



## OBSTACLES AND OPPORTUNITIES AT THE INTERSECTION OF PUBLIC FINANCE AND THE HOUSING CRISIS



### **Session Two | Opportunity in Our Own Backyards: Development and Finance of Accessory Dwelling Units**

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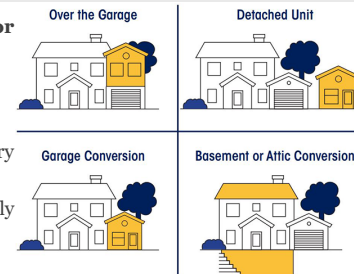
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## Definitions

### What is an ADU?

- Also commonly referred to as a “grannyflat,” an ADU is an accessory dwelling unit with complete independent living facilities for one or more persons and has a few variations:
  - Detached: The unit is separated from the primary structure
  - Attached: The unit is attached to the primary structure
  - Converted Existing Space: Space (e.g., master bedroom, attached garage, storage area, or similar use, or an accessory structure) on the lot of the primary residence that is converted into an independent living unit
  - Junior Accessory Dwelling Unit (JADU): A specific type of conversion of existing space that is contained entirely within an existing or proposed single-family residence
  - May be conventionally site-built, but also includes Modular and Manufactured units



### Modular

- Partially constructed in a factory and shipped to the homeowner’s lot, where it's pieced together, put on a foundation and then completed
- Like traditional homes, modular homes are placed on a permanent foundation and often have full basements



VS

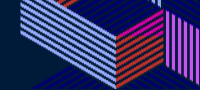
### Manufactured (or “Factory Built”)

- Completely constructed in a factory and built on a fixed, steel chassis (rather than a permanent foundation)
- GSEs<sup>(1)</sup> will require unit to be attached to a permanent foundation with evidence of compliance with HUD standards (typically an attached HUD Data Plate)



**In all cases, ADUs must conform to local Building Codes**

(1) Government Sponsored Entities, mainly, in the case of ADUs, FNMA (Fannie Mae) and FHLMC (Freddie Mac)



## Orders of Magnitude #s Would Suggest There's a Gold Mine in the Back Yard !

Median Cost to Build an ADU <sup>(1)</sup>	\$150,000	
Monthly Mortgage Cost <sup>(2)</sup>	\$612	
		Implied DTI <sup>(3)</sup>
Average CalPERS Pension (monthly)	\$2,975 <sup>(4)</sup>	21%
Average CalSTRS Pension (monthly)	\$4,475 <sup>(5)</sup>	14%
Median ADU Rental Income <sup>(1)</sup>	\$2,000 / month	
Net to Homeowner	~\$1,400 / month <sup>(6)</sup>	

**Most commonly cited reasons for low/slow ADU implementation: 1) Local zoning/permitting and 2) Financing (particularly “upfront” costs)**

(1) UC Berkley Center for Community Innovation Study April 22, 2021

(2) 30-year fixed @ 2.75%;

(3) DTI = debt-to-income ratio; Excludes Any Other Debt

(4) Source: <https://www.calpers.ca.gov/docs/forms-publications/facts-pension-retirement.pdf>

(5) Source: [https://www.calstrs.com/sites/main/files/file-attachments/public\\_pensions\\_for\\_california\\_educators.pdf](https://www.calstrs.com/sites/main/files/file-attachments/public_pensions_for_california_educators.pdf)

