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Financing Ancillary Apartments on Residential Properties: Challenges and Solutions

Author

Wegmann, Jake

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Jake Wegmann

EXECUTIVE SUMMARY:

The Blocked Market for Financing Small Apartments on Residential Properties, and What the State of California Can Do About It

The Underground Housing Market in California's Metropolitan Regions

Low- and middle-income renters in urban and suburban regions of California face a more severe lack of affordable housing than their counterparts almost anywhere else in the United States. As a result, a large underground housing economy has arisen in certain areas. It takes a variety of forms (sometimes referred to as Accessory Dwelling Units, or ADUs) in residential neighborhoods, including garages converted to living spaces, single-family houses partitioned into multiple units without permits, and recreational vehicles parked in driveways serving as quasi-permanent dwellings. As an example, from 1981 to 2000, an estimated 55% of the housing units added in ten cities in Los Angeles County were attributable to the underground housing market, i.e., were unpermitted.

The Hidden Impacts of California's Underground Housing Market

While the underground housing economy can be viewed as a solution to a seemingly intractable problem, it imposes major impacts of concern to local communities and to the California state government. These include environmental stresses; life-safety and health risks from construction that does not comply with building codes; a strain on infrastructure and public facilities; insecure tenure for both homeowners and renters; and political invisibility for tenants who live in fear of their homes being discovered.

The Blocked Market for Financing Small Apartments on Existing Residential Properties

There are at least three ways in which the existing residential finance system constitutes a "blocked market" for financing residential properties that include ADUs:

- Homebuyers seeking to finance a purchase on a property that includes an ADU cannot borrow against the ADU's expected rental income.
- Homeowners interested in adding ADUs to their residential properties cannot obtain construction loans on the strength of the expected rental income from the ADUs.

- Since 2009, it has become much more difficult for homebuyers to finance the purchase of a home that includes existing unpermitted living space.

How the State of California Can Unleash a "Race To The Top" Among Cities and Counties for Safe, Affordable Housing in Residential Neighborhoods

Building on already existing residential mortgage programs, the State of California could add new loan products designed to address the blocked market described above. These would be intended to assist with:

- Purchasing residential properties with existing ADUs
- Purchasing residential properties with existing unpermitted space, which could then be upgraded to code-compliant ADUs
- Constructing code-compliant new ADUs

To maximize the impact of limited funds, the loan programs could be made available to local jurisdictions on a competitive basis. To gain funds, localities would need to demonstrate the implementation of land use reforms and programmatic efforts that collectively encourage ADU production and the upgrading of unpermitted living spaces. These would include:

- Loosening zoning restrictions on ADUs
- Implementing amnesty programs to regularize unpermitted dwellings
- Instituting a system of graduated building permits to encourage homeowners to comply with building codes over time
- Shifting code enforcement from a punitive to a compliance-oriented approach

Such a suite of reforms could encourage a burst of economic activity via the upgrading of existing housing and the construction of small-scale new housing within California communities suffering from a lack of affordable rental housing.

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Financing Ancillary Apartments on Residential Properties: Challenges and Solutions

The Underground Housing Market in California's Metropolitan Regions

There are few places in the United States where low- and even middle-income renters are as economically squeezed as they are in the urbanized regions of California. In recent decades, declining housing production, particularly in coastal areas, has sent rents skyrocketing. When coupled with stagnating wages for low- and middle-income workers, this dynamic has resulted in punishing rent burdens for a large and growing share of California households.

In many of California's regions with high rents, a large *off-the-books housing economy* has arisen in response to housing scarcity. While the Los Angeles garage apartment is perhaps California's most visible and well-known emblem of what is sometimes referred to as *informal housing*, there are many other forms. These include former single-family houses partitioned into multiple units or converted into bunkhouses; permanently inhabited trailers and recreational vehicles parked on residential lots; and purpose-built back houses. The common thread among all of them is that they are in violation of local zoning ordinances, building codes, or both.

