ISSUE BRIEF SERIES:

Making It Happen: Scaling Accessory Dwelling Units

By Ahmad Abu-Khalaf

October 2023

Enterprise

Acknowledgments

The author would like to thank Michael Andersen from Sightline Institute, Matthew Glesne from Los Angeles City Planning, and Denise Pinkston and Celeste Goyer from Casita Coalition for their contributions.

This research was made possible through the generous support of JPMorgan Chase & Co. Unless otherwise specifically stated, the views and opinions expressed in the report are solely those of the report's author and do not necessarily reflect the views and opinions of JPMorgan Chase & Co. or its affiliates.

About the Author

Ahmad Abu-Khalaf is a senior research analyst on Enterprise Community Partners' Policy Development & Research (PD&R) team. He conducts research and analysis of affordable housing and community development policy, focusing on strategies for expanding the supply of affordable homes and bending the cost curve. Ahmad holds a master's degree in urban planning from the University of Arizona, Tucson.

About the Enterprise PD&R Team

PD&R provides thought leadership and data-backed recommendations to influence housing and community development policy, addressing both emerging policy issues and long-term needs. Read reports and policy briefs by the team (www.enterprisecommunity.org) and follow us on X @E_HousingPolicy.

Table of Contents

Photo Credit: BuildingAnADU.com

Photo Credit: BuildingAnADU.com

Background

In 2019, the Enterprise Policy Development and Research (PD&R) team launched a research series with the purpose of examining different methods of overcoming the regulatory and financing barriers to bringing to scale affordable housing design, construction and production strategies. Between 2019 and 2022, Enterprise issued several research papers and briefs, exploring policy solutions to boost a range of housing innovations, including off-site construction, accessory dwelling unit (ADU) development and low-density multifamily housing.

Enterprise's PD&R team is launching a new issue brief series titled, "Making it Happen." The series explores recent successes in scaling affordable housing innovations and highlights newly launched initiatives that are designed to overcome regulatory and financing barriers to these innovations. First in the "Making it Happen" series, this brief will lay out recent progress in bringing ADU development to scale.

In 2020, Enterprise released a white paper titled, "**Overcoming Barriers to Bringing ADU Development to Scale**."[1] An ADU, also called an in-law suite, granny flat or casita, is a smaller, self-contained residential dwelling that is located on the same parcel as a primary, larger residential dwelling, which is typically a single-family home. Our research highlights the idea that ADU development is a housing production strategy with great potential to boost gentle residential density, diversity of housing types and housing affordability, especially in predominantly single-family neighborhoods.

Since we released our paper in 2020, recent data analyses have shown that previously enacted ADU-supportive land use and zoning reforms have had a positive impact on ADU production, especially in West Coast jurisdictions that have adopted such reforms.[2] This experience is not universal as regulatory barriers to ADU production remain in several jurisdictions nationwide.

Additionally, since the release of our ADU paper, several private and public entities have launched efforts to boost ADU-tailored financing products. As of the writing of this brief, these efforts have yet to materialize into an adequate or abundant national supply.

Overcoming Regulatory Barriers to ADU Development

State and local zoning regulations are one of the prominent factors in shaping the form and scale of ADU construction. At a minimum, municipal governments must permit ADU development in some or all single-family zones to support this housing strategy. However, in many jurisdictions where ADU development is permitted, homeowners interested in adding an ADU on their lots may still face regulatory and zoning provisions that can create a range of challenges, including complex, lengthy permitting processes and reduced feasibility of creating ADUs.

While local housing market conditions and zoning barriers to ADU production may vary from one jurisdiction to another, places interested in addressing regulatory barriers to ADU production can enact reforms that either eliminate or mitigate prominent regulatory and zoning provisions. These include reforms to:

