Evaluation of Future Purposes and Functions of the Alaska Industrial Development and Export Authority

EVALUATION OF FUTURE PURPOSES AND FUNCTIONS OF THE ALASKA INDUSTRIAL DEVELOPMENT AND EXPORT AUTHORITY

Prepared for
Board of Directors
Alaska Industrial Development and Export Authority

by
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December 1990

This publication is printed on recycled paper.

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ACKNOWLEDGEMENTS

State officials, bankers, business community leaders, and AIDEA staff provided us with invaluable information, data, and suggestions regarding the future direction of AIDEA. We would like to acknowledge them (in alphabetical order):

Milton Barker, Deputy Commissioner, Department of Revenue

Ruby Caswell, Loan Documentation Specialist, AIDEA

Ron Bosi, Former Chairman, Board of Directors, Security Pacific Bank Alaska

William Diamond, Consultant on Development Financing Institutions; former Vice President for Finance, World Bank, Washington, D.C.

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INTRODUCTION

Origin of the Study

In their endeavor to sketch a strategic plan for the 1990s, the board of directors of the Alaska Industrial Development and Export Authority (AIDEA) asked the Institute of Social and Economic Research (ISER) of the University of Alaska Anchorage (UAA) to render independent, professional advice on how to establish a framework for evaluating AIDEA's direction and options for the future. With direction from ISER, the study was undertaken by Dr. Musa Essayyad, the William Seward Professor of International Finance at UAA, and Mr. David Gordon, a consultant and former director of the industrial development and finance department of the World Bank in Washington, D.C.

The analysis and findings of the study are based on the policy and functional issues unique to AIDEA, and on the experiences of similar development financing institutions in other countries. Several factors make this study particularly timely:

(a) **Declining State Petroleum Revenues:** Declining oil production from the Prudhoe Bay field in the coming years will sharply reduce the state government's oil revenues--potentially creating a $1 billion gap in the state budget by the year 2000. Some analysts believe that even if the gas pipeline were built and if Congress allowed oil development in the Arctic National Wildlife Refuge, those two developments together would not bring in enough revenue to bridge the budget gap. Consequently, AIDEA--as a state financial institution--needs to determine how best to preserve its financial assets from possible erosion that could result from misallocation of resources.[1]

The potential budget shortfall could, however, be affected by the oil companies' recent investment of more than $1 billion in additional gas-handling facilities, intended to increase North Slope production by 90,000 barrels a day by 1991 and by another 100,000 barrels a day by 1995.[2]

(b) **Federal Tax Changes:** In the past, tax-exempt financing provided 93 percent of the funds for AIDEA's purchases of loan participation. The 1986 Tax Reform Act sharply restricted the use of tax-exempt financing, constraining AIDEA's ability to provide lower cost loans for local businesses. Furthermore, banks had previously been allowed to deduct 80 percent of the interest they paid to finance tax-exempt securities holdings. The 1986 act also eliminated that deduction--so banks no longer find this program as attractive, which represents another constraining element for the future operations of AIDEA.

(c) **AIDEA's Changing Role:** AIDEA recognizes that its role in enhancing Alaska's economy is in a period of transition. For the past decade, AIDEA concentrated mostly on supplying secondary market financing for retail and commercial office buildings through its taxable and tax-exempt bond programs. To a lesser extent, AIDEA also provided similar financing for business enterprises. Currently, there is little demand for the role AIDEA historically filled. In 1987, AIDEA's federally guaranteed loan program was repealed. In 1990, AIDEA's business assistance program was downsized. The export assistance program is inactive, and AIDEA's involvement in venture capital investing is still controversial. Even the project development program, the only program left intact, is struggling to justify the feasibility and desirability of few investment projects in Alaska.

(d) Political Factors: A new governor has just taken office, possibly leading the way toward restructuring of AIDEA, taking into consideration the economic and tax implications mentioned above. AIDEA's board, therefore, deemed it timely to take stock of the past performance of the institution in order to sketch its future direction--based on the organization's strengths, weaknesses, opportunities, and perils.

Purpose of the Study

This study addresses specific questions:

(a) Has AIDEA accomplished its mission?

(b) Should AIDEA continue to exist as a traditional entity, facilitating financing for small and medium businesses, relieving problems of unemployment, and creating additional employment?

(c) Should the need be established for AIDEA's continuation, what should be (1) AIDEA's goals, given the nature of Alaska's economy, the linkage with the state government, the financing needs of Alaska businesses, and the local banking environment; and (2) AIDEA's functions--debt financing, equity financing, or guaranteed financing?

(d) Should the decision be made to downsize or discontinue AIDEA's operations, what are the options available to the state government for the future use of AIDEA's assets?

Overview of the Study

A summary of findings and recommendations follows this introduction, and four subsequent chapters detail our findings. Chapter I renders a "situation audit" of AIDEA's mainstream programs, evaluating whether the institution has accomplished its mission. It also discusses the linkage between AIDEA and the state government, delineates the implications for the board of directors, executive director, and staff, and examines the relationships between AIDEA and local financial institutions, the local Small Business Administration (SBA), and the local business community.

Chapter II investigates AIDEA's move into venture capital investment. It highlights the pitfalls of AIDEA's involvement in the venture capital business and pinpoints the constraints on Alaska's access to venture capital markets. Chapter III appraises AIDEA's export assistance program. It discusses why there is currently little demand for export financing in Alaska and other states.

Chapter IV proffers suggestions about the following questions: Is there a future need for AIDEA? What should its mission be? What are the likely objects of AIDEA investment? What types and devices of financing should AIDEA use? What type of equity financing should AIDEA provide?

SUMMARY OF FINDINGS AND RECOMMENDATIONS

Key Recommendations

AIDEA should continue to be a public corporation of the State of Alaska, but it should look and function like a development finance institution. AIDEA's purposes should continue to be to promote, develop and advance the general prosperity and economic welfare of Alaskans; to relieve problems of unemployment; and to create additional employment. But it should do so by functioning as a full-fledged development finance institution.

AIDEA should translate its mission and goals into specific criteria for pursuing and selecting development finance projects and for measuring its progress toward meeting its goals. AIDEA's goals related to employment and economic prosperity need to be defined in ways that both guide and evaluate investment proposals and performance. Its investment performance should then be reported and judged on the basis of those criteria.

AIDEA should not be privatized or liquidated. Local banks and private investors would not receive privatization of AIDEA favorably. The huge liquidity of local banks offers convincing evidence of the paucity of profitable investment projects in Alaska. Without a reasonably high and stable rate of return for investors, the stock of the privatized development institution would be lackluster. Also, AIDEA's privatization and subsequent entry into the commercial banking market would dilute the profit margins of existing banks and adversely affect AIDEA's own operations.

AIDEA should concentrate on investing in industrial development projects and stay out of commercial real estate investment. Although AIDEA is intended to be an industrial development organization, in the past more than 90 percent of its investments have been in commercial real estate.

AIDEA should continue to be a financially prudent institution, avoiding competition with local profit-driven banks. It should finance or invest in economically "feasible" and "desirable" industrial development projects, such as resource-based and general support projects.

AIDEA should consider financing projects that are of limited profitability but are "desirable" because they could produce economic benefits for Alaska. For example, a given project might produce modest returns to AIDEA, but create jobs or broaden the tax base in a community. Another example of a "desirable" type of investment that could pay off over the long-term by strengthening and broadening the state economy would be investment in the Alaska Science and Technology Foundation, which is intended to bolster education and technology in Alaska. To avoid endless requests for subsidies, state and AIDEA officials would need to develop stringent standards for assessing projects that might fit into this "desirable" category.

AIDEA should not have involved itself in venture capital investing. We found that AIDEA's management and staff lack expertise in venture capital investing, and that there is no shortage in Alaska of capital to support projects that meet conventional venture capital investment standards. The board of directors should consider transferring the $6 million currently in the Polaris Fund to the Alaska Science and Technology Foundation. As we noted above, that foundation is intended over the long-term to improve technology and education in Alaska; improved technology and education are the necessary bases for developing worthwhile venture capital projects.

AIDEA would first need to determine the process necessary for making such a transfer of funds.

AIDEA should not now have an export assistance program. The program has been inactive since it was established. AIDEA doesn't have the expertise required to manage the program and has not adequately publicized it.

AIDEA should identify and undertake unique roles in Alaska's financial market. AIDEA could provide direct financing, equity, and credit insurance without competing with local financial institutions. The new AIDEA could carve a niche for itself without jeopardizing profitability of local banks and without duplicating purposes of other state funds. Possible roles for AIDEA include providing long-term financing (which banks abhor) or equity, and financing projects in rural Alaska, where expansion and diversification of Alaska's basic industries will take place.

AIDEA should be given more autonomy but at the same time made more accountable. Changes in AIDEA would include expanding the board of directors to include more public members and more members with institutional finance experience; formalizing institutional objectives; systematically evaluating the executive director and staff for AIDEA's performance; and identifying staff skills needed to plan and implement AIDEA's new role. Both the board and management of the more autonomous AIDEA should be more accountable; performance criteria consistent with AIDEA's goals should be developed and incorporated as required elements of its annual performance audits.

Assessment of AIDEA

AIDEA Mission

Finding: Although AIDEA is intended to promote industrial development, more than 90 percent of projects it has financed to date have been commercial real estate ventures.

Finding: Figures provided by AIDEA suggest that it has reasonably achieved its purpose of creating or retaining jobs over the past decade. But many of the jobs attributed to AIDEA financing in the past decade may not have been new jobs but rather existing jobs that were re-located to new commercial developments (malls, for instance) financed by AIDEA.

Recommendation: **AIDEA should concentrate on financing industrial development projects and should not be involved in financing real estate, unless such financing leads to development of specific industrial projects.**

Finding: AIDEA has no consistent, quantitative measure of how well proposed projects meet AIDEA's objectives of creating or retaining jobs. Also, AIDEA in the past has not developed its own estimates of numbers of jobs associated with projects, but rather relied on estimates provided by borrowers.

Recommendation: **AIDEA's management should develop and use consistent, quantitative measures for assessing feasibility of proposed projects.** Criteria for such assessment standards should include how much employment and value added proposed projects would contribute to Alaska's economy. AIDEA itself should develop reliable, defensible estimates of how many jobs specific projects would create, and not leave that task to borrowers, equity participants, or co-financiers.