. . . it would be a mistake to overlook some of the very real downsides of the underground housing economy

Consider a 10-city slice of southeast Los Angeles County's Gateway Cities area made up of Bell, Bellflower, Bell Gardens, Compton, Cudahy, Huntington Park, Lynwood, Maywood, Paramount, and South Gate, which for the purposes of my research I have defined as the "City of Gateway," a term used in Figure 1. An estimate relying on housing permit and decennial census data, coupled with some conservative assumptions about the rate of housing stock loss, indicates that fully 55% of the housing units produced in this area from 1981 to 2010 lacked permits (Figure 1).[1]

Clearly, the off-the-books housing market cannot be accurately described as a marginal or residual phenomenon. Instead, it is the mechanism by which hundreds of thousands, and perhaps millions, of Californians find places to live.

The Hidden Impacts of California's Underground Housing Market

In at least some respects, the emergence of the off-the-books housing economy is something to be celebrated. Viewed one way, it is a triumph of resilience and ingenuity that has allowed a great many people, many of them immigrants, to find housing where it is otherwise scarce. Unpermitted housing can be viewed as a strategy that allows its practitioners to be thrifty with their finances by building incrementally and bringing in income; to provide housing for family, friends, and acquaintances who need it, at a price they can afford; and to add rental housing deep within residential neighborhoods, where it would otherwise be unavailable, in a way that meets residents' cultural preferences.

However, it would be a mistake to overlook some of the very real downsides of the underground housing economy to its participants, residents of the surrounding neighborhoods, and the region as a whole. These include the following:

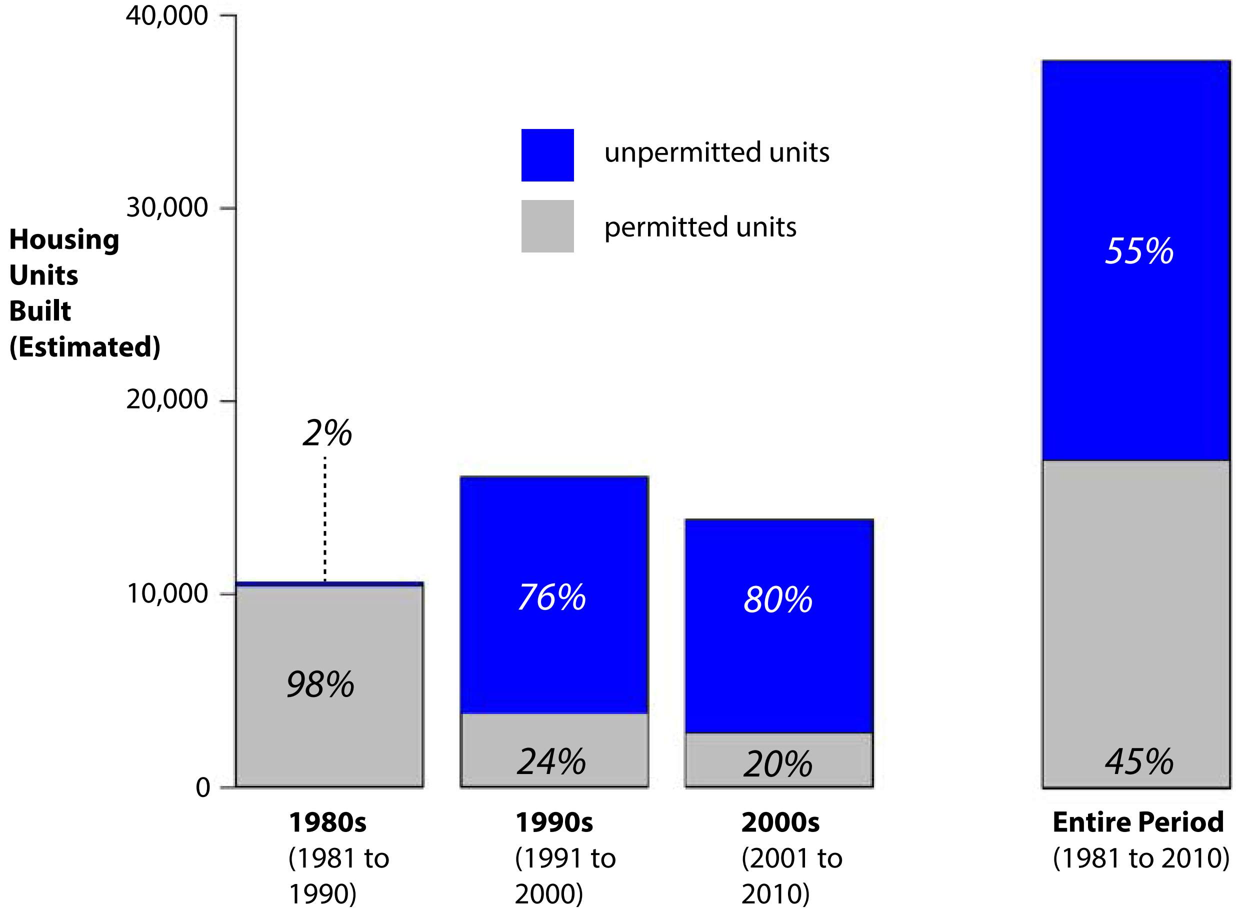
- *Environmental stresses.* Unpermitted housing involving the expansion of existing structures, or the construction of new ones at the rear of residential lots, tends to be built close to the ground in order to evade detection by municipal code enforcement. This results in high densities of buildings that consume backyard open space instead of being built vertically as multi-story structures (Figure 2). The ensuing loss of vegetation raises concerns about storm water runoff, air pollution, and the urban heat island effect, particularly in low-income communities.