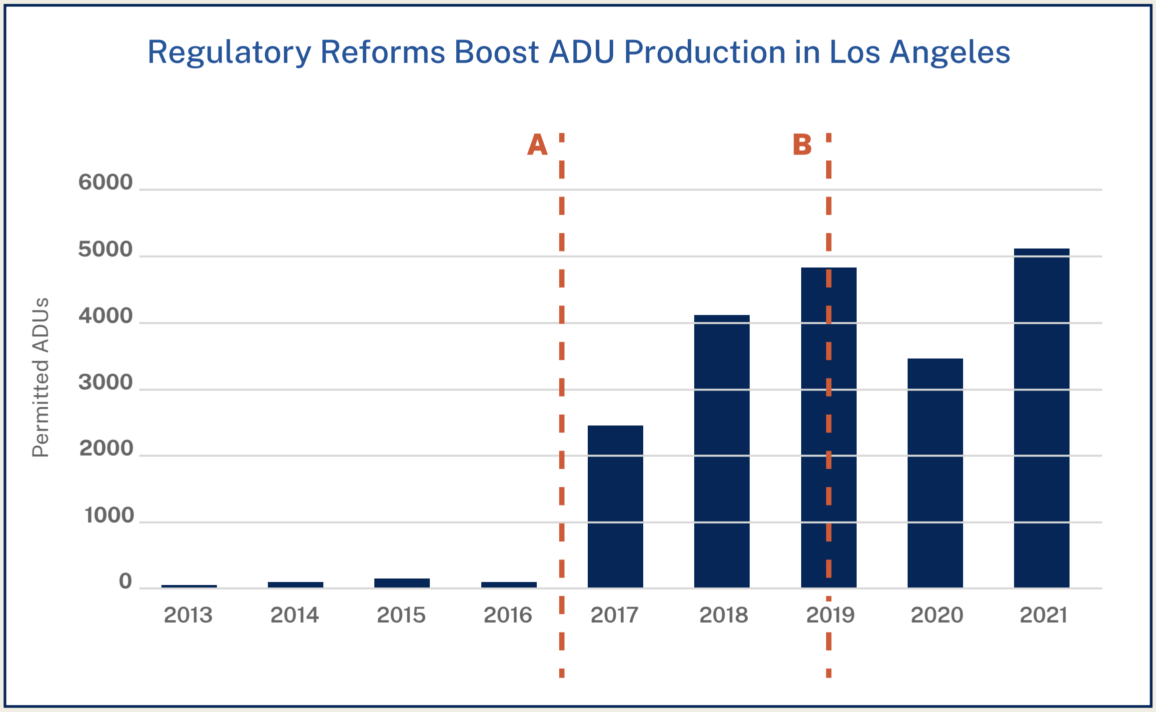
- **Permitting processes:** Approving ADU development under a streamlined and expedited review process that is intended to confirm compliance with municipal zoning requirements, as opposed to a discretionary review process that gives local agencies the authority to impose specific requirements on each ADU development proposal on a case-by-case basis.

- **Parking requirements:** Easing or eliminating off-street (on-site) parking spots for ADUs to avoid hurting the financial and/or physical feasibility of ADU development.

- **Lot size requirements:** Easing excessive minimum lot size requirements for ADU development, which indirectly prohibit homeowners with small and moderately sized lots from creating ADUs.

- **Bulk specifications:** Ensuring that underlying bulk requirements, such as setback and height cap requirements, do not inhibit or negatively impact the physical and financial feasibility of ADU development.

To overcome regulatory barriers to ADU production, a number of jurisdictions across the country have enacted state- or city-level reforms that are designed to boost ADU development. Recent increases in ADU permitting in the West Coast region show that state- and city-level reforms have been effective in boosting ADU production.