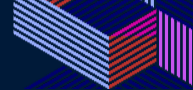
(6) Excludes insurance & taxes



## Recent Statutory Changes in California Reflect Strong “Pro ADU” Legislative Intent

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- **The Legislature has determined and declared that allowing ADUs in zones that allow single-family and multi-family uses provides critically needed rental housing and is an essential component in addressing California’s pressing housing crisis**
  - A multitude of bills have been adopted to reduce local impediments to ADU production
- **Local agencies can still impose certain limited objective design standards, and local building codes and health and safety requirements still apply. However:**
  - Any adopted local agency ADU ordinance must comply with State ADU law and is subject to HCD review (and enforcement)
  - Absent an adopted (compliant) local ADU ordinance, new ADUs subject only to standards set in State ADU law
  - Cannot include minimum lot size requirements, and lot coverage requirements cannot preclude a “Statewide Exception ADU” = < 800 sq ft, 16 feet in height, with 4 feet side/rear yard setbacks
- **Generally, requires only *ministerial approval* of an application for ADU/JADU building permits within a residential or mixed-used zone**
  - No discretionary review or hearing
- **An application for the creation of an ADU or JADU shall be *deemed approved* if the local agency has not acted on a completed application within 60 days**
- **ADUs < 750 square feet exempt from local agency impact fees**
  - < 500 square feet exempt from school impact fees
- **ADUs considered “invisible” for purposes of complying with local agencies’ general plan and zoning densities**
- **Parking requirements for ADUs shall not exceed one parking space per unit or bedroom, whichever is less**
  - May be satisfied as “tandem parking” on a driveway
- **When a garage, carport or covered parking structure is taken out by an ADU, local agency cannot require replacement off-street parking**
- **Local ordinances cannot limit the # of bedrooms in an ADU**



## Recent Statutory Changes in California Reflect Strong “Pro ADU” Legislative Intent (continued)

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- ADUs not considered “new residential use” for purposes of calculating connection fees or capacity charge for utilities (including water and sewer)<sup>(1)</sup>
- No owner-occupancy requirement for new ADUs constructed between 1/1/2020 and 12/31/2024
- Except for State Exemption ADUs, local agencies may limit areas permissible for ADU development based on the adequacy of water and sewer services, as well as the impacts on traffic flow and public safety
- A local agency’s “housing element” must include zoning parameters *vis-a-vis* ADUs and must include a plan that incentivizes and promotes the creation of ADUs
- ADUs (and JADUs) may be counted for purposes of local agencies’ Regional Housing Needs Allocation (RHNA) compliance
- Manufactured Homes qualify as ADUs
- In September, Governor Newsom signed 31 bills related to affordable housing and ADUs
  - Created a new Housing Accountability Unit at HCD to provide technical assistance to local jurisdictions, as well as enforcement powers *vis a vis* compliance with RHNA goals
  - Established a \$100 million program under CalHFA to provide grants up to \$25,000 to income-qualified homeowners to build ADUs

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<sup>(1)</sup> Unless constructed with a new single-family dwelling



**SAN DIEGO ADU EXAMPLE 1**  
Peterlynn Drive | Manufactured Unit



**SAN DIEGO ADU EXAMPLE 2**  
Enero Street





**SAN DIEGO ADU EXAMPLE 3**

Kimsue Way





# City of San Jose's Accessory Dwelling Units

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**Jacky Morales-Ferrand**  
Director, Housing Department

# Facts & Stats



**180**

Sq. miles

**1M**

2018 pop.