- *Life safety and health risks*. Because they are so often built without complying with building codes, unpermitted units are more likely to pose dangers to their occupants as a result of fire danger and unhealthful conditions, including poor or nonexistent moisture protection and lack of heating or cooling.

- *Strain on infrastructure and public facilities.* In parts of greater Los Angeles, unpermitted housing has exacerbated the strain on overtaxed water and sewer lines, as well as public facilities such as schools. Mechanisms such as system development charges and impact fees that ensure that new, permitted housing development contributes financially to the upkeep of such amenities do not capture revenues from the addition of unpermitted housing.

- *Insecurity of tenure.* Occupants of unpermitted housing, already some of the most economically vulnerable renters, face the additional risk of eviction in the event that code enforcement action results in their dwellings being red tagged. In cases where they are exploited or otherwise mistreated by their landlords, they lack even

Figure 1. Housing Construction by Mode, City of Gateway (Incorporated Only), 1981 to 2010.



the relatively minimal recourse available to tenants of permitted apartments. Conversely, landlords operating unpermitted units face the risk that disgruntled tenants or neighbors will report them to the authorities, which could result in a loss of income or even, in some cases, their property. The net result is often an insecurity of tenure for both occupants and owners, and consequently a destabilization of local communities.

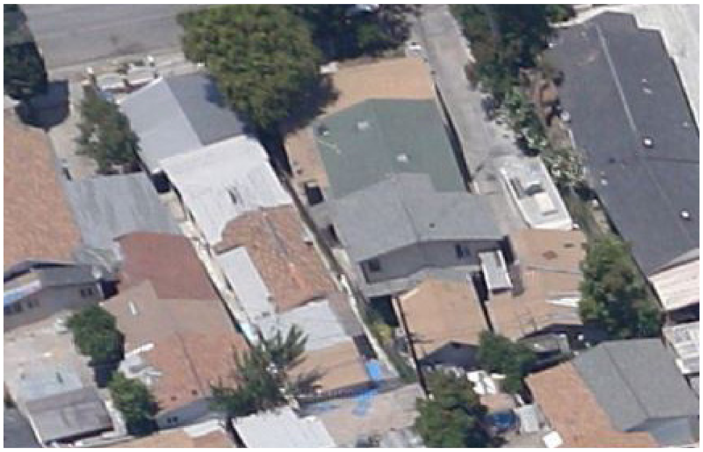
- *Political invisibility.* In some California cities, such as Santa Monica and East Palo Alto, robust tenants'-rights movements have pressed city councils to adopt renter-friendly policies, including but not limited to rent stabilization ordinances. By contrast, in cities where the underground housing market predominates, many tenants are reluctant to organize and collectively make their case within the local political sphere for fear of being identified and evicted. As a consequence, the underground housing market is often curiously absent from public debates in the jurisdictions where it is most prevalent.

The Blocked Market for Financing Small Apartments on Existing Residential Properties

Past research, including work by IURD researchers, has documented a *blocked market* for permitted ancillary living spaces, also known as Accessory Dwelling Unites (ADUs) on residential (1-4 unit) properties.[2] These studies, examining places such as Northern California's East Bay, have shown the effect of restrictive *land use regulations* in constricting the current and potential market for ADUs.