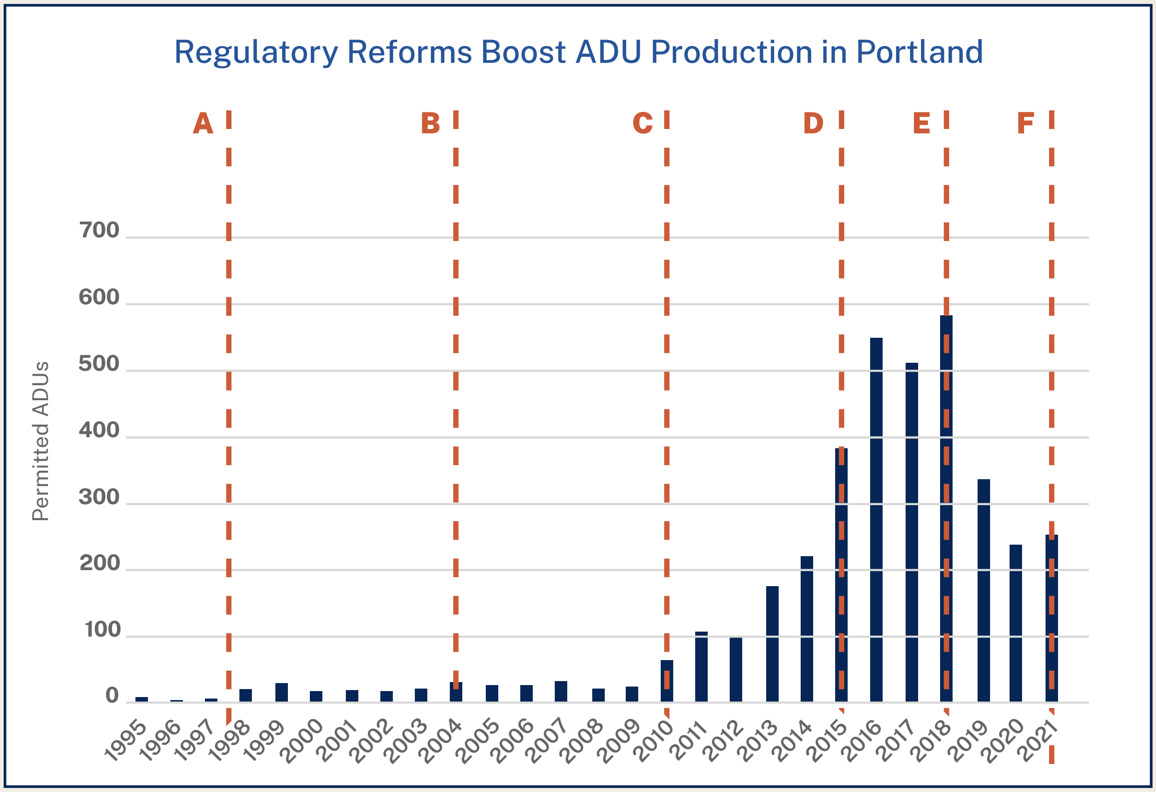


Data Source: California Department of Housing and Community Development's Housing Element Implementation and Annual Progress Reports Dashboard

- **Line A:** In 2016 and 2017, the state of California adopted several ADU reforms[3] including:
    - Permitting ADUs through a ministerial rather than a discretionary process.
    - Removing previous passageway requirements for ADU development.
    - Waiving parking requirements for eligible ADUs, such as those near transit stops, and allowing zero setbacks for ADUs created through existing garage conversions.
    - Relaxing size caps on ADUs.