Financial Operations and Profitability

Finding: AIDEA has no consistent measure for assessing whether proposed projects meet profitability requirements. Although the legislature did not intend AIDEA to be a profit-driven entity, it likewise did not want AIDEA to be a subsidy-granting fund. Rather it was to help provide financing for projects that were "economically and financially feasible" and that were capable of producing revenue "adequate to repay the bonds or loans financing them."

Recommendation: **AIDEA should develop standards to be used consistently in assessing whether proposed projects would produce adequate returns.** Such standards should involve weighing the prospective rate of return against the cost of capital.

Finding: Had AIDEA been a taxable entity, the after-tax return/asset ratio would have been negligible during most of the years under study.

AIDEA's return on assets dropped throughout the 1980s, plunging from 7.6 percent in 1981 to 0 percent in 1988 but recovering to about 3 percent by 1990. AIDEA's returns dropped because many of its real estate loans became delinquent during the recession of the late 1980s.

Finding: The percentage of AIDEA loans in delinquency increased from less than 5 percent in 1984 to 10 percent in 1986 and to 24 percent by 1988. By 1989 that trend began reversing, and in 1990 the percentage of delinquent loans was down to 13.

The sharp increase in delinquent loans was due to the severe recession in Alaska commercial and residential real estate, particularly in Southcentral Alaska. By the end of the decade the real estate markets had begun recovering. Many loans that had been delinquent earlier had gone through foreclosure, and the rate of new delinquencies had slowed down.

Recommendation: **Except for industrial sites, AIDEA should stay out of commercial real estate investment.**

Finding: AIDEA has historically had high liquidity, but in the late 1980s its liquidity rose dramatically due to the combined effects of the recession; the 1986 Tax Reform Act that sharply restricted sale of tax-exempt bonds; and AIDEA's difficulty in identifying feasible investment projects.

AIDEA maintains a high ratio of liquid assets to total assets in order to retain a high-quality bond rating. In the boom years of the early 1980s that ratio increased slowly from about 23 percent in 1981 to 27 percent by 1985. But by 1987 the ratio had climbed dramatically to 47 percent; by 1990 it had dropped back to 39 percent.

Finding: AIDEA's ratio of liquid to total assets is about twice as high as that of national and international commercial banks in growth-oriented economies. But compared to liquidity ratios of development financing institutions in other nations, it is just slightly higher, given that these institutions are involved in equity, debt, and guarantee financing, and that they are better able to identify feasible projects.

Finding: Alaska banks have even higher liquidity than AIDEA, presenting strong evidence that there is no capital shortage in Alaska. Alaska's state chartered banks had liquidity ratios of 95 percent and nationally chartered banks 54 percent as of June 1990. These were much higher ratios than AIDEA's 39 percent, and show that Alaska's banks hold exceptionally high percentages of their assets in cash and highly marketable government securities.

> ***Recommendation*: Since both AIDEA and local banks have such high liquidity, they could consider teaming up to finance some more risky projects (those in rural Alaska, for example)--thereby taking advantage of their available liquid assets and reducing the risk to both.**

Finding: AIDEA has not used any hedging technique such as financial futures to protect its high liquidity against the ravages of fluctuating market interest rates.

> ***Recommendation*: AIDEA should emulate development financing institutions and commercial banks by adopting appropriate hedging techniques to protect its liquid assets against fluctuating market interest rates.**

Finding: Another sign of AIDEA's strong liquidity position is that its equity capital grew at an average annual compounded rate of 11.2 percent over the last decade. AIDEA's capital increased from $197 million in 1981 to $572 million in 1990. That increase is explained by infusions of capital from the state government for a variety of AIDEA programs established after 1984, including the development program and loan guarantee programs.

Finding: A good indication of AIDEA's prudent, conservative investment policies is that its equity multiplier (a measure of the adequacy of an institution's capital) is low, ranging between 1.1 and 1.8 over the past decade. However, AIDEA's portfolio is not well diversified, since more than 90 percent of its operations are in commercial real estate.

AIDEA's low equity multiplier (EM) means that its potential risk exposure is low. EMs tend to vary directly with bank size. The typical U.S. commercial bank has an EM of about 14, while the giant U.S. commercial banks have EMs in the range of 20 to 25.

Finding: AIDEA's cumulative profitability increased throughout most of the 1980s, despite the minuscule return on assets. Cumulative profitability (as measured by the ratio of retained earnings to total assets) of AIDEA increased throughout the 1980s, except in 1987, moving from 8 percent in 1981 to 27 percent in 1990.

AIDEA's profitability was higher in 1990 because interest on loans and on investments was higher. In 1987, the bottom of the recession, the demand for loans in Alaska dropped sharply and the number of delinquent loans increased. AIDEA's allowance for loan losses increased from $4.2 million in 1986 to $10 million just a year later.

Export Assistance Program

Finding: AIDEA has not succeeded in promoting its export assistance program, due to lack of staff expertise, poor marketing, problems with local banks, duplication with programs of the U.S. Export-Import Bank (better known as Eximbank) and the federal Small Business Administration (SBA), and generally stagnant local demand.

In 1987 the Alaska Legislature gave AIDEA the task of establishing an export assistance program that would provide existing and prospective Alaska exporters with loan guarantees. The legislature hoped these loan guarantees would encourage export of Alaska products by encouraging Alaska lenders to make money available to exporters.

But to date AIDEA has provided no loan guarantees. AIDEA has not developed a marketing plan and has made little effort to publicize the program. The staff members involved in this program turn over frequently and are poorly trained.

Local banks are skeptical of the program, for a number of reasons. They believe established, creditworthy enterprises could get loans without the guarantees. Also, they cite the program's relatively high financing costs as a potential barrier to businesses just starting out. Another objection of local lenders is that the program would not guarantee the financing of equipment and infrastructure needed to produce items for export.

In some respects the loan guarantee program would also duplicate programs of Eximbank and the SBA. Finally, the Anchorage SBA office reports that there has been little demand for its own Export Revolving Line of Credit, because most creditworthy exporters can qualify under SBA's general loan guarantee program. Similar export-related programs in other states have encountered similar discouraging problems.

> ***Recommendation*: AIDEA's export assistance program should be discontinued, based on lack of demand; unreceptiveness of local banks; duplication with Eximbank and SBA programs; lack of expertise within AIDEA; and the discouraging experiences of other states with similar programs.**
>
> Local exporters seeking help could be referred to the Foreign Credit Insurance Association (FCIA) and Eximbank. State and federal agencies which provide information on international trade could make those referrals. Those agencies include the U.S. International Trade Administration, the Governor's Office of International Trade, and the Alaska Center for International Business at the University of Alaska Anchorage.

Venture Capital Investment

Finding: AIDEA's investment in a venture capital fund is not justified on economic and financial grounds.

In February 1990 AIDEA's board of directors voted to put $6 million in the Polaris Fund, a venture capital fund managed by private general partners. The fund's general partners agreed to raise another $24 million in private money. So far the general partners have not raised any private money and have not approved any investment projects.

One of the chief justifications for putting AIDEA money into the fund was that there was a capital shortage in Alaska. This decision was apparently based just on anecdotal information without any serious study. We found that there is no shortage of venture capital in Alaska, but rather a shortage of feasible projects to invest in. Two local banks that have funds for small business development are currently investing outside Alaska. Other arguments against using AIDEA money as venture capital include:

1. AIDEA's management and staff lack expertise in the complex field of venture capital investment.

2. AIDEA's objective of long-term economic development for Alaska might not be compatible with the objective of most venture capitalists--which is to make their money within a fairly short time and then get out of the investment.

3. The state government's last attempt at venture capital investing was the ill-fated Alaska Renewable Resources Corporation (later renamed the Alaska Resources Corporation). From its inception, that corporation operated like a poorly managed venture capital fund. So many of its investments went bad and its problems were so immense that the Alaska Legislature at last decided to do away with it.

4. An important goal of AIDEA is creating jobs in Alaska. There is no evidence that AIDEA examined how investing in a venture capital fund would create Alaska jobs. The Polaris Fund is to invest at least "partially" in Alaska projects, but it's not clear how much "partially" is.

5. Financial analysts see many barriers to luring venture capital to Alaska, including the fact that many outside investors still think of Alaska as harsh, isolated, costly, and with few investment opportunities that would generate high enough returns to justify the risks.

***Recommendation*: AIDEA should not have been involved in venture capital investing. It is not currently equipped to handle venture capital investing, and it could better achieve its purposes of creating jobs and fostering economic development by transferring the $6 million currently in the Polaris Fund to the Alaska Science and Technology Foundation.**

A prerequisite to successful venture capital investment is that technology and education be at an appropriate level. We believe that by bolstering education and technology in Alaska through the Alaska Science and Technology Foundation we can eliminate some of the current impediments to investment here and make Alaska a more attractive place for venture capitalists. AIDEA would first have to determine the necessary process for putting AIDEA money into the Science and Technology Foundation.

AIDEA Management and Staff

Finding: AIDEA's board of directors currently has only two members from the general public, and its members have limited expertise in institutional finance.

> ***Recommendation***: **Public representation on the board of directors should be increased from two to four members, and several members should be required to have previously worked in or with financial institutions.**

Finding: Other than the Alaska Legislature, no state or private entity currently oversees the performance of AIDEA or holds the board members accountable for any of their decisions.

Finding: It would be difficult to assess performance of AIDEA management and staff, because performance standards and the corresponding performance measures are lacking.

> ***Recommendation***: **The state government should develop performance standards and reporting requirements that weigh performance of AIDEA against its objectives. Such standards could then be used to ensure management and staff accountability.**

Finding: Current law allows board members to delegate decision-making authority to persons who may not have adequate knowledge of the subject.

Board members can now authorize other persons to attend board meetings and make crucial decisions on their behalf, sometimes without adequate preparation or information about the matter under consideration.

> ***Recommendation***: **Only board members themselves should be allowed to make crucial decisions concerning AIDEA, and they should be held accountable for those decisions.**

Finding: AIDEA's by-laws do not address many important elements of the executive director's job, leaving too much room for political appointment.