But another important aspect of the blocked market for ADUs is an inability for homeowners, or at least non-affluent ones, to access financing to allow them to either purchase homes that include existing ADUs, or to build new ADUs. This dynamic helps perpetuate the off-the-books housing economy described in the last two sections. For instance, if a homeowner cannot get a loan to build a new, legal ADU on her existing property, she might instead install an unpermitted unit in order to fulfill her goal of housing relatives or generating rental income from tenants (Figure 3).

Figure 2. An Example of Unpermitted Housing Covering the Open Space on Residential Lots, Florence-Firestone.



Source: Google Maps.

Figure 3. Unpermitted Back House in Lynwood.

Source: Redfin.

Homeowners are affected by the blocked market for ADU financing in at least three ways:

- *Homebuyers cannot borrow against the expected future income generated by a permitted ADU.* Past scholarship has demonstrated that Fannie Mae, Freddie Mac, and Federal Housing Administration (FHA) mortgage guidelines—all directly or indirectly influenced by the federal government—treat ADUs in a different manner from "mortgage helper" units in duplexes, triplexes, and four-plexes.[3] Whereas prospective owner-occupants of the latter are generally allowed to count 75% of the expected income from the rental units toward their incomes, underwriting guidelines for Fannie, Freddie, and FHA (together accounting for the overwhelming majority of prime mortgages in the US) prohibit this practice for ADUs. Consequently, typically homebuyers can only afford to purchase properties with legal ADUs if they already have sufficient incomes or assets to qualify for the larger mortgages needed to purchase such properties.

- *Homeowners have difficulty obtaining construction loans to add ADUs to their existing properties, and generally cannot use rental income to qualify for them.* As with mortgages for home purchases, as described above, existing homeowners seeking to add an ADU to their properties generally cannot persuade banks to allow them to use the likely future rental income from the unit to qualify for a construction loan. In addition, even homeowners who do have sufficient income or assets to qualify for a construction loan must often portray an ADU building or conversion project as a home renovation in order to gain the lender's approval. Ironically, while conventional home improvements, such as added bedrooms or updated kitchens, may or may not ultimately pay for themselves in the form of an equal or greater increase to the value of a property, an ADU, which is capable of delivering an immediate, monthly income stream to the homeowner, is treated much less favorably in routine lending practice. One consequence is that homeowners who would like to borrow money to upgrade unpermitted living spaces on their properties into fully code-compliant ADUs find, in most cases, that they cannot obtain a loan to do so.

- *Since 2009, it has become dramatically more difficult and costly for homebuyers to purchase homes with existing unpermitted living spaces.* Appraisers play a critical role in determining the value of properties and, by extension, whether a given would-be homebuyer's lender will approve a mortgage for the purchase. The professional standards of the appraisal profession dictate that unpermitted living spaces should not count toward the value of a home, although the identification of unpermitted space is not straightforward and requires judgment on the part of the appraiser. However, in the past, lenders had discretion to select their preferred appraiser for a given potential loan transaction, which in some cases

ABOUT THE AUTHOR

Jake Wegmann is an assistant professor in the community and regional planning program at the School of Architecture at the University of Texas at Austin. He received his doctorate from UC Berkeley in 2014, studying under Professor Karen Chapple, an affiliated faculty member at IGS. Prior to entering academia, Wegmann worked in housing development, both for-profit and nonprofit, in Denver and San Francisco.

led to value being assigned to unpermitted spaces. In 2009, this all changed: first Fannie, and shortly thereafter Freddie, adopted guidelines under which loan officers could no longer be involved in personally selecting appraisers. While this policy change was undoubtedly made for sound reasons aimed at curtailing the worst mortgage lending excesses leading up to the worldwide economic crisis of 2008, it has had the effect of making it difficult for purchasers to buy homes with unpermitted spaces already included. To do so, they or the sellers must often bear the often-considerable costs of demolishing the non-code-compliant living quarters before the transaction can proceed. In the process, current or potential housing units, albeit unpermitted ones, can be lost. In other cases, homeowners with unpermitted space who would like to sell their homes find that they simply cannot do so, and thus have to take their properties off the market.

Section 4: How the State of California Can Unleash a "Race To The Top" among Cities and Counties for Safe, Affordable Housing in Residential Neighborhoods

Ideally, the factors listed above contributing to the blocked market for financing ADUs and upgrading unpermitted living space would be addressed at the federal level. There is some precedent for federal policy attention to informal housing. For instance, for decades programs housed within various US government agencies have directed funds toward the upgrade of communities in border areas of the Southwest lacking a full complement of infrastructure, sometimes known as *colonias*.