**1777**

Year founded

**10th**

US pop rank

**\$116K**

Med. HH Income

**\$3,328**

2-bedroom rent

**40%**

Foreign Born

**45%**

Pop with B.A.+

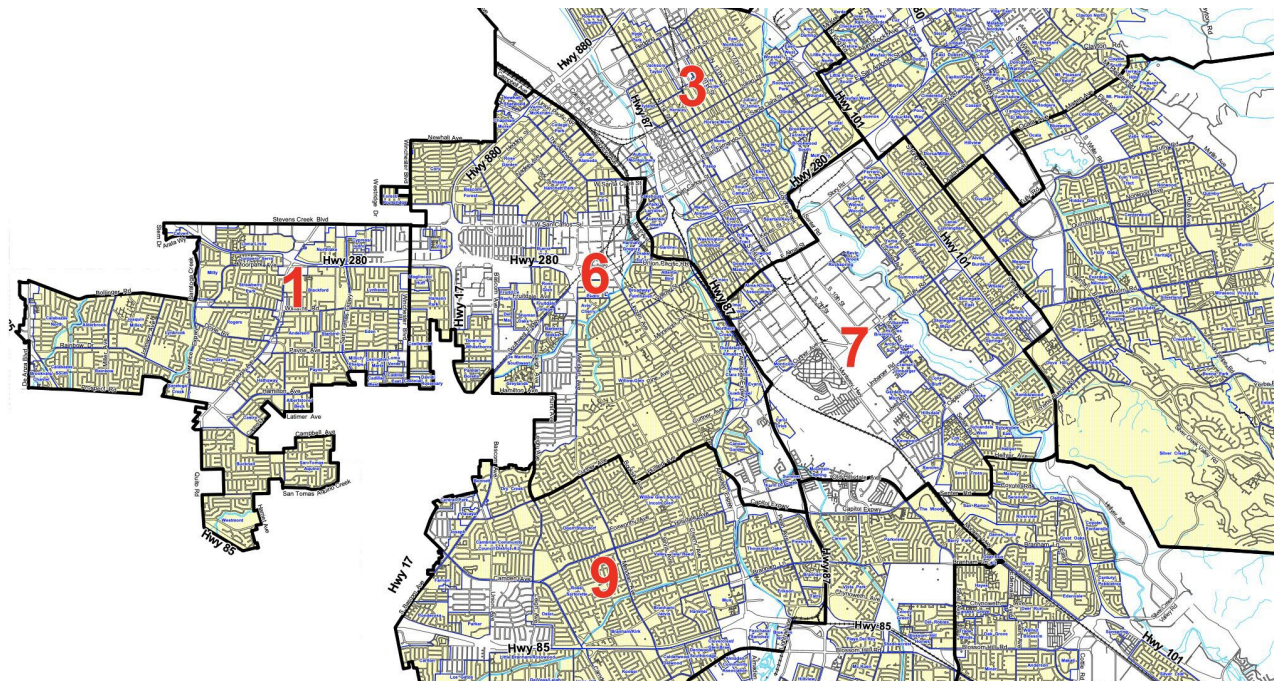
**SAN JOSE**



SoFA Street Fair



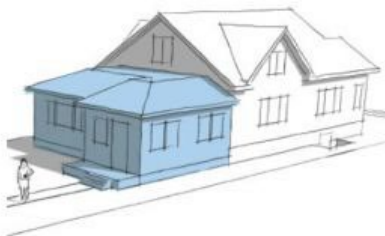
# Housing Crisis



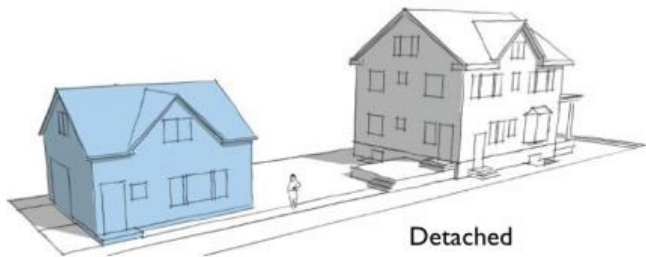
# Accessory Dwelling Units



Internal



Attached



Detached

- 🏠 State eliminated obstacles
- 🏠 San Jose has thousands of parcels big enough to support ADUs
- 🏠 We have POLITICAL WILL!

# Process Improvements



## Customer Readiness



ADU Ally



Universal Checklist



ADU Website

## Expedite Reviews



ADU Tuesdays



Master Plans



Inspection Issues  
Checklist




# Ordinance Updates



## ADU Emergency Ordinance Update

1. Minimum lot size to qualify for an ADU is eliminated
2. ADUs allowed in more single-family zoning districts and duplex and multifamily zoning districts
3. Junior ADUs are now allowed
4. ADUs can be bigger with up to 2 bedrooms
5. Attached ADU size is eased
6. Backyard coverage rule is eased
7. Rules for ADUs on historic properties are eased
8. Replacement parking no longer required

## ADU- Amnesty Program



CITY OF  
**SAN JOSE**  
CAPITAL OF SILICON VALLEY  
*Planning, Building and  
Code Enforcement*

**BULLETIN #999** 12/31/19 SUBJECT TO CHANGE

ADU Amnesty Program

### ADU Amnesty Checklist

Fill out this checklist to the best of your ability. The purpose of this checklist is the first step in evaluating an unpermitted ADU and to help you understand what might be required to participate in this program. After answering these questions, the homeowner can reach out to the Amnesty Program point of contact to discuss the responses and process for next steps. There is no risk for contacting the City staff.