AIDEA's current executive director has a pertinent academic background, technical financial and government expertise, and nine years' experience in the job. AIDEA's operations have been stable during his tenure, and the organization's data indicate that it has created or retained many jobs. Nonetheless, the absence in the by-laws of many job criteria could result in less qualified persons being appointed.

> ***Recommendation***: **AIDEA's by-laws should cite the academic background and expertise required for the job of executive director; the number of terms the executive director may hold the job; the entity or persons who should evaluate the performance of the executive director; the criteria that should be used in the evaluation process; and the hiring/firing procedures.**

Finding: AIDEA's development department is currently staffed by only two employees who rely heavily on consultant services.

> ***Recommendation*: If AIDEA is to be successful in identifying, preparing, and promoting industrial development projects, its development department has to be strengthened and staffed by personnel having stronger academic credentials and seasoned expertise in project identification and appraisal.**

Finding: AIDEA has no computer data base for its operations activities. Data on AIDEA's operations is currently logged manually, making it very difficult for AIDEA to quickly assess its operations and make managerial decisions.

> ***Recommendation*: AIDEA should develop a computer data base and other tools it needs to monitor and assess its operations.**

Finding: AIDEA by-laws do not specify procedures for hiring and firing, for promotion, for pay, or for pensions of employees.

> ***Recommendation*: AIDEA's by-laws should be augmented to require promulgation of personnel policies and procedures.**

Relations with Local Banks

Finding: There has been long-term discord between AIDEA and Alaska banks. Partly that is due to the different nature and goals of private banks and public corporations: banks want to maximize their profits and AIDEA wants to encourage economic development.

But the problems have been aggravated by several factors. First, the federal 1986 Tax Reform Act eliminated a tax provision that formerly allowed banks to deduct interest they paid to finance tax-exempt securities. That change has made it less attractive for banks to act as primary lenders for AIDEA-financed projects. Second, AIDEA has recently attempted to embark on direct financing of certain development projects and has invested in a venture capital fund--moves that banks see as putting AIDEA into competition with them.

Also, AIDEA's failure to market and publicize its export assistance program and other programs leave banks unaware of how they might benefit from taking part in those programs.

> ***Recommendation*: For AIDEA to achieve its purpose of promoting economic development, it must improve its financial delivery system by forging an effective and efficient working relationship with local banks. One way for banks and AIDEA to improve their working relations to the benefit of both would be for them to co-finance projects, with each putting up some of the financing and each assuming some of the risk.(The section on AIDEA's future role, beginning on page 10, provides more discussion of other possible means of cooperation between AIDEA and banks.)**
>
> Since banks abhor long-term financing, the joint financing could be arranged so that the banks would be paid back more quickly. Since AIDEA's main interest is long-term economic development, it could be paid back over a

longer period, possibly accepting smaller principal payments at the start and higher ones when the cash flow from the project was adequate.

Finding: The local banks that survived the recession generally have very conservative lending policies (which in part explains why they survived the recession).

The local bank structure also has become very concentrated in recent years, as many banks failed and just a handful emerged.

Finding: Although local banks have money to lend, their increased concentration and conservative lending policies probably limit available financing for projects that involve risk.

***Recommendation*: Reluctance of banks to finance riskier industrial development projects could leave a niche for AIDEA to fill. But such projects would still have to meet certain economic and financial standards, and AIDEA would need to structure its financial risk proportionate to its investment.**

Finding: Currently, AIDEA can not purchase any loans from originators with more than 2 percent of their loans in delinquency. Such a threshold is probably appropriate for real estate loans, but it is far too low for industrial development loans--which are the types of loans AIDEA should be concentrating on.

***Recommendation*: As it concentrates more and more on industrial development loans, AIDEA should seek necessary changes to allow it to deal with loan originators with somewhat higher rates of loan delinquency.**

Relations with Local Business Community

Finding: AIDEA's problems with the local business community stem from AIDEA's failure to adequately publicize its financing programs; by the multiplicity of state loan programs with complicated regulations that tend to discourage those they are intended to serve; and by lack of communication between AIDEA and other local organizations promoting economic development.

In 1989 the Governor's Conference on Small Business recommended that state agencies with programs intended to help businesses should do a better job of publicizing those programs and should simplify their regulations.

There also appears to be fighting between economic development organizations over political turfs. Other economic development organizations say that AIDEA secretly promotes development projects without coordinating with local organizations like the Anchorage Economic Development Corporation. Whatever the case, it is certainly true that relations between AIDEA and other development organizations could be improved if they coordinated what they were doing.

***Recommendation*: AIDEA and the Anchorage Economic Development Corporation and similar organizations in other Alaska cities should sign protocol agreements to ensure more coordination and less fighting about political turfs.**

AIDEA should also coordinate more with Alaska Regional Development Organizations (ARDORs), which are intended to aid economic planning and development at the regional and local levels.

Relations with Local Small Business Administration

Finding: AIDEA's federally guaranteed loan program seems to have been an example of successful cooperation between AIDEA and SBA. That program helped finance short-term working capital needs, but AIDEA discontinued it in 1987 after a change in federal policy made it costlier and more inconvenient for AIDEA.

With the participation of financial institutions and the SBA, AIDEA's federally guaranteed loan program helped finance short-term working capital needs. Under the program, AIDEA provided up to $500,000 per borrower by purchasing loans (usually 90 percent of the loan amount) from primary lenders. These loans were guaranteed by agencies of the federal government, including the SBA. After AIDEA dropped the federal program, the Alaska Legislature in 1988 created its own Loan Guarantee Program to be operated by AIDEA.

> ***Recommendation*: AIDEA should be involved in loan guarantees for Alaska's small businesses. Those businesses need a program that helps finance short-term working capital needs. AIDEA's board of directors may want to consider reintroducing the federally guaranteed loan program, since it was one of AIDEA's most successful programs.**

AIDEA's Future Role

Can AIDEA play a necessary or useful role in Alaska's future, helping bring investment projects to life--and if so, how? We believe it can, even though that role must be different from what it has been in the past.

Advantages of AIDEA

Why is there a continuing need for AIDEA? After all, changes in federal law have greatly reduced the use of tax-exempt bonds to finance projects, and tax-exempt bonds provided most of AIDEA's past financing. AIDEA's business assistance programs have either been eliminated or are inactive. And there doesn't seem to be a shortage of liquid funds in Alaska right now. Any projects that meet the criteria of local financial institutions and can pay market rates should be able to finding financing without AIDEA--or so it would seem.

However, there are gaps in development financing that AIDEA can very usefully fill:

Adapting financing terms to project needs. Many projects (for example, start-up enterprises or infrastructure projects involving heavy initial costs and low returns at first) need term loans that include long amortization periods, and perhaps reduced or nil payments on principal--or even capitalization of interest--during the early years.

Banks generally don't like long-term loans--they are happier with exposure limited to no more than five years--and loathe the idea of foregoing current interest payments. Mortgage banks do make term loans, and municipal bond financing is usually for much longer periods, but these kinds of financing are generally for purposes other than industrial and export promotion.

By contrast, AIDEA's primary mission is promoting industrial development--and it has the capacity to structure its financing in almost any way that would enhance a project's feasibility and success, so long as the sums come out positive in the end. For example, it might join with a bank (or banks), each providing part of the funds required. But the banks would be repaid over a short time, while AIDEA would hold the longer maturities--possibly accepting smaller principal payments at the start, compensated by suitably higher ones later when the project's cash flow was adequate. Early years' interest might be added to principal in some cases, to be paid with a bonus later.

Continuing ability to offer favorable financing terms. It is true that AIDEA's use of tax-exempt bonds--which carry lower interest rates--has been sharply limited by the 1986 changes in federal tax law. And the lush financial resources that once allowed the state government to offer many kinds of loans at below-market rates have shrunk and will continue shrinking.

Investments by state agencies like AIDEA are generally required to be self-financing--which means that their interest rates will have to be close to commercial rates. However, if a proposed project seems likely to have a lower return but it is judged likely to serve some important public objective, the state government might top up AIDEA financing with a specific government subsidy either to capital cost or to the interest rate.

Even without such explicit government subsidies, AIDEA might sweeten financial packages in various ways. We already suggested that AIDEA could take on the longer maturities in joint lending operations with banks, or adjust principal payments to the estimated earning capacity of the project, or capitalize interest. Another device would be to make part of a loan at a somewhat reduced rate as quasi-equity--that is, with an option for a specified share in the profits of an enterprise "if and when" it became profitable.

AIDEA's flexibility and discretion in adapting the form of its financing to the specific needs of an operation are what principally distinguishes it from other institutions in Alaska's rather stodgy financial sector.

Potential to finance rural projects in the growing fishing, timber, mining, and tourism industries. Historically Alaska banks have been reluctant to finance developments in certain of Alaska's basic industries--partly because much of the development in these industries is in rural areas. Local banks have always been and are likely to remain leery of investing in rural Alaska. AIDEA could fill a very real need and help expand and diversify the state's economic base by helping finance development in rural areas.

Types of Projects

What kinds of projects might the future AIDEA invest in? AIDEA has a number of proposed projects now under consideration, including an ore terminal at Skagway, a fishing dock in Unalaska, and an aircraft maintenance facility in Anchorage.

Other general types of projects offer the potential for small but not insignificant diversification of Alaska's economy. These include further and more varied fish processing; manufacture of timber products including furniture and flooring; and targeted farming ventures that would take advantage of Alaska's excellent conditions for fast-maturing crops--vegetables, fruits, and fodder for the local markets, rather than large-scale grain growing or meat production.

Project Definition and Preparation

Although AIDEA now has some projects under consideration, there are not many. One of the things limiting the number of proposed development projects AIDEA might help finance could be (1) *potential developers' lack of knowledge about the types of projects eligible for* *consideration and the criteria used to assess projects;* and (2) *inadequate local expertise in preparing projects for consideration.* AIDEA, if it were functioning as a full-fledged development financing institution, could help alleviate both those problems. It should, as we noted earlier, better publicize its programs and undertake a vigorous campaign to improve communications with local financial institutions. It could also help project sponsors better prepare proposals by advising them about where to get necessary information and technical expertise. In exceptional cases, it might even be worthwhile for AIDEA to finance feasibility or design studies.