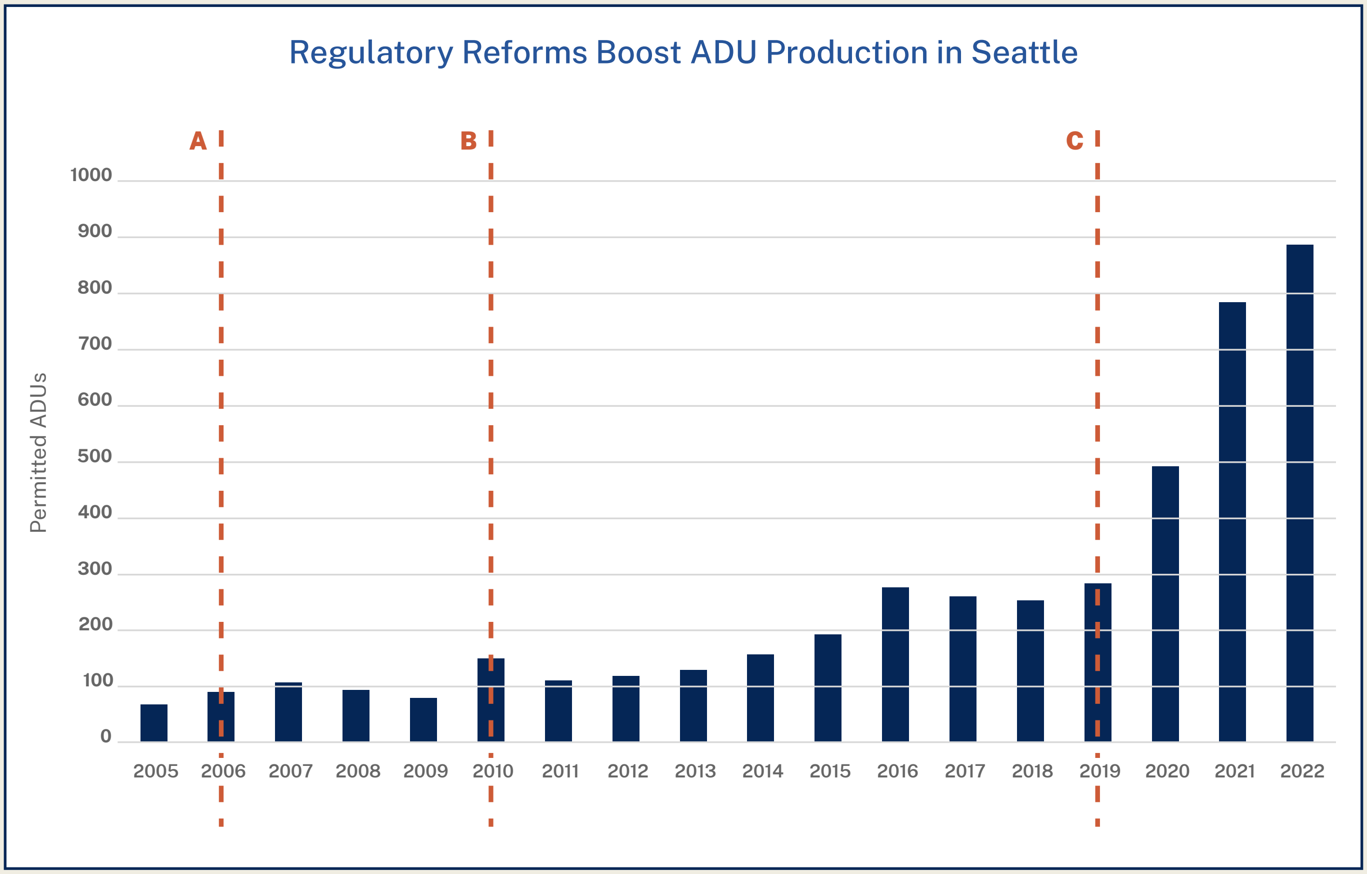
  It is important to note the city of Los Angeles saw a large spike in ADU permitting after California passed these ADU reforms, which replaced the city's ADU code entirely and comprehensively addressed previous local regulatory barriers to ADU development, compared to other major cities in the state.[4]

- **Line B:** In 2019, California Governor Gavin Newsom signed into law a group of bills[5] to relax regulatory restrictions on and provide more flexibility in ADU development including:
    - Freezing owner-occupancy requirements for all proposed ADUs until January 1, 2025.
    - Eliminating parking requirements for eligible ADUs, capping parking requirements for ADUs at one parking space per ADU or per bedroom (whichever number is smaller), and clarifying that local agencies cannot require off-street parking replacement for an ADU that was created through a garage or covered parking structure conversion.
    - Waiving minimum lot size requirements for ADU development and prohibiting local jurisdictions from adopting maximum ADU size requirements that are less than 850 square feet for a one-bedroom ADU.
    - Allowing the creation of a junior ADU in addition to the lot's larger ADU.
    - Waiving impact fees for eligible ADUs.



