August 14, 2015

Dear members of the Planning and Neighborhoods Committee of the Austin City Council,

At the invitation of Councilmember Casar's office, I am writing to provide some suggestions that may be of use to members of the Committee as they consider the creation of a city-run financing program intended to spur the construction of Accessory Dwelling Units ("ADUs"). Let me open by expressing my thanks to the Committee for the invitation to appear at your next meeting on August 17, 2015. Because of a schedule conflict, I am unable to attend, but I hope that these written comments can be of some help.

I joined the faculty of the Community and Regional Planning program at the School of Architecture at UT-Austin one year ago. The lessons and recommendations expressed below are based upon research that I conducted in the course of my doctoral work at the University of California, Berkeley from 2009 to 2015. While the topic of financing for ADUs is under-researched, below I list several points for the Committee to consider that emerged from the various ADU-related research projects in which I was involved.

ADU financing programs are few and far between, with the best examples in Santa Cruz, California and north of the border.

Throughout the United States, in general there has been far more attention paid to addressing the barriers to ADU construction in the form of restrictive land use laws (particularly zoning) than to financing. While Portland, Oregon and Seattle are regarded as the leaders among big US cities in easing restrictions on building ADUs, to my knowledge neither city has a significant city-sponsored ADU financing program. I commend Austin's City Council and the Committee for deliberating on a financing program in tandem with land use reforms impacting ADUs; they are both essential pieces of the puzzle. For better or for worse, Austin will have to develop new policies that are largely non-existent in its peer cities.

The most comprehensive ADU reform effort in the United States to date took place in 2005 in Santa Cruz, California, a small coastal city with a severe affordable housing shortage. In addition to significant zoning reforms, Santa Cruz partnered with a local financial institution to provide low-interest financing to homeowners. When I interviewed city staff, I learned that the program lacked visibility for a time because the loose mortgage lending conditions immediately prior to the Great Recession meant that many Santa Cruz homeowners were able to easily and cheaply access financing without use of the city-sponsored program. However, following the beginning of the Great Recession, the program came into its own and helped allow ADU production to continue. Unfortunately, the program's funds were subsequently exhausted, and have not been replenished since that time. Nonetheless, I suggest that it may be productive to contact the City of Santa Cruz, particularly Housing and Community Development Manager Carol Berg, regarding that city's experiences.

The largest and most durable big-city ADU financing programs of which I am aware are in Western Canada. Edmonton and Calgary, both in Alberta, have ongoing ADU (referred to by Canadians as "secondary suites") grant programs. There is also a similar program in Victoria, British Columbia, but it is smaller in scope. Obviously, the legal, fiscal, and political context is entirely different in Canada, but it may still be useful for the Committee and staff to contact their counterparts in Canadian cities, particularly Edmonton (in many ways Austin's Canadian twin city) and Calgary.

A revolving loan structure to fill a gap in the lending market and to spur ADU production over a long period should be considered.

I believe that a properly-conceived revolving loan fund, likely operated in partnership with a local financial institution, is a promising structure for the Committee to consider. Such a fund would not duplicate existing financial products, because at present the private mortgage industry is largely failing to offer loan products that make ADU production feasible for homeowners with modest equity. *This is because at present, almost all private lenders fail to count the expected rent from an ADU as income that supports the loan*. This is true both for mortgages—in large part because Fannie Mae and Freddie Mac guidelines explicitly call for ADUs to be treated differently than duplexes—and for construction loans. The result is that at present, to finance the construction of an ADU, homeowners must have sufficient home equity or other wealth to backstop a construction loan. Obviously, this precludes a great number of homeowners from pursuing an ADU project, particularly backyard cottages (the most costly form of ADU).

In other words, there is a gap in the private market, and the City of Austin is in a position to help fill it. If the City of Austin can structure a financing program with loans—even ones with interest rates comparable to construction loans available for home remodels or additions—that achieve a demonstrated track record of success, then the private market may begin to offer similar products on its own. The loan product would need to allow expected rent collections to count towards the borrower's income, just as is routine for loans on 2-4 unit properties.

In other words, if such a program succeeded and replenished its funds over time, it would be a major policy success even in the absence of income and rent restrictions imposed on the tenants of the resulting ADUs. Austin would have achieved something that has, to my knowledge, eluded all of its peer cities in the United States. In so doing, assuming that the Council's current efforts to loosen land use restrictions on ADUs are also successful, ADUs could begin to "scale up" in Austin and contribute to easing the housing shortage that plagues the city.

Means-testing homeowners for participation in a financing program may make sense; but imposing income restrictions on ADU renters should be approached with caution.

The Committee may see fit to design an ADU financing program to demand certain income and affordability restrictions in return for participation by homeowners. I urge the Council to be cautious about such restrictions, particularly for renters of the resulting ADUs. My research suggested that many homeowners shy away from participating in programs that impose rent restrictions on their newly-built rental units. They tend to have a relatively low tolerance for restrictions on to whom and for how much they can rent out a rental unit that is on their property. Homeowners do not approach projects on their own properties in the same way that professional developers do: they tend to fear and resent programs with intrusive restrictions, and they are not accustomed to them. The great risk of imposing too many restrictions is that the program ends up with too few takers, and ultimately fails.