Financing Criteria and Policies

How should AIDEA finance projects? We've discussed possibilities throughout this summary, but it's useful to draw them together here and to point out that some proposed financing methods may differ from what AIDEA has done in the past. The major changes we are proposing would of course require legislative approval.

AIDEA financing should most commonly take the form of loans. Such loans could involve AIDEA taking quasi-equity in a project. As we discussed earlier, taking quasi-equity in a project could mean offering a somewhat reduced interest rate on a loan in exchange for a share of the profits in later years.

AIDEA should seek authority to be an equity investor. AIDEA could become an equity investor (that is, a part owner of a project rather than just a financier) through conversion of the quasi-equity portion of its loans. Or it could finance a start-up or major expansion of a project unable to initially carry a heavy burden of fixed debt but which promises handsome returns later on. In general AIDEA should only hold a minority share of any projects. In rare cases where it might be justified in becoming a majority owner, AIDEA should not manage projects itself but should rather contract with an experienced private manager.

All AIDEA financing--whether loan or equity--should be expected to yield a return over time sufficient to cover AIDEA's costs of borrowing, administrative expenses, and a modest margin for reserves. In the outer years of a long project, the return might be subject to a considerable discount to reflect the cost of money outstanding for a long period.

Joint financing between AIDEA and Alaska banks should be encouraged. AIDEA could contribute long-term financing and other devices to tailor financing to specific projects. Banks could contribute short-term financing and loan supervision systems.

AIDEA should welcome opportunities to sell its loans or portions of loans when it can do so advantageously. For example, as long-term loans came close to maturity, AIDEA could sell them to banks. It could sell mixed packages of loans representing a cross-section of its portfolio to the public or possibly to the managers of the Alaska Permanent Fund. Such transactions would not only replenish AIDEA's funds, but also increase cooperation with local financial institutions; help broaden the securities market in Alaska; make the secondary market more liquid; and put AIDEA's credit standing on a more solid base.

CHAPTER I: SITUATION AUDIT OF MAINSTREAM PROGRAMS

This chapter reviews AIDEA's purposes and programs, analyzes its past activities, and highlights any special accomplishments or deficiencies. In the parlance of strategic planning, this chapter presents a "situation audit," determining where the organization stands today by pinpointing its strengths, weaknesses, opportunities, and threats.

Purposes And Programs

AIDEA was established by the Alaska Legislature in 1967 as a public corporation, constituting a political subdivision within the Department of Commerce and Economic Development but also a separate and independent legal entity. According to the statutes, the purposes of AIDEA are to promote, develop, and advance the general prosperity and economic welfare of the peoples of Alaska; to relieve problems of unemployment; and to create additional employment.

The legislature authorized AIDEA to provide various means of financing and means of facilitating financing for business, in cooperation with federal, state, and private institutions. Specifically, AIDEA was created to help give Alaska businesses access to capital markets at a reduced cost of financing. Quality bond ratings by Moody's and Standard and Poor's have helped AIDEA issue bonds at lower interest rates. To avoid competition with local financial institutions, AIDEA does not act as a primary lender. Rather, financial institutions are considered originators of the credit. Originators are responsible for funding from 10 percent to 100 percent of the loans, depending on the type of financing involved.

Since its inception, AIDEA has used two methods of financing, accounted for in the Enterprise Development Fund: medium- to long-term tax-exempt bonds, and a short-term federally guaranteed loan program. Under the first, federal and state tax-exempt bonds are issued for projects deemed eligible according to Section 103 of the federal Internal Revenue Code, thereby saving two to three percent in interest cost. The amount of bonds issued for any single project can not exceed $10 million, unless the project is an exempt facility, and no one can be the beneficiary of more than $40 million at any one time.

The two major types of tax-exempt financing are umbrella bonds and stand-alone revenue bonds. Under the umbrella bond program, AIDEA has helped borrowers reduce their costs of capital by packaging a number of loans and selling bonds on national markets. Those funds are then used to purchase 90 percent of the loans not exceeding $1 million, or 80 percent of the loans not exceeding $10 million. Umbrella bonds are the general obligation of AIDEA, and its participation is secured by a first lien on the primary collateral.

Under the stand-alone revenue bond program, which was the only source of financing up to July 1, 1980, AIDEA does not have financial participation. Rather, it intermediates between the borrower and the lender, who must pledge to buy all the issued bonds.

With the participation of financial institutions and the Small Business Administration (SBA), AIDEA's federally guaranteed loan program helped finance short-term accounts receivable, inventory, working capital, and equipment, as well as providing some refinancing of existing debt. Here, AIDEA provided up to $500,000 per borrower by purchasing from a lender participation in a loan (usually 90 percent of the loan amount) that was guaranteed by the U.S. government, or by one of its agencies or instrumentalities, including the SBA.

On June 24, 1982, the governor of Alaska signed legislation authorizing and funding a multi-family housing loan program. Under this legislation, the state government in July 1982 appropriated $21 million in certificates of deposit to AIDEA, to establish a security fund to provide a loan loss reserve for certain multi-family housing loans. Although the 1986 Tax Reform Act retained the tax-exempt eligibility of multi-family housing projects, legislators repealed it in June 1987.

In 1984, the Industrial Development Act was amended by legislature that authorized AIDEA to own and operate certain types of development projects. For this purpose, the Economic Development Fund was established. The scope of AIDEA was changed and the fund was created to meet the financing needs of the DeLong Mountain Transportation System Project, better known as the Red Dog project. This project consisted of a road and a port to serve northwest Alaska's needs and permit transportation of zinc concentrates and other minerals from the Red Dog mine in the DeLong Mountains of northwest Alaska. AIDEA's impressive role in making this infrastructure project a success has been recognized by the local business community, Cominco Alaska Incorporated, NANA Corporation, and construction contractors.

The 1986 Tax Reform Act phased out tax-exempt financing as the major source of funds for AIDEA's purchase of loan participation. The act limited projects eligible for tax-exempt financing to certain manufacturing facilities, multi-family housing projects, and projects designated as "exempt facilities." The act made office buildings and office/warehouse complexes ineligible for tax-exempt financing. Furthermore, it eliminated the deductibility of 80 percent of the interest banks pay to finance tax-exempt security holdings. Without that deduction, banks no longer find this program as lucrative.

AIDEA anticipated further restriction of the tax-exempt program as a result of the 1986 Tax Reform Act, and in 1987 started to implement its taxable bond program along the same guidelines as the tax-exempt program. AIDEA has an annual authorization of $400 million to finance projects under its bond programs. This authorization is valid until January 1992.

In 1987, the legislature expanded the scope of AIDEA by adding an export assistance program to be implemented later in 1988. This program was intended to facilitate the export of Alaskan goods, services, and raw materials by providing pre-shipment or post-shipment export loan guarantees for eligible export transactions. This program is still inactive.

In 1988, the legislature created the Business Assistance Program, better known as the Loan Guarantee Program. This program was established to help bridge the guarantee gap created in 1987 when AIDEA stopped participating in the federally guaranteed loan program. The new program provided a guarantee of up to $1 million for new loans or loans to refinance existing debt. This program was intended to enhance the ability of qualified businesses to borrow funds for reasonable commercial activities--either to start new projects or to refinance existing ones--in a tight money market.

A more recent development in AIDEA's operations is its involvement in providing capital to venturesome business. Despite the controversy surrounding the involvement of state government in establishing a venture capital institution, the state government entered, through AIDEA, into a limited partnership agreement with Polaris Fund. AIDEA's board of directors voted in February 1990 to allocate $6 million to the fund. The fund's general partners committed to manage it and raise $24 million in private money from institutional investors.

So far, no funds have been raised by the general partners, and no investment projects have been approved.

Has AIDEA Accomplished Its Mission?

The following sub-sections will try to assess the performance of AIDEA in terms of employment creation, profitability of individual projects, and profitability of operations.

Employment Creation

AIDEA's past performance should be evaluated in terms of its purposes. The purposes of AIDEA are to promote, develop, and advance the general prosperity and economic welfare of the peoples of Alaska; to relieve problems of unemployment; and to create additional employment. In other words, we should study the economic impacts--including both the direct and indirect employment--created by projects financed through AIDEA.

Economic projects should be formulated and evaluated to single out for financing those that would contribute most to AIDEA's objectives. It follows that AIDEA requires a methodology for comparing and evaluating alternative projects to assess their potential contributions to its objectives.

Indeed, the objective of employment creation has been a common goal of public policy in many countries. Although employment is a valuable social as well as economic objective, it is very generic and lacks specificity.[3] There are various reasons why creating jobs is considered valuable. Manpower is human capital and therefore an important economic resource. Employment is not sought for its own sake, but as a means to generate more output. Employment should be subservient to output creation. Indeed, it could well be that if we tried to spread a given amount of capital investment too thinly over a great many workers, the output might be less than if the same amount of investment were made to equip fewer workers.

Different industrial and business projects have different employment implications. A capital-intensive project has different revenue-generating implications from a labor-intensive project. While a capital-intensive project might employ few workers directly and provide a large tax base to a local community, a labor-intensive project might provide employment for a large number of workers and contribute a small amount to the local tax base.

Another problem related to employment is its estimation. Different forecasters may develop very different estimates of the number of jobs needed to produce the same product. This can be explained by the fact that two different engineering firms may use different design concepts. Also, the two firms may have very different direct employment requirements for the same project, even if they have the same engineering design. Some jobs may be unanticipated or underestimated in large projects. For example, the operation phase of the trans-Alaska oil pipeline was originally estimated to provide approximately 500 jobs. The actual number is closer to 1,000.[4]

Despite these constraints, AIDEA management should develop and use consistent, quantitative measures to assess feasibility of proposed projects. Criteria for such assessment standards should include how much employment and value added proposed projects would contribute to Alaska's economy. If AIDEA is to be evaluated and held accountable for managing its financial resources, it should have a less subjective measure of evaluation.

Although lacking specificity, the statutes provide a more general yardstick. They state that for AIDEA to finance or invest in any project, it "should provide, or retain, employment reasonably related to the amount of the financing by the authority, considering the amount of investment per employee for comparable facilities and other relevant factors."