Data Resource: The City of Portland, Oregon

- **Line A:** Between 1997 and 1998, ADU reforms in Portland, Oregon, included:
    - Allowing ADU development by right.
    - Expanding the property's overall floor area, rather than being only through internal space conversions.
    - Removing owner occupancy requirements for ADUs.[6]
- **Line B:** Portland removed on-site parking requirements for ADU development.[7]
- **Line C:** Portland started offering a temporary waiver (subsequently extended in 2013 and 2016) of system development charges (SDCs), which are collected by the city to offset the impact of new development on its infrastructure and public services, for homeowners in return for agreeing not to rent the ADU or the primary residence as a short-term rental for a specific period of time.[8] Portland also increased the maximum ADU size from 33% to 75% of the main dwelling's size.[9]
- **Line D:** Portland amended its codes to allow an extra two feet of height for two-story ADUs and provided more flexibility in design and setback requirements for ADU development.
- **Line E:** Starting August 1, 2018, Portland indefinitely extended its SDC waiver for ADUs on sites dedicated entirely to long-term rentals, but reimposed SDCs on any newly built ADU whose owner does not pledge to avoid using any part of any structure on the site as a short-term rental for at least 10 years. The penalty is a fee larger than the initial SDC. In the next few years, just 6% of new ADUs opted to pay SDCs (55 out of 799). The Sightline Institute suggests that these changes partially explain the succeeding drop in ADU permits, due to the new impact fee for short-term ADU rentals and a lack of urgency for applying for ADU permits after the city made the temporary impact fee waiver for long-term ADU rentals permanent.[10]
- **Line F:** Portland legalized the creation of two ADUs per lot.[11]



Data Source: The City of Seattle's ADUniverse

- **Line A:** In 2006, Seattle adopted an ordinance to launch a pilot program that allows detached ADUs in specific single-family residential neighborhoods.[12]
- **Line B:** In 2010, Seattle adopted policy changes to allow detached ADUs in all single-family residential neighborhoods.[13]
- **Line C:** In 2019, Seattle enacted reforms[14] to remove regulatory barriers to ADU development in the city's single-family zones, including:
    - Reducing the minimum lot size required to build a detached ADU from 4,000 to 3,000 square feet.
    - Increasing the maximum size of a detached ADU from 800 to 1,000 square feet, excluding any parking or storage areas.
    - Removing owner occupancy requirements for ADUs.
    - Increasing height limits for detached ADUs by 1-3 feet.
    - Eliminating on-site parking requirement for ADUs.
    - Permitting the addition of two ADUs per lot for eligible ADUs.

Photo Credit: BuildingAnADU.com

Overcoming Barriers to Financing ADU Development

The scarcity of lending products tailored for ADU financing has made tapping into homeowners' cash savings or home equity the most common path for financing development, which typically does not work for homeowners with lower incomes and limited equity in their homes. Additionally, when loans used to finance ADU development do not include projected rental income in the appraisal process, the resulting under-appraised property value leads to a lower offered loan amount. Furthermore, when lending products used to finance ADU development do not include the projected rental income in the debt-to-income ratio (DTI), homeowners may experience challenges in securing financing.[15]

The exclusion of the projected ADU rental income results in the disqualification of borrowers who would otherwise be eligible. Without the inclusion of rental income from the ADU as part of the borrower's income, the "back-end" DTI calculation,[16] which measures borrowers' debt load and financial stress by dividing the borrower's total minimum monthly debt payments over their monthly income, might exceed the maximum DTI allowed for the loan.

Photo Credit: BuildingAnADU.com

To overcome this challenge, several federal agencies have pursued policy changes to allow for calculating the market-rate rent for ADUs and using ADU rental income to qualify for federally backed loans that can be used to finance or refinance properties with ADUs including:

- **Freddie Mac** (a government-sponsored enterprise, or GSE) has adopted a policy change[17] to allow for the inclusion of expected rental income from an eligible ADU that will be added to a one-unit property used as a primary residence in the underwriting of any GSE mortgages that can be used to finance ADU development. Freddie Mac requires the applicant to provide documentation of the qualifying ADU rental income through an executed lease with monthly rental income payments that either begin before or on the date the first mortgage payment is due and under at least a one-year term. The qualifying ADU rental income cannot exceed 30% of the borrower's total income used to qualify for the mortgage.