QUESTIONS	COMMENTS	
<b>SECTION A. GENERAL</b>		
1. Is the ADU attached or detached from the primary residence?		
2. Was the ADU built as an ADU, or was a permitted structure converted to the ADU.		
3. Estimated date of conversion?		
4. When was the ADU built? (Estimated date)		
<b>SECTION B. FIRE</b>		
5. Are there any walls at least 5' to the property line?	YES	NO
Are all windows, doors, or openings greater than 3' to the property line?		
6. If detached, is it at least 10' from the main house?		
7. If attached, is the wall 1-hour rated and sound rated (1 hour rated: If the wall has 5/8" type x dry wall both sides)		
<b>SECTION C. BUILDING</b>		
9. Does the ADU have an exterior door that is at least 3' wide and at least 6'8" high?		
10. Does each room used for sleeping have an exterior door or window providing at least a 5.7 sq ft opening? Is the dimensions at least 20" wide and 24" high. Is the exterior window sill less than 44" high from the floor?		
11. Does the ADU have independent heating and its own thermostat?		
12. Does the ADU have at least 7'6" ceiling height?		





# Results



YEAR	Total Permits Issued
2015	11
2016	35
2017	72
2018	141
2019	329
2020	349
2021 To- date	350



# Study to Identify Challenges



Stanford Law School  
Law and Policy Lab



San José Housing Department



# Results



- 🏠 Do not want another unit on my property
- 🏠 Do not want to be a landlord or have tenants
- 🏠 It's too expensive to build
- 🏠 I fear an ADU would increase my property taxes
- 🏠 I don't know where to begin
- 🏠 My property doesn't qualify

# Costs -- Deeper Look



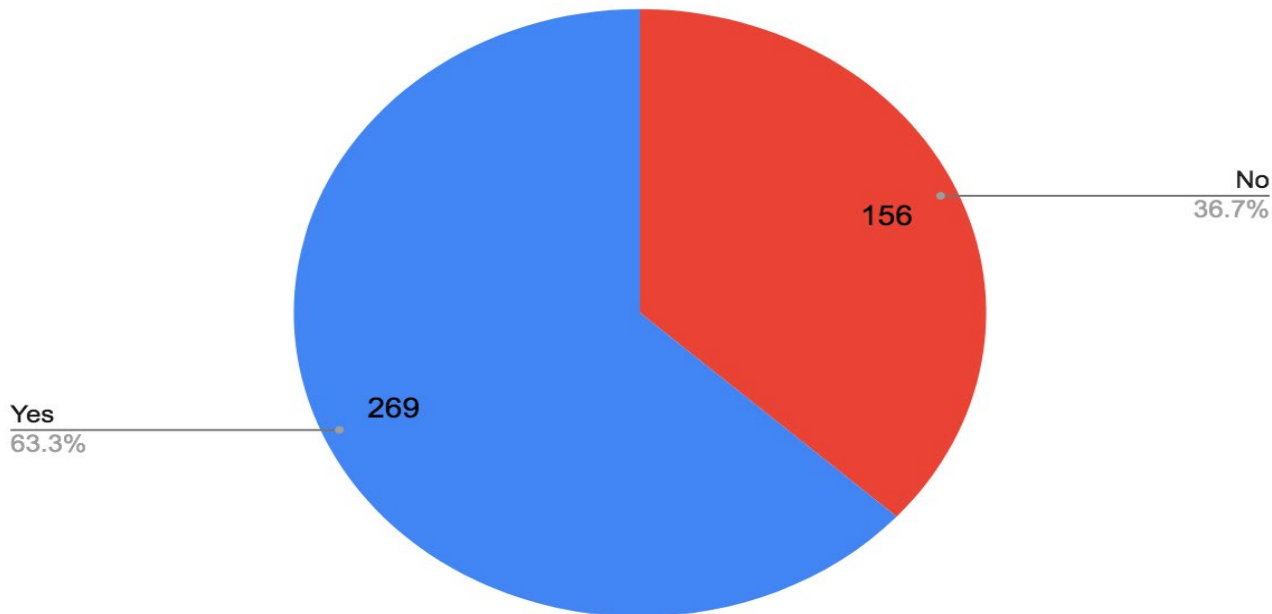
“The City has done a great job of making improvements. The biggest obstacle right now is the exorbitant cost of construction.”