Further, the statutes do not indicate whether indirect as well as direct employment should be considered before the financing decision is made. Also, the statutes do not say whether employment creation is the overriding criterion for financing a project, irrespective of its economic "feasibility" as opposed to its economic "desirability." Additionally, the statutes require the applicant to prepare a finance plan, but they do not require the plan to include an estimate of the number of jobs that will be created.

Table 1 shows the geographic distribution of AIDEA's total cumulative financing and employment under umbrella and revenue programs since January 1981. The table indicates that during the period 1981-1990, AIDEA provided $872 million to finance 806 economic projects which created or retained an estimated 13,636 jobs, mostly (90 percent) in commercial buildings and properties. According to AIDEA, two-thirds of total financing provided, of projects financed, and of jobs created or retained went to southcentral Alaska--including Anchorage, which garnered more than half (52 percent) of the financing provided, of projects financed (52.4 percent), and of jobs created or retained (52.6 percent). Southeast Alaska was the next largest beneficiary of AIDEA's umbrella and revenue programs, with 15.5 percent of total financing and 14.3 percent of jobs created or retained. The lowest volumes of financing and employment went to northern Alaska (3.5 percent and 3 percent respectively) and southwest Alaska (6 percent and 5.8 percent respectively).[5]

The numbers and percentages do not include financing and investment related to the Red Dog, Healy, and Skagway projects. AIDEA estimates that the Red Dog project created approximately 1,050 construction jobs, while Cominco (the mine operator) created 364 operations and maintenance jobs. AIDEA estimates that the Healy project will create approximately 200 construction jobs by 1995. The operational increase will be approximately 35 jobs at Golden Valley Electric and 5 jobs at Usibelli Coal. Further, AIDEA estimates that there will be approximately 16 construction jobs and 10 full-time and 5 half-time operational jobs at the Skagway Ore Terminal project.

Table 1
AIDEA's Umbrella and Revenue Bond Programs
Regional Distribution of Financing and Employment
1981-1990

Total Financing	Northern	Interior	Southwest	Anchorage	Southcentral	Southeast	Total
$ Value	$30,535,250	$99,875,825	$52,095,250	$458,710,805	$97,815,500	$135,237,100	$874,269,730
% of Value	3.5%	11%	6%	52%	11%	15.5%	100%
No. of Projects	27	91	44	422	135	87	806
% of Projects	3.3%	11.3%	5.5%	52.4%	16.7%	10.8%	100%
Employment	439	1,480	788	7,178	1,804	1,949	13,636
% of Employment	3%	11%	5.8%	52.6%	13%	14.3%	100%
Financing/Employment Ratio	$69,556	$67,484	$66,111	$63,900	$54,221	$69,388	$64,115
Total Expense							$217,057,810
Expense/Employment Ratio							$15,918

The financing/employment ratio in Table 1 also indicates that the State of Alaska (through AIDEA) provided an average of $64,115 in financing for each job created or retained. However, according to the total expense/employment ratio for the last decade, it cost the state an average of $15,918 to create or retain a job.

We found that all employment estimates were made by borrowers rather than by AIDEA or loan-originating banks. We also found that although the feasibility study by SRI International evaluated the rate of return of the Red Dog mine project, it did not discuss or estimate the project's potential to create jobs--a paramount purpose for the establishment of AIDEA. We did not have access to the original feasibility studies for the Skagway Ore Terminal and the Unalaska Marine Center. *The Summary of Projected Economic, Social, and Environmental Effects* of the two projects did, however, contain relevant information on employment. However, information related to the Healy project was not furnished.[6]

We recommend that AIDEA should develop reliable, defensible estimates of how many jobs specific projects would create, and not leave the task to borrowers, equity participants, or co-financiers.

Profitability of Projects

The state government didn't intend AIDEA to function as a profit-driven financial institution nor as a subsidy-granting fund. However, when we apply the general financing criteria the statutes provide for AIDEA, we need to consider whether the commercial profitability of a project is important or not.

Consider the following example: Suppose that the return from investing in a project in region A would be higher than the return from a project in region B--but region B is a particularly impoverished rural area. The statute states that for a project to be financeable it should be "economically and financially feasible and able to produce revenue adequate to repay the bond or loans with which it is financed," and "the project applicant should be financially responsible."

The statute, however, does not refer specifically to an estimated minimum rate of return from the project relative to the cost of capital. AIDEA should develop standards to be used consistently in assessing whether proposed projects would produce adequate returns. Such standards should involve weighing the prospective rate of return against the cost of capital.

Also, the statue does not distinguish between economic "feasibility" and "desirability". AIDEA should consider financing projects that are of limited profitability but are "desirable" because they could produce economic benefits for Alaska. For example, a given project might produce just modest returns for AIDEA, but create jobs or broaden the tax base in a community. Another example of a "desirable" type of investment that could pay off over the long-term by strengthening and broadening the state economy would be investment in the Alaska Science and Technology Foundation, which is intended to bolster education and technology in Alaska. To avoid endless requests for subsidies, state and AIDEA officials would need to develop stringent standards for assessing projects that might fit into this "desirable" category.

Evaluation of AIDEA Financial Operations

Here we evaluate AIDEA's liquidity, profitability, and loan delinquency exposure. Table 2 contains the relevant data and ratios. Figures 1 through 5 show the 1981-1990 trends in relevant financial ratios.

Table 2 and Figure 1 show that AIDEA's liquidity ratio (liquid assets/total assets) has historically been high, rising slowly from 23 percent in 1981 to 27 percent in 1985. AIDEA's high liquidity ratio is attributable to the statutory requirement of maintaining quality ratings by bond ratings institutions. The ratio climbed dramatically to 47 percent in 1987 and stood at 39 percent by 1990. The dramatic jump is explained mainly by the following factors: stagnant demand for AIDEA financing due to the economic recession; the effects of the 1986 Tax Reform Act; and AIDEA's difficulty in identifying feasible investment projects in Alaska, including projects in rural areas.

AIDEA's ratio of liquid to total assets is about twice as high as that of national and international commercial banks in growth-oriented economies. However, compared to development financing institutions, AIDEA's liquidity ratio is just slightly higher, given that these institutions are involved in equity, debt, and guarantee financing, and are better able to identify feasible projects. Some of them, such as the OPEC International Fund For Development, use co-financing and thus rely on the expertise of more established co-financiers such as the World Bank or International Finance Corporation.

AIDEA's 1990 liquidity ratio of 39 percent seems very low, however, compared to that of Alaska banks--95 percent for state chartered banks and 54 percent for nationally chartered banks as of June 1990. The high liquidity ratios of local banks and AIDEA present strong evidence that there is definitely no shortage of capital in Alaska. High liquidity for banks may be explained by the conservative policies of the largest banks in Alaska. Unless there is a unique niche to capitalize on, any new entering commercial bank may not survive in the local market. Since both AIDEA and local banks have high liquidity, they could consider teaming up to finance some more risky development projects.

Although it recognizes its high liquidity ratio, AIDEA has not used any hedging technique--such as financial futures--to protect its high liquidity against the ravages of fluctuating market interest rates.

Our analysis of AIDEA's liquidity ratio is further supported by the steady growth of its equity capital, from $197 million in 1981 to $572 million in 1990--an average annual compounded rate of growth of 11.2 percent during the last decade. AIDEA's equity multiplier (EM)--total assets/equity--which measures capital adequacy, is very small. Table 2 and Figure 2 indicate that AIDEA's EM ranged from 1.1 in 1981 to 1.8 in 1986 and 1.5 in 1990.

Table 2

AIDEA Liquidity, Profitability and Loan Delinquency Analysis

	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990
Cash & Liquid Investments	$49,523,234	$81,532,973	$88,170,992	$101,522,575	$140,629,819	$204,462,552	$420,239,928	$352,131,511	$330,774,043	$330,699,015
Loans Less Loss Allowance	163,752,349	217,217,080	254,476,035	325,028,487	372,119,454	368,586,237	430,003,602	360,931,487	330,448,864	295,021,928
Total Assets	217,555,431	307,362,980	350,297,501	435,300,796	524,863,395	586,581,061	888,062,317	812,548,657	820,704,048	839,124,807
Equity (Capital & R.E.)	197,229,568	226,263,415	248,839,986	274,777,574	305,073,901	333,949,102	519,672,661	520,847,018	542,629,700	572,029,254
Professional Fees	707,359	252,238	122,605	134,023	114,243	119,809	96,205	440,078	508,897	635,829
Total Expenses	1,667,354	6,983,938	12,198,156	17,606,229	22,060,125	26,084,609	35,956,138	43,565,508	28,184,399	22,751,347
Net Earnings	16,483,039	21,033,847	22,576,571	25,269,388	29,752,227	28,875,201	23,102,148	1,174,357	21,782,682	29,399,554
Retained Earnings	16,641,236	37,675,083	60,251,654	85,521,042	115,273,269	144,148,470	178,360,729	187,262,293	201,317,768	230,717,322
RATIOS										
Liquidity	0.23	0.27	0.25	0.23	0.27	0.35	0.47	0.43	0.40	0.39
Return on Assets	0.08	0.07	0.06	0.06	0.06	0.05	0.03	.00	0.03	0.04
Cum. Profitability	0.08	0.12	0.17	0.20	0.22	0.25	0.20	0.23	0.25	0.27
Capital Adequacy	1.10	1.36	1.41	1.58	1.72	1.76	1.71	1.56	1.51	1.47
Prof. Fees/Total Exp.	0.42	0.04	0.01	0.01	0.01	.00	.00	0.01	0.02	0.03
LOAN DELINQUENCY EXPERIENCE										
Current Loans	$155,344,000	$210,082,466	$242,381,031	$312,325,338	$351,683,511	$335,858,568	$341,829,620	$292,842,348	$277,487,530	$277,589,188
Past Due Loans	10,975,000	9,701,614	14,662,004	15,270,149	23,002,943	36,975,029	101,775,032	92,187,264	82,741,897	41,087,520
Total Loans	$166,319,000	$219,784,080	$257,043,035	$327,595,487	$374,686,454	$372,833,597	$443,604,652	$385,029,612	$360,229,427	$318,676,708
Ratio: Past Due/ Total Loans	0.07	0.04	0.06	0.05	0.06	0.10	0.23	0.24	0.23	0.13