- **Fannie Mae** (another GSE) offers the HomeReady[18] mortgage, which can be used by eligible borrowers to purchase or refinance a home with an existing ADU. Income generated from an ADU can be considered as rental income to help applicants qualify for the loan. HomeReady requires the submission of an appraiser estimation of the ADU's market-rate rent based on the market-rate rents of similar ADUs within properties that include one primary unit plus an ADU, or appraisals that are based on similar non-ADU rental properties, adjusted for factors that affect market rent.

- **The Federal Housing Administration** (FHA) is updating its lending policies[19] to allow for appraisal of the market-rate rent of an eligible ADU that will be added to a single-unit property and using the projected ADU rental income to qualify for FHA-insured mortgage financing. The FHA is also updating its guidance for appraisers regarding how to determine and report the market-rate rent for properties with ADUs, either based on at least one comparable rental that is a single-family dwelling with a rented ADU or the most appropriate rental available. If the borrower does not have a history of rental income from the ADU since the previous tax filing, the ADU's effective income would be calculated based on the appraised market-rate rent or the ADU rent reflected in the lease or other rental agreement. The rental income from the ADU cannot exceed 30% of the borrower's total income used to qualify for the FHA-backed mortgage.

Some private lenders have launched lending products that are tailored to financing ADU development and do not rely on tapping into home equity to access ADU financing. Examples include:

- **Redwood Credit Union**, which offers banking services in the San Francisco area, provides ADU construction loans that include a significant share of the projected rental income in assessing the applicant's eligibility. Redwood Credit Union also includes the assessed overall value of the property with the proposed ADU, which is calculated based on the projected rental cash flows, an underwriting process that often leads to offering larger loan amounts.[20]

- **First Citizens' Federal Credit Union**, which is headquartered Fairhaven, Massachusetts, has launched an ADU lending product that offers flexibility to use the ADU's projected rental income in reviewing loan applications for approval.[21]

- **Craft3**, a nonprofit community development financial institution (CDFI) based in the Pacific Northwest region, offers fixed-interest, long-term loans that may finance up to 100% of the ADU development costs, allowing homeowners to borrow up to $250,000 to cover ADU design, permitting and construction costs. This loan product offers reduced rates to qualified borrowers. Craft3 also offers flexibility in borrower's eligibility requirements, including more lenient credit requirements.[22]

Overall, private lenders can support ADU development through launching and offering lending products tailored for ADU development. While taking into consideration local market conditions, these products would:

- Include the projected rental income from the ADU in calculating the DTI and appraised value to avoid the risk of facing higher loan denials and/or being offered lower capital due to undervalued appraised property value.

- Provide a loan underwriting process and loan terms that are tailored for the population in need of ADU financing, especially low-and moderate-income homeowners interested in pursuing ADU development on their lots.

Photo Credit: BuildingAnADU.com

Looking Ahead

Bringing ADU development to scale requires the adoption of jurisdiction-wide regulatory reforms designed to address municipal regulations and requirements that often create regulatory barriers to ADU development. Recent increases in ADU permitting in the West Coast region show that state- and city-level comprehensive regulatory reforms have been effective in boosting ADU production.

Other jurisdictions can adopt similar comprehensive reforms that address prominent regulatory barriers to ADU production, particularly delays related to the approval and permitting processes, excessive on-site parking requirements, substantive minimum lot size and restrictive bulk specifications.

HUD and the GSEs are working towards greater support for ADU-tailored financing, illustrated by the recent policy changes allowing for the inclusion of projected ADU rental income in the DTI calculation. At the present time, we do not know the level of impact the recent policy changes will have on expanding access to financing for ADU construction.

Additionally, federal efforts to expand ADU financing should be complemented by private loans tailored for ADU development, especially those designed to fill financing gaps faced by low- and moderate-income borrowers seeking to build income and wealth through the addition of ADUs to their properties.

Both expanding the number of federally backed and private ADU-tailored loans and easing regulatory barriers are needed to significantly boost ADU production nationwide.