# Proposed Forgivable Loan of \$20K who rent for \$2,040 or less for 5 years



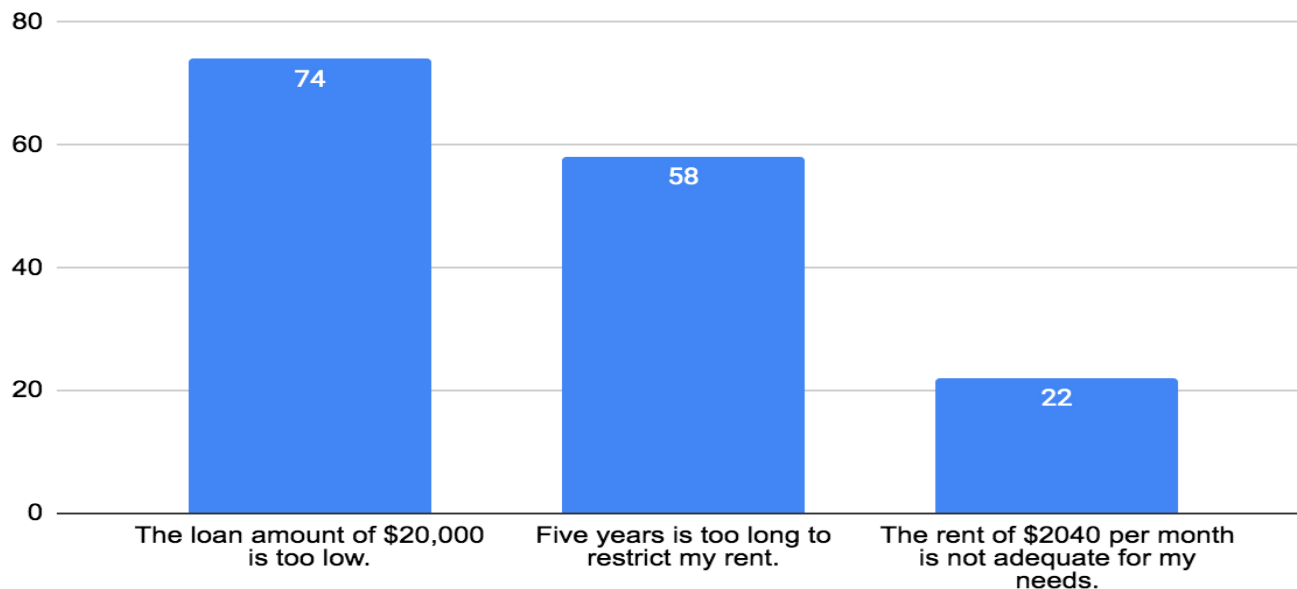
63% said yes; 37% said no



# Why doesn't the program Interest You?



48% specifically said the loan was too low to interest them





# Increase the Forgivable Loan Amount



"Since contractors are so expensive, you have to empower the homeowner."

"The City has done a great job of making improvements. The biggest obstacle right now is the exorbitant cost of construction."

"I can't afford the costs.... It would take me 12 years of rental income to pay off the necessary loan."

"I'd like the city to work with lenders to provide low cost loans to make the process more achievable."

"We need bigger forgivable loans."

# Ideas to Improve Program



- Address perceived imbalance of landlord/tenant rights for ADUs (educate on ADU exemptions)
- Explain Property Tax Implications Up Front; Consider Property Tax Relief For ADUs
- Expand Library of Pre-Approved Designs - More Variety, Price Points
- Add More Prefabricated Models to Library of Pre-Approved Designs
- Publicize and Simplify Existing ADU Checklist
- Increase the Forgivable Loan to \$50,000 (even with longer rent-cap requirement)
- Alternatively, publicize the median cost to dissuade those who can't afford to build from entering the process only to divert staff time away from those who can afford to build
- Create a List of Contractors That Use Alternative Financing Models (e.g. Rent The Backyard)



# City of San Jose's Accessory Dwelling Units

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Director, Housing Department

