation for an Oakland ADU loan program. Alameda County’s recent bond set-aside for its Innovation and Opportunity Fund might be another good source of funds to tap. Once a successful ADU loan program is in place, it is possible that private capital from institutional investors or real estate crowdfunding may serve as a more enduring way to capitalize such loans without tapping other affordable housing funds. If private capital expresses interest in investing in Oakland ADUs, Oakland may wish to consider working with other Bay Area municipalities to establish a regional ADU loan fund to tackle housing supply issues region-wide and to achieve efficiencies of scale.

Fundamentally, there are no good cut-and-paste models out there. It appears no large American city has ever launched a successful city-supported ADU loan program at scale. While
it can be daunting to be first in such a field, Oakland has a unique opportunity to once again lead the nation in finding solutions to the defining challenges of our time. If Oakland can point the way toward reducing the financial burden of ADU construction, homeowners and renters across the country would have profound reason to be grateful for Oakland’s leadership.

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