Figure 1
Liquidity Ratio: 1981-1990
(Cash + Liquid Assets/Total Assets)

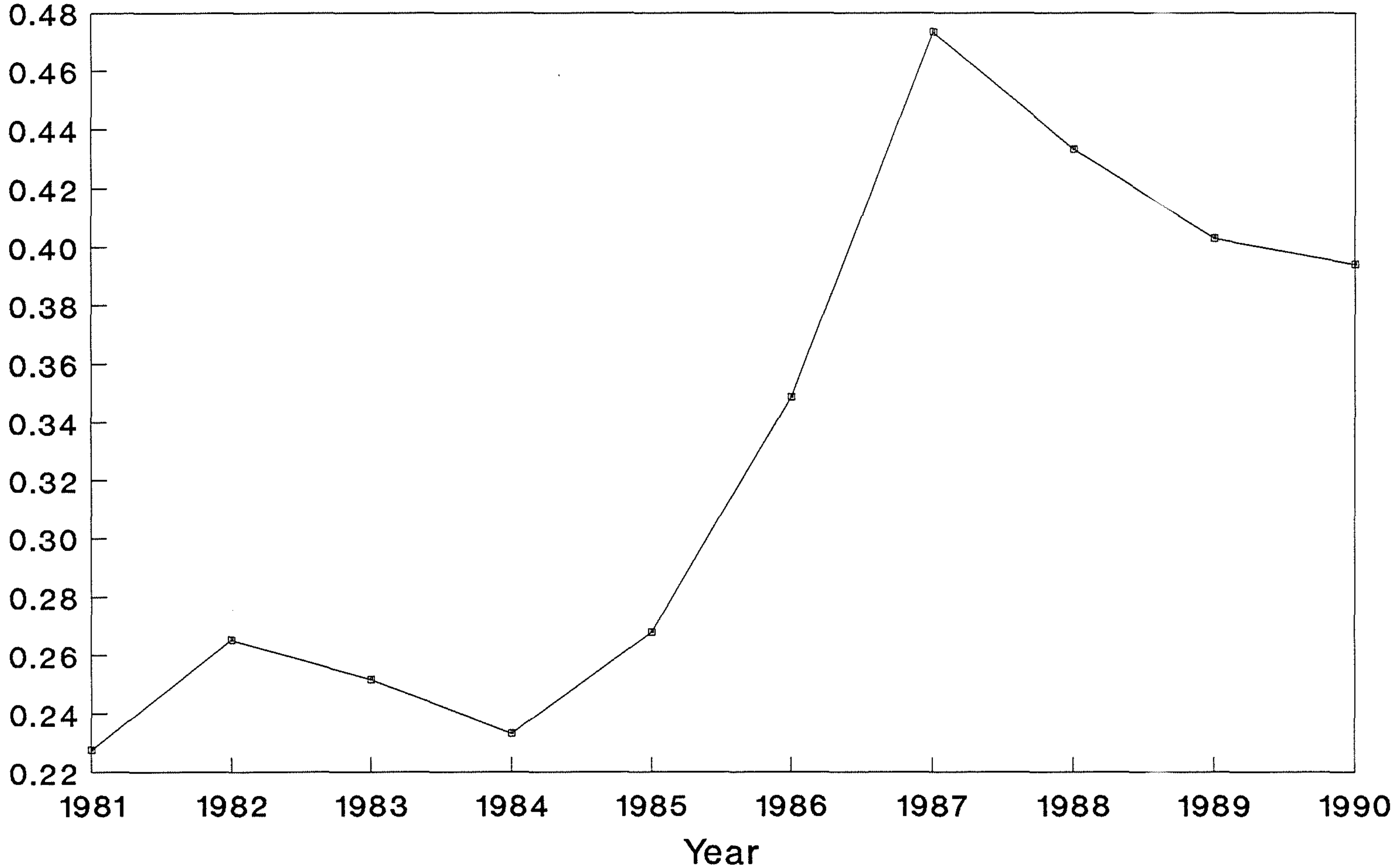
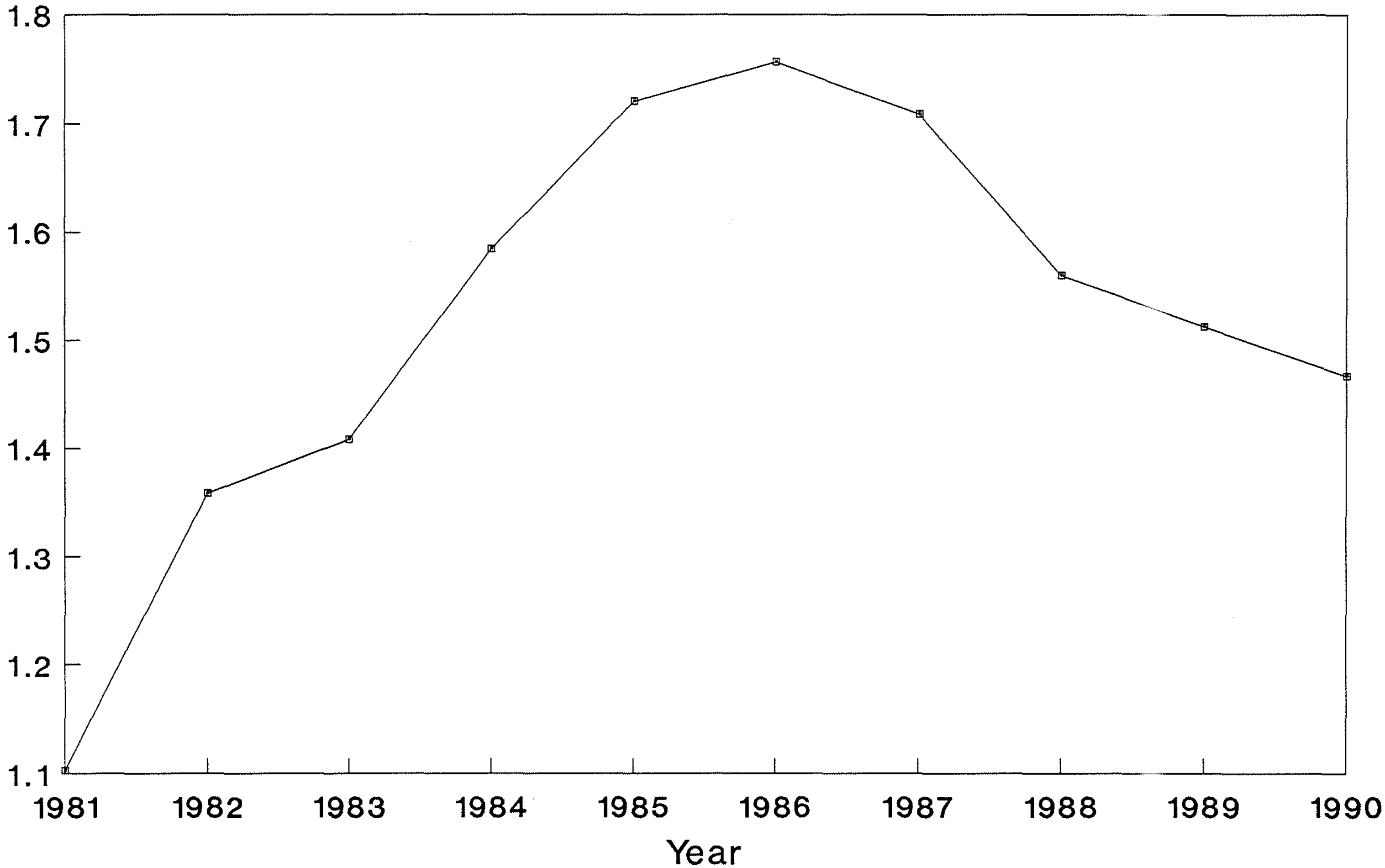


Figure 2
Capital Adequacy Ratio: 1981-1990
(Total Assets/Equity)



Generally, the larger the EM the greater an institution's potential risk exposure, other things being equal. EMs tend to vary directly with bank size. The typical U.S. commercial bank has an EM of about 14, while the giant U.S. commercial banks have EMs in the range of 20 to 25. While Alaska state banks have an average EM of 12.5, Alaska national banks have an average EM of 8.6 as of June 1990. The small size of AIDEA's EM can be ascribed to the functional differences between AIDEA and commercial banks. While AIDEA has to have high equity capital to get better credit ratings for its issued bonds, banks are forbidden by the Glass-Stegal Act of 1933 to issue and float bonds on behalf of borrowing corporations. Additionally, AIDEA adopted a prudent, conservative policy, based on the premise that AIDEA is not a profit-driven institution.

Table 2 and Figures 3 and 4 illustrate the profitability of AIDEA during the period 1981-1990. Figure 3 shows that the return on AIDEA's assets dived from 7.6 percent in 1981 to a trough of almost 0 percent in 1988. Had AIDEA been a taxable entity, the after-tax return/asset ratio would have been negligible during most of the years under study. This downward trend is explained by the concomitant upward trend in the ratio of non-performing loans/total loans, which also peaked in 1988.

Although AIDEA's return on assets was minuscule for much of the decade, its cumulative profitability (retained earnings/total assets) has been continually increasing since 1981--except in 1987, when the demand for loans declined and the number of delinquent loans increased. During this period, the allowance for loan losses increased from $4.2 million in 1986 to $10 million in 1987. The small coefficient of variation (standard deviation/mean) of the net earnings for the 1981-1990 indicates relative stability of AIDEA's net income.

Table 2 and Figure 5 show that the percentage of AIDEA loans in delinquency (nonperforming loans/total loans) increased from less than 5 percent in 1984 to 10 percent in 1986 and to 24 percent by 1988. By 1989 that trend began reversing, and in 1990 the percentage of delinquent loans was down to 13. The sharp increase in delinquent loans was due to the severe recession in Alaska commercial and residential real estate, particularly in Southcentral Alaska. By the end of the decade the real estate markets had begun recovering. Many loans that had been delinquent earlier had gone through foreclosure, and the rate of new delinquencies had slowed down.