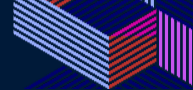


## Building the Foundation for a Viable ADU Financing Program

- As part of the State Treasurer's Housing, Economic Development, Jobs and Opportunity Zone Ad-Hoc Committee, Loop's first task was to identify "the friction points" in the existing financial ecosystem related to ADU financing



- We started "at the back-end first" – to identify the various GSEs' criteria related to ADUs, knowing that without a viable offtake, banks would be unlikely to make construction loans or takeout loans for ADUs
- A key objective was to find a way to enable ADU "sponsors" (homeowners) to monetize prospective ADU rental income
- Both Fannie Mae and Freddie Mac have programs that allow inclusion of ADU income in qualifying *income but only for first-time home buyers of properties with existing ADUs* (which would not add to the housing stock)



## What Qualifies as an Accessory Dwelling Unit For FNMA<sup>(1)</sup>

The ADU must provide for living, sleeping, cooking and bathroom facilities and be on the same parcel as the primary one-unit dwelling

- **Only one ADU is permitted on the parcel of the primary one-unit dwelling.**
- **ADUs are not permitted with a two- to four-unit dwelling**
- **The ADU must**
  - be subordinate in size to the primary dwelling.
  - have the following separate features from the primary dwelling:
    - means of ingress/egress, kitchen, sleeping area, bathing area, and bathroom facilities.
- **The ADU may, but is not required to, include access to the primary dwelling. However, it is not considered an ADU if it can only be accessed through the primary dwelling or the area is open to the primary dwelling with no expectation of privacy.**
- **The kitchen must, at a minimum, contain the following:**
  - cabinets;
  - a countertop;
  - a sink with running water; and
  - a stove or stove hookup (hotplates, microwaves, or toaster ovens are not acceptable stove substitutes)

(1) Source: FNMA Selling Guide, March 3, 2021



## Fannie Mae's HomeStyle Program

- **A HomeStyle renovation loan would allow homeowners to tap the equity in their primary residence to finance the addition of an ADU (through a limited cash-out refinance)**

- Prospective ADU income is NOT included in qualifying income;
- However, it appears that sponsoring governmental agencies can loan against the prospective ADU income (if structured in compliance with Fannie Mae's Community Seconds checklist)

- **Assuming a single ADU on a single parcel owned by the borrower/primary resident, and a fully amortizing fixed-rate first lien mortgage (secured by the entire property):**

- The maximum cost for renovations for HomeStyle Renovation must not exceed 75% of the “as completed” appraised value of the property
- For example, if the appraised value of the property (with ADU added) is \$400K, then the maximum renovation cost allowed would be \$300K
- For a limited cash-out refinance on a 1 unit, the maximum LTV/CLTV/HCLTV for a fixed-rate first-lien mortgage is 97%<sup>(5)</sup>
- Using the same example, if the appraised value (after ADU added) is \$400K, then the maximum allowable Homestyle Mortgage (97%) would be \$388K

Maximum LTV, CLTV, HCLTV <sup>(2)</sup>	Credit Score / LTV <sup>(4)</sup>	Minimum Reserves <sup>(3)</sup>	Credit Score / LTV <sup>(4)</sup>	Minimum Reserves <sup>(3)</sup>
97%	680 if > 75% 640 if ≤ 75%	0	720 if > 75% 680 if ≤ 75%	0
	620 if ≤ 75%	2	700 if > 75% 660 if ≤ 75%	6
	660 if > 75%	6		6

<b>Requirement:</b>	<i>Renovation cost ≤ 75% of appraised property value</i>	<i>LTV/CLTV ≤ 97% of appraised property value</i>
<b>Appraised Value Example:</b>	\$400,000	\$400,000
<b>Maximum Renovation Cost/HomeStyle Mortgage:</b>	\$300,000	\$388,000

- **Importantly, the appraisal would be done pre-construction of the ADU on an “as completed” basis (factoring in the estimated incremental value of the planned ADU)**

- **Credit Scores are an important factor, and it does not appear that a state/local agency loan backstop is a viable patch**

- Facilitating ADU production by lower credit score homeowners may require a state/local agency funded program (potentially in partnership with Foundations)
  - Seasoned, performing loans could be securitized, with proceeds recycled into new ADU loans

(1) DTI = Debt to Income ratio. Gross monthly income vs monthly rent, mortgage, credit card and any other installment debt payments.