References

[1] Abu-Khalaf, A. (2020). Overcoming Barriers to Bringing ADU Development to Scale. Enterprise Community Partners. https://www.enterprisecommunity.org/sites/default/files/2021-06/overcoming-barriers-to-bringing-adu-development-to-scale.pdf

[2] Gabobe, N. (2020, December 2). West Coast Cottage Reforms Lead to Explosive Rise in Permits. Sightline Institute. https://www.sightline.org/2020/12/02/west-coast-cottage-reforms-lead-to-explosive-rise-in-permits/

[3] HUD Office of Policy Development and Research. (n.d.). In Depth: Reducing Regulation Expands ADU Construction in California. Regulatory Barriers Clearinghouse. https://www.huduser.gov/portal/rbc/indepth/interior-051821.html

[4] Gabobe, 2020.

[5] Gabobe, N. (2019, November 22). California Looks to a Future Beyond Single-Detached House Zoning Sightline Institute. https://www.sightline.org/2019/11/22/california-looks-to-a-future-beyond-single- detached-house-zoning/

[6] Menard, L. (2016, March 4). How Portland Became ADU-Friendly (And How Your City Can, Too). Accessory Dwellings (blog). https://accessorydwellings.org/2016/03/04/how-portland-became-adu-friendly/

[7] Menard, 2016.

[8] Chapple, K., Wegmann, J., Mashhood, F., & Coleman, R. (n.d.). Jumpstarting the Market for Accessory Dwelling Units: Lessons Learned from Portland, Seattle and Vancouver. San Francisco chapter of the Urban Land Institute. https://communityinnovation.berkeley.edu/sites/default/files/adu_report_4.18.pdf

[9] Menard, 2016.

[10] Gabobe, 2020.

[11] Britschgi, C. (2022, June 13). Portland Legalized 'Missing Middle' Housing. Now It's Trying to Make It Easy to Build. Reason. https://reason.com/2022/06/13/portland-legalized-missing-middle-housing-now-its-trying-to- make-it-easy-to-build/

[12] Chapple et al.

[13] Seattle Department of Planning and Development. (2015). Removing Barriers to Backyard Cottages. https://www.seattle.gov/documents/Departments/OPCD/OngoingInitiatives/EncouragingBackyardCottages/RemovingBarrierstoBackyardCottages.pdf

[14] Seattle City Council. (2019, July 1). Backyard Cottages and Basement Units. City of Seattle. https://www.seattle.gov/council/issues/past-issues/backyard-cottages-and-basement-units

[15] Abu-Khalaf, 2020.

[16] Abu-Khalaf, 2020.

[17] Freddie Mac. (2022, August 4). Accessory Dwelling Unit (ADU) FAQ. Freddie Mac Single-Family. https://sf.freddiemac.com/faqs/accessory-dwelling-unit-faq

[18] Fannie Mae. (n.d.). HomeReady Mortgage. https://singlefamily.fanniemae.com/originating-underwriting/mortgage-products/homeready-mortgage

[19] U.S. Department of Housing and Urban Development. (2023, April 13). Federal Housing Administration Seeks Feedback on Proposed Changes to Increase Access to Affordable Financing for Properties with Accessory Dwelling Units [Press release]. https://www.hud.gov/press/press_releases_media_advisories/hud_no_23_075

[20] DuPlessis, J. (2022, March 22). Redwood CU Helping to Finance Homeowner Rental Units. Credit Union Times. https://www.cutimes.com/2022/03/22/redwood-cu-helping-to-finance-homeowner-rental-units/

[21] First Citizens' Federal Credit Union. (2019, August 22). First Citizens' Federal Credit Union Announces Accessory Dwelling Unit (ADU) Loan Program [Press release]. https://www.firstcitizens.org/assets/files/alBO9hae/ADU%20Loan%20press%20release_FINAL.pdf

[22] Craft 3. (n.d.). ADU Loans. https://www.craft3.org/homeowner-loans/adu-loans

About Enterprise Community Partners

Enterprise is a national nonprofit that exists to make a good home possible for the millions of families without one. We support community development organizations on the ground, aggregate and invest capital for impact, advance housing policy at every level of government, and build and manage communities ourselves. Since 1982, we have invested $64 billion and created 951,000 homes across all 50 states, the District of Columbia, Puerto Rico and the U.S. Virgin Islands – all to make home and community places of pride, power and belonging. Join us at enterprisecommunity.org.