However, federal policy attention to informal housing within California urban areas such as Los Angeles seems unlikely in the near term. Unlike *colonias,* which drew nationwide media attention because of unsanitary living conditions that were facilitating the spread of infectious diseases not commonly seen in the US, the off-the-books housing markets in Los Angeles and other urban areas and their consequences are poorly understood. In this interim, this California issue deserves attention from the State of California.

CalHFA already possesses the institutional structure and expertise needed to roll out new loan products

California's Housing Finance Agency, CalHFA, already offers mortgages targeted to subpopulations underserved by the existing market for home finance: first-time homebuyers, veterans, and those seeking to buy houses in low-income areas. Thus, CalHFA already possesses the institutional structure and expertise needed to roll out new loan products specifically designed to open up the blocked market in home finance for ADUs and unpermitted space. Three new loan products should be introduced:

1. *A mortgage for purchasing properties with existing ADUs.* Underwriting standards would allow ADUs to be treated similarly to rental units within owner-occupied duplexes, i.e., as legitimate sources of future income that home purchasers can rely upon to qualify for their mortgage.

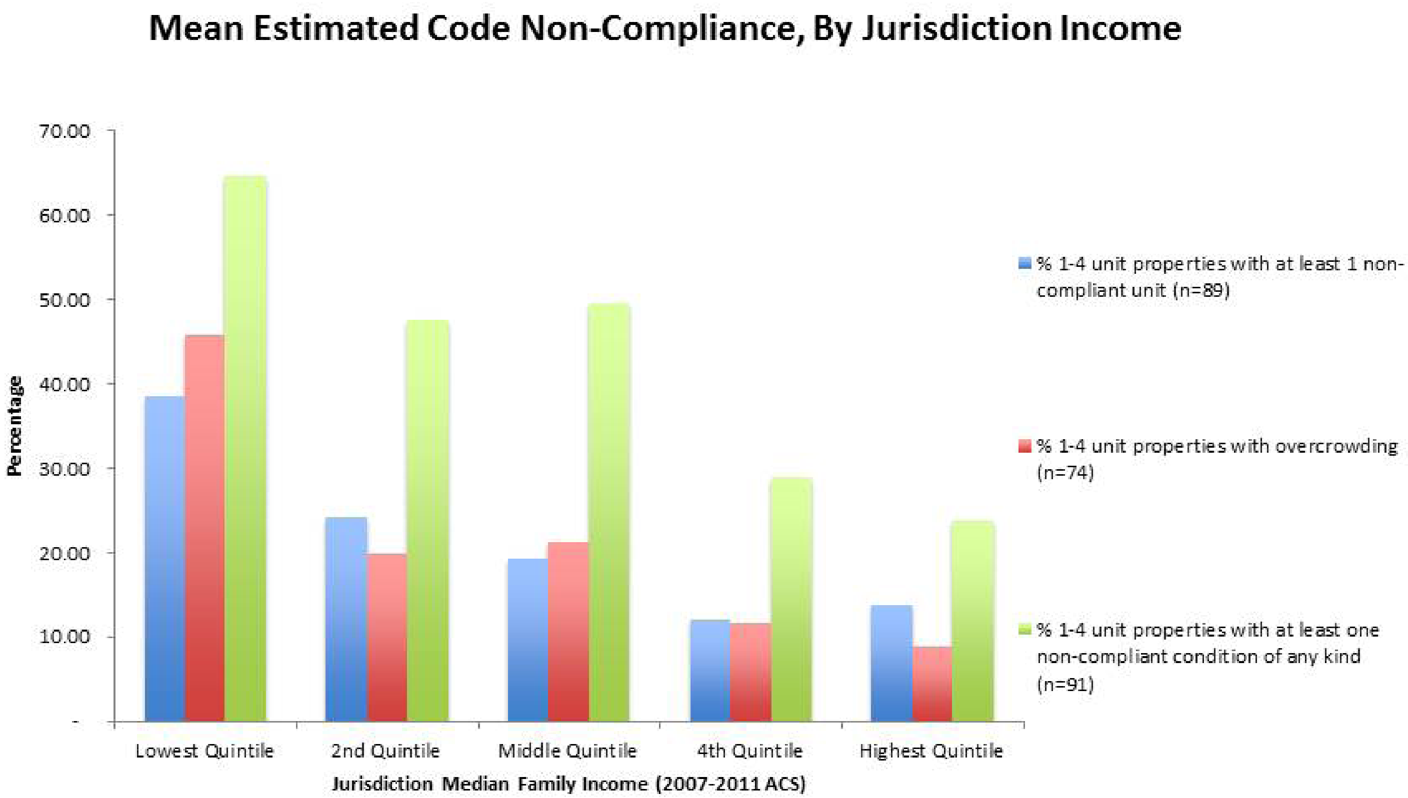
2. *A mortgage for purchasing properties with existing unpermitted space.* This mortgage would provide for extra funds above the purchase price of the main (permitted) living space, to be used to upgrade the unpermitted space toward compliance with locally-applicable land use and building code requirements. Future rental income from the upgraded living space could be used by the homeowner to help cover the additional cost. The UCLA planning scholar Vinit Mukhija has proposed the mortgage lender VanCity as a precedent worthy of study for its willingness to grapple with the large informal housing market in its home territory of Vancouver, British Columbia.