(2) Limited cash-out refinance, single property

(3) “Minimum Reserves” refers to months of mortgage payments demonstrated on borrower's 2 most recent bank statements – a “point in time” (at the time of the application) evaluation. The reserves shown are for manually underwritten loans. Desktop Underwriting will determine the reserve requirements based on the overall risk assessment of the loan and the minimum reserve requirement that may be required for the transaction. 97% LTVs are limited to Desktop Underwriting. Manually underwritten loans are limited to 95% LTV.

(4) LTVs shown are limited to Desktop Underwriting

(5) For LTVs > 95%, for limited cash-out refinance transactions, the loan must be owned or securitized by Fannie Mae





## Parameters for a State or Local Agency-Provided Community Second to “Monetize” Potential ADU Income

- **To reduce borrowers’ First (funded by Fannie Mae), and enable borrowers to monetize expected ADU income, the State or other sponsoring local agency could potentially offer a Subordinate Second, subject to:**
  - Combined LTV<sup>(1)</sup> ≤ 105% of value determined pursuant to Fannie Mae’s appraisal standards
  - The 2<sup>nd</sup> loan must be fixed-rate, fully amortizing – no balloon
    - If structured to include negative amortization, acceptable if either:
      - (a) The interest is accrued at a rate that is not more than 75% of the rate of the first lien<sup>(2)</sup> and is fully deferred until sale or transfer of the property, refinance or other full repayment of the first lien, or
      - (b) Accrued interest is only assessed as a penalty upon default under the subordinate financing documents
  - The interest rate on the 2<sup>nd</sup> cannot exceed the interest rate on the first mortgage loan by more than 2%
- **If the Second is structured as a zero interest “participating second,” the Sponsoring Agency’s share of sale proceeds cannot exceed the original ratio of the initial loan amount to the initial value of the property as determined per the appraisal upon which Fannie Mae made its First**
  - For example, subject to certain exceptions, if the Second had an initial amount of \$30,000, and the initial value of the property (including the estimated incremental value of the ADU) was \$300,000, then the Sponsoring Agency’s share of sale proceeds would be capped at 10%

**Per Fannie Mae’s Selling Guide, donated Grant funds from an acceptable entity (such as the State, a local housing agency, a Community Foundation or other philanthropic organization) can be used to fund all or part of the down payment, closing costs, or financial reserves subject to the minimum borrower contribution requirement.<sup>(3)</sup>**

(1) Fannie Mae First + governmental Second

(2) i.e. The negative amortization speed of the Second cannot exceed 75% of the amortization speed of the First

(3) Note: Fannie Mae’s Selling Guide ultimately governs the eligibility guidelines for loans eligible for delivery to Fannie Mae



## Key Takeaways

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- **The Legislature has demonstrated a strong intent to encourage/facilitate ADUs to help address the State’s pressing housing crisis**
- **Adopted legislation limits local impact fees, overrides certain local zoning restrictions and requires expedited/ministerial approvals**
- **Local ADU ordinances are subject to HCD review, which has been provided enhanced oversight/enforcement authority**
- **FNMA’s HomeStyle renovation loan appears to provide a viable offtake for construction lenders for ADU loans**
- **The State and/or local agencies can help homeowners monetize ADU income through qualifying Community Seconds, including “participating seconds”**
  - Participating loans may also be a viable path for the State/local agencies to directly assist lower credit score ADU sponsors
- **CalHFA’s new \$100 million ADU grant program is intended to produce 4,000 new ADUs**



## Recommended Resources

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### California Department of Housing and Community Development (HCD)

- ***Accessory Dwelling Unit Handbook***

- Updated December 2020

Source: [https://www.hcd.ca.gov/policy-research/docs/adu\\_december\\_2020\\_handbook.pdf](https://www.hcd.ca.gov/policy-research/docs/adu_december_2020_handbook.pdf)

### UC Berkeley Center for Community Innovation

- ***Implementing the Backyard Revolution: Perspectives of California's ADU Owners***

- April 22, 2021

Source: <https://www.aducalifornia.org/wp-content/uploads/2021/04/Implementing-the-Backyard-Revolution.pdf>