I found that owner-occupants tend to rent out ancillary units on their own properties for lesser rents than do absentee landlords. Many of them report doing so because they value having long-term tenants, so as to minimize turnover that disrupts their own home lives. Therefore, they are often willing to provide rent discounts below market rates to retain tenants. Thus, even non-income restricted ADUs are likely to result in at least some gains in housing affordability when compared with other non-subsidized housing alternatives.

Means testing *homeowners* for participation in a financing program, however, may make a great deal of sense. This way the program could help meet the all-important "but for" test: funds would be loaned to homeowners who could not obtain financing to construct an ADU but for the existence of the program.

If means testing for ADU renters is to occur, offering it in return for fee reductions rather than as a condition of participating in the financing program is a better approach.

Above I outlined my concerns about imposing income and rent restrictions on ADUs whose construction would be financed by a City of Austin program. If Council proceeds in this direction, however, I urge it to consider requiring the restrictions in exchange for fee waivers rather than as a precondition for participating in the program. If the City offers a waiver on a fee, such as a water or sewer connection charge, in return for an income and rent restriction on the resulting ADU, many homeowners will perceive that they have received a benefit in return for the restriction imposed on them. Furthermore, if the program is structured appropriately, the homeowner could later have the flexibility to eliminate the affordability restriction (perhaps following a designated period of time) provided that she reimburse the City for the waived fee.

Homeowners, in general, are wary of making long-term commitments regarding how they manage rental units on their properties that cannot be modified for a long period of time. For instance, it is very common for homeowners to want to have the option to allow an elderly parent to move into an ADU following a major life event such as the death of a spouse or a sudden decline in health. Thus, locking homeowners into long-term commitments, such as affordability restrictions, that cannot be undone should be approached with great caution or avoided.

I was told that Santa Cruz had a successful program that required affordability requirements for the ADU in exchanging for granting a homeowner a partial break on the substantial expense of sewer connection fees for the ADU. Santa Cruz had a simple method of verifying compliance: it simply mailed a form to each homeowner participating in its sewer fee reduction program, and asked that once per year, the homeowner sign an affidavit certifying that the ADU was rented to tenants earning below a threshold income and for below a threshold rent. While such a compliance system is not perfect, it is administratively simple and provides evidence in the event that a tenant who is being overcharged brings a complaint to the city.

The Committee should consider disbursing any grant (as opposed to loan) funds for ADU production to local nonprofit partners rather than to individual homeowners.

In this memo I have discussed the benefits of a revolving loan fund. If the Committee sees fit to disburse *grant* funds for ADU production in addition to or instead of a loan fund, I urge the City of Austin to consider disbursing grant funds to local housing nonprofits rather than to individual homeowners. This is for several reasons. First, a grant program is likely to impose more exacting requirements than a loan program for the simple reason that expectation of public benefits is likely to be higher for a grant than for a loan. Assuming this is true, nonprofits are in a much better position to comply with those stipulations, whatever they are, than individual homeowners, and they are less likely to be deterred from using the funds. Second, many nonprofits serve particular neighborhoods. Research has demonstrated that ADUs, like solar panels, have a beneficial "contagion effect"—when they are visible and geographically concentrated, there is a tendency for other homeowners in the area to decide to install them at a higher rate than they otherwise would. Thus, nonprofits building ADUs within particular small areas could have positive spillover benefits.

Finally, running grant funds through a nonprofit would make it more feasible for the resulting ADUs to have income and rent restrictions imposed upon them. This is because nonprofits are skilled at assessing the needs of communities and the homeowners who live in them. Thus, the City's grant funds would be most likely, in this manner, to translate into the production of rent-restricted affordable housing. In other words, the nonprofits involvement would mitigate some of the concerns I raised earlier about the possible non-participation of homeowners in an ADU financing program that demands rent and income restrictions on the resulting new units.

I hope that these brief thoughts are of use to the members of the Committee and to the wider City Council. I stand ready to provide any follow-up clarifications or answer any questions that the Committee may have. Thank you for your important work in helping to tackle Austin's pressing affordable housing shortage.

The Committee should later consider easing land use restrictions on cheaper forms of ADUs than detached new construction.

This last recommendation pertains more to the Committee's future work than to its current consideration of creating an ADU financing program. But it is worth reminding the members of the Committee that detached ADU construction, the type of ADU that would benefit from loosened land use restrictions currently under contemplation by the Council, is the most expensive form. "All in" costs (excluding land, since ADUs are built on land that homeowners already own) for detached ADUs are upwards of $100,000—still far cheaper than any other form of non-subsidized housing other than some manufactured homes. But other types of ADUs, such as second units created by carving a separate living space out of existing single-family houses, can be much cheaper still. To the extent that, down the road, the City Council can loosen restrictions on other, less costly forms of ADUs, the funds allocated to any financing program that is eventually created will yield the production of even more new homes for Austinites.

Sincerely,

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