Figure 3
Return on AIDEA Assets: 1981-1990
(Net Equity/Total Assets)

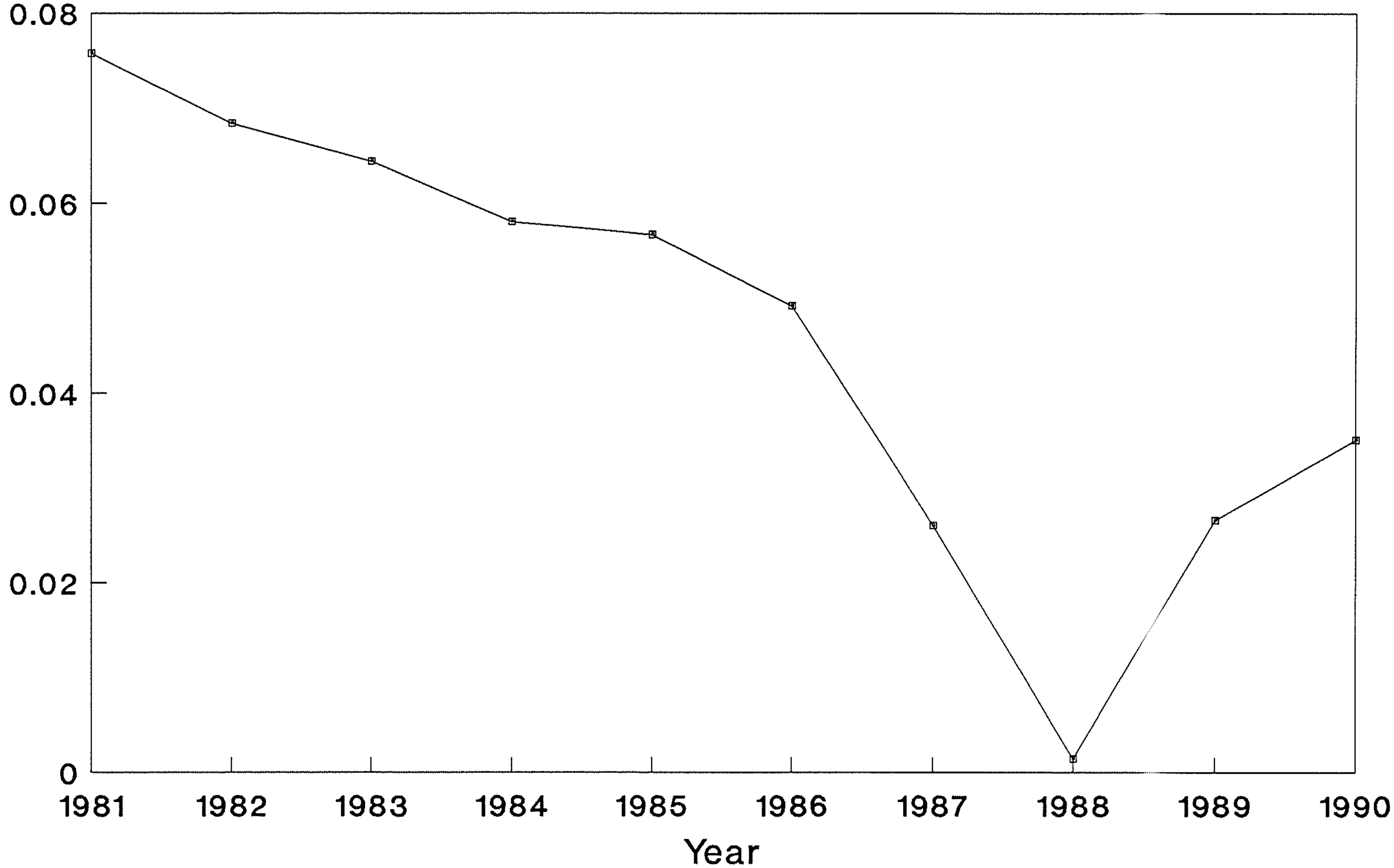


Figure 4
Cumulative Profitability: 1981-1990
(Retained Earnings/Total Assets)

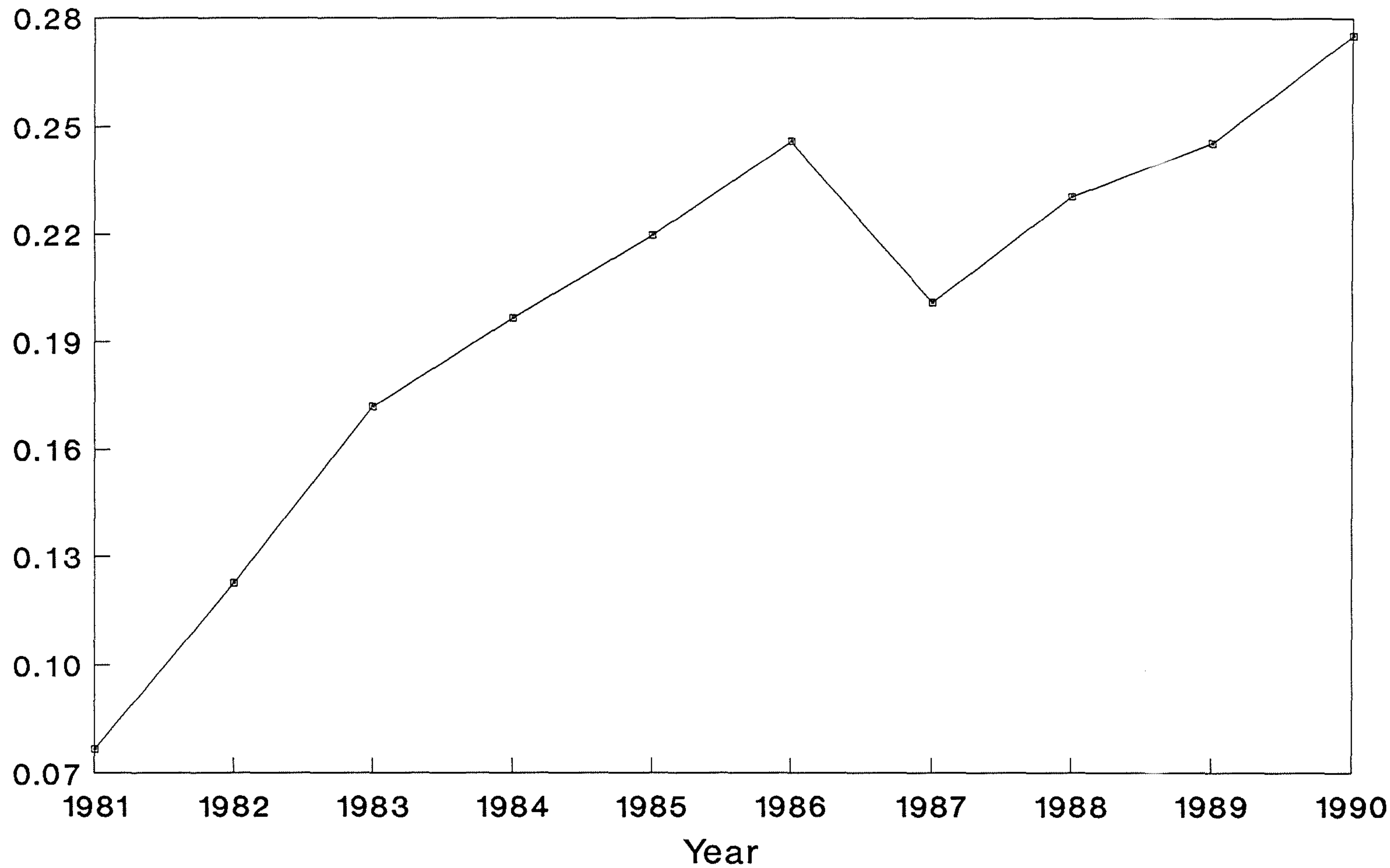
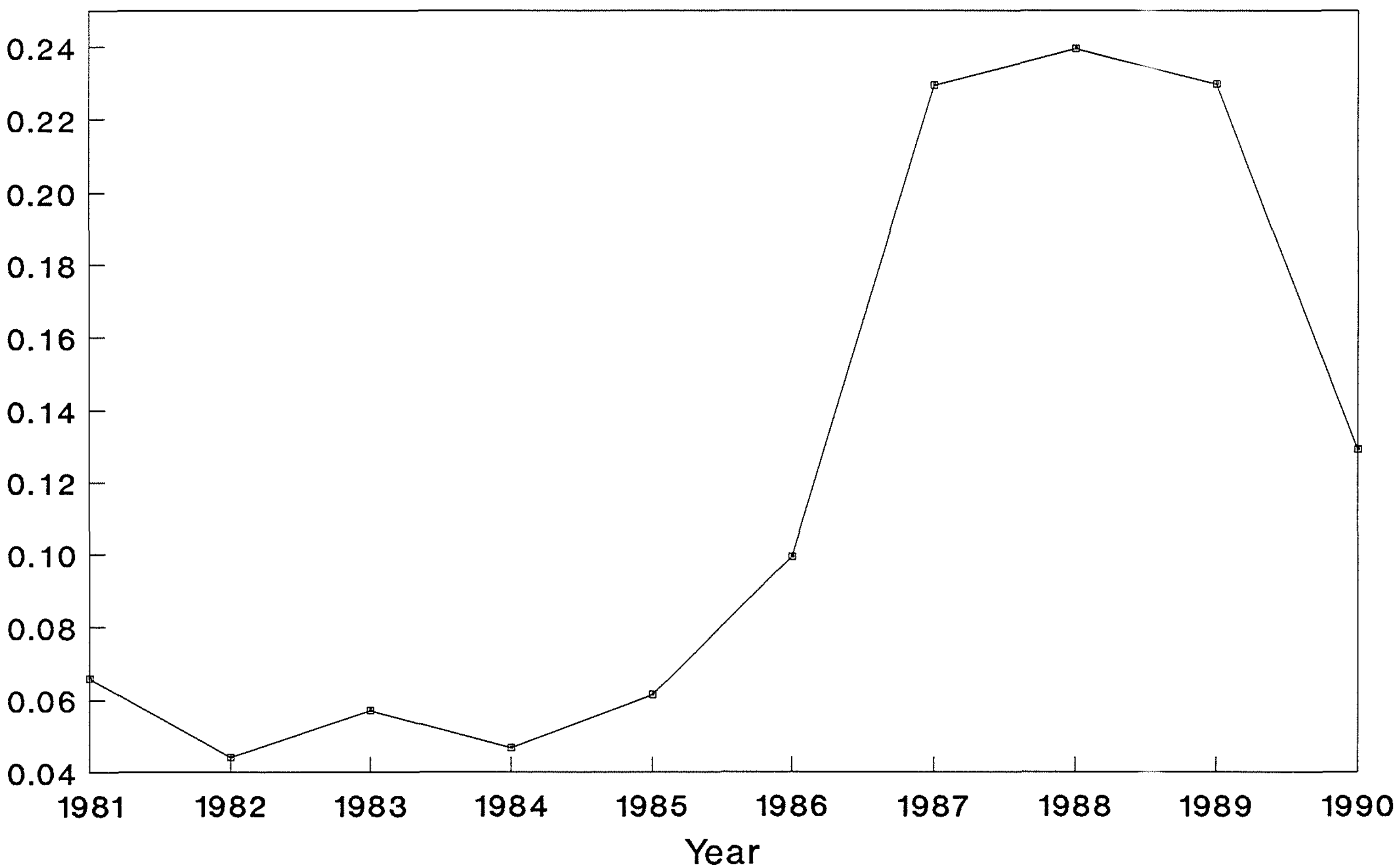