3. *A construction loan for code-compliant ADUs.* Underwriting guidelines for this loan product should explicitly treat the addition of an ADU to a residential property as the creation of an income-generating asset, and not simply as an increase to the property's value.

To succeed, these new loan products would be reliant upon steps taken by individual jurisdictions to ease their currently typically harsh treatment of ADUs and unpermitted living spaces. For that reason, new CalHFA loan products could be rolled out on a pilot basis and made available only to California cities or counties that have demonstrated a willingness to undertake the politically difficult task of reforming their land use and building code requirements. This emulation of the federal government's "Race To The Top" approach[4] toward education policy reform would be intended to spur localities to

- Loosen restrictive parking regulations, height limits, setback requirements, and other zoning parameters that discourage permitted ADUs;
- Implement amnesty programs for unpermitted living space, so that homeowners have an orderly and transparent process they can follow for upgrading their noncompliant living quarters;
- Institute a system of graduated building permits, so that homeowners can bring their unpermitted living spaces into code compliance over a period of several years, while addressing the most urgent life safety concerns first; and
- Shift the emphasis of municipal code enforcement from *punishment* to *compliance*, helping noncompliant homeowners attain compliance by referring them

Figure 4. Percentages of Residential (1-4 Unit) Properties Estimated to Have Various Non-Code-Compliant Conditions.



Source: Calculations by the author.

to funding (including the new CalHFA loan products) and technical assistance, while striving to preserve and expand modestly-priced rental housing on residential properties.

It would be a mistake to assume that the new programs proposed here would eliminate the off-the-books housing market in Los Angeles or other California metropolitan regions. However, these new programs might play a role in reducing the size of the off-the-books markets, and in curtailing the most problematic conditions that they bring about.

Finally, the potential benefits of creating a constituency in support of injecting economic activity and physical improvements to the housing stock into some of California's most economically distressed communities (Figure 4) should not be underestimated. The possibility of the State of California helping unleash a flurry of small-scale construction activity, jobs, and entrepreneurial opportunities within the most forward-thinking jurisdictions might just be enough to loosen the seemingly intractable blockade on progressive reforms of local policy toward ADUs and unpermitted space along the way.

Notes

[1] For methodological details, see Wegmann, Jake. 2014. "We Just Built It:" Code Enforcement, Local Politics, and the Informal Housing Market in Southeast Los Angeles County. PhD dissertation, Department of City and Regional Planning, University of California, Berkeley. (Refer to Chapter 4 and Appendix 4–2.)

[2] Accessory Dwelling Units, sometimes known as secondary units, are small (typically two bedrooms or fewer) apartments on residential (1–4 unit) properties. They can be freestanding structures, attached to or incorporated within the main structure, or placed over garages.

[3] Brown, Martin J. and Taylor Watkins. 2012. "Understanding and Appraising Properties with Accessory Dwelling Units." *Appraisal Journal*, 80(4).

[4] No endorsement or condemnation of the policy objectives underlying the educational Race To The Top policy is intended here; rather, this is a call to emulate its method of spurring policy changes by lower levels of government using "carrots," in this case an influx of mortgage capital.

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