Figure 5
Delinquent AIDEA Loans: 1981-1990
(Delinquent Loans/Total Loans)



AIDEA Management and the Role of State Government

Although the statutes say AIDEA is an independent legal entity, it is an institution that is completely run by state government. It was established by the Alaska Legislature as a public corporation, constituting a political subdivision within the Department of Commerce and Economic Development. It is a state government entity, but also a "separate and independent legal entity."

The powers of AIDEA are vested in the board of directors, which has five members--all appointed by the state government, including the two members from the general public. Further, any change in the statutes or regulations should be approved by the state legislature. Prior legislative approval is also required for providing financing for certain types of development projects. Additionally, AIDEA's executive director and administrative staff are considered government employees, and are subject to government regulations.

The high degree of state government involvement in managing and deciding on the future direction of AIDEA, a quasi-development finance institution by definition, raises many questions. The major issue pertains to politicization of decision making: adopting policies that would insulate the declared functions of AIDEA from the need to finance projects or become involved in areas of development that had political rather than economic implications.

Based on the experience of development finance institutions (DFIs) in many developed and developing nations, we believe that AIDEA should remain as a governmental institution, but should be accorded more autonomy. As long as the mission of AIDEA is to provide a social value added, it should not be privatized. Historically, since World War II, the relationships between DFIs and governments have engendered the following advantages:

(1) Government participation has been essential not only to provide capital but also to lend strength and stability and to proffer status.

(2) The participation of governments in the ownership and management of DFIs has been justified on the grounds that they can ensure the proper development of fledgling instruments of growth.

(3) The link between governments and DFIs has also assisted DFIs to fit their operating policies more accurately into the national economic development framework and given them better access to the national planning process. This in turn has enabled the more vigorous DFIs to play a part in the shaping of development policy.

(4) It has been argued that DFIs can not function in isolation, and that since their primary function is that of a catalyst for development, they could only profit from close linkages with governments. Completely independent DFIs would quickly be isolated and rendered obsolete by government policies--so government participation and influence has been considered a form of insurance.

Notwithstanding these advantages of ties between governments and DFIs, governments have recognized that DFIs can best fulfil their function when left free to operate with the least possible interference. Even when the best intentions prevail, the possibility of government influence has remained a matter of concern. These fears have been exacerbated by the tendency of some governments to put pressure on the management of DFIs to make loans on projects that under normal criteria would not qualify.

In Alaska apprehension stems from the disheartening experiences of the Alaska Renewable Resources Corporation (ARRC) and its later offspring, the Alaska Resources Corporation (ARC). From its inception in 1972, the ARRC functioned like a venture capital fund that was managed ineffectually by an academician and government officials who lacked seasoned managerial expertise, technical knowledge, and "due diligence" insight to oversee ARRC investments.

In 1982, legislators changed the name of ARRC to the ARC--which inherited not only the financial assets and investment portfolio of ARRC but also its tarnished image. But in 1984 the legislators acknowledged the immense magnitude of the problems ARC had inherited from its predecessor, and decided that it should be terminated on December 31, 1989.

Implications for the Board

For AIDEA to achieve its objectives, it has to meet two prerequisites: a credit standing adequate to mobilize financial resources, and a decision-making process which would enable it to invest those resources wisely. The quality credit rating AIDEA enjoys emanates from its high degree of liquidity. AIDEA's decision-making power is vested in its board of directors, which authorizes the executive director to implement its decisions, taking into account the statutes, regulations, and by-laws. Given the nature and the purpose of AIDEA as a government financial institution, we believe that the current structure of the board creates constraints that may inhibit the institution from achieving its purpose. Those constraints include:

Limitations of Board Membership

a. Currently, all members of the board, including the two persons from the general public, are appointed by the state government. Although we oppose privatization and believe state government plays an indispensable role in AIDEA's decision-making process, we would like to see its financing decisions more autonomous and based more on the social and economic merits of the projects under consideration. One director expressed his dismay because some of AIDEA's financing decisions were based on anecdotal information.

b. The proportion of members from the private sector is very small, given the fact that AIDEA was created to help provide financing for private business.

c. The credentials of the current members of the board are indeed very impressive. However, we would like to see at least some of the members have experience in pertinent fields such as commercial banking, investment banking, or industrial development banking. Our research shows that since 1981, the board has had only three directors who worked as bankers and two who worked in finance-related positions.

The implication of these limitations is that the decision making of the board is definitely constrained, and sometimes compromised to a certain extent. Although the statutes provide considerable powers for the board, some of the members are not fully using these powers--blaming AIDEA for deficiencies and even publicly criticizing the operation and staff of the very institution they direct.

Limitations of Accountability

Other than the Alaska Legislature, no state or private entity, such as a state economic development board or stockholders, currently oversees the performance of the institution or holds the members of the board accountable for any of their decisions.

Additionally, AIDEA has no consistent performance measures, and therefore it would be difficult to assess performance of AIDEA management and staff.

Limitations of Delegation of Authority

Due to time constraints, members of the board sometimes authorize other persons to attend board meeting on their behalf, and make crucial decisions without either enough knowledge or preparation on the subject matter under consideration. This is one of the shortcomings of the statute which empowers board members to delegate their authority.

Based on the above observations, we recommend the following to help AIDEA accomplish its mission:

(1) The board should be restructured to add at least two more members from the general public. Four members from the general public, and three from state government, might serve the purpose. To create more community support for AIDEA programs, the local banking industry and non-banking business sector could be equally represented on the board.

(2) The members of the board should be experienced in, or have had prior extensive working relationships with, financial institutions in Alaska or elsewhere.

(3) The state government should develop performance standards and reporting requirements that weigh performance of AIDEA against its objectives. Such standards could then be used to ensure management and staff accountability.

Implications for the Executive Director

In view of the pervasive role of the state government in running the affairs of AIDEA through a politicized board whose decision making has yet to become more autonomous, the job of the executive director has continued to be a natural target for criticism from local bankers, the business community, and even from some members of the board who ironically have a statutory power to keep or terminate his services.

The current executive director actually functions as a secretary-cum-treasurer, deriving all his authorities from the board. The board authorizes him, among other things, to keep all records, deposit AIDEA's funds in such banks as he may select, and invest AIDEA's funds as directed by the statutes. With the open-ended power of the board, it is even incumbent on the board to appoint or fire the executive director. Further, the board has the discretion to assign to some other person or persons all or part of the duties of the secretary-cum-treasurer of AIDEA, and may give that person or persons an appropriate title, including that of assistant secretary-treasurer.

Yet, the current executive director is undoubtedly powerful. His power probably emanates from three sources: first, his own pertinent academic preparation and technical, financial, and government expertise, coupled with many years of experience as executive director; second, lack of highly seasoned financial expertise among some members of the board; and third, the relatively stable profitability of AIDEA's operations during his tenure, and the organization's data indicating that it has created or retained many jobs.

However, two major events and a personal trait may have worked against him: first, the change in federal tax laws; second, the collapse in world oil prices in 1986 and its adverse effect on the Alaska economy; and finally, the need for a more professional, tactful attitude in dealing with business and banking executives.

The by-laws of AIDEA ignore many important elements of the position of the executive director:

(1) Qualifications: The board has not formally established a list with the academic background and expertise needed for the position of executive director, leaving more room for political appointment.

(2) Term of appointment: The by-laws also do not specify the number of terms allowable for the executive director to stay in office.

(3) Performance evaluation: The by-laws neither indicate the entity or persons who should evaluate the performance of the executive director, nor do they pinpoint the criteria that should be used in the evaluation process, or say how often the director should be evaluated.

(4) Recruitment/termination procedure: The by-laws do not delineate the recruitment/firing procedure for the executive director. Arbitrary, politically motivated procedures could hurt the effectiveness and continuity of AIDEA.

Implications For AIDEA Staff

To help him accomplish his duties as secretary-cum-treasurer of AIDEA, the executive director hires his administrative staff. AIDEA has an administrative staff of 21 working in three departments: the credit department, which underwrites loan packages and monitors lender servicing; the finance department, which is responsible for accounting, investment, personnel, and data processing functions; and the development department, which administers the Red Dog project and evaluates other prospective development projects.

Using an organization chart, resumes, and personal interviews, we found the following:

(1) Although AIDEA is now trying to promote development projects--an area which requires diverse economic, engineering, environmental, and social education and expertise--AIDEA's development department is staffed by only two employees who rely heavily on consultants services. If AIDEA is to be successful in the identification, preparation, and promotion of industrial development projects, the department has to be staffed by personnel with stronger academic credentials and seasoned expertise in project appraisal.

(2) AIDEA lacks a computerized data base covering its operations. The current data compilation is done manually. This deficiency adversely affects the managerial decision-making process.

(3) AIDEA is presumed to be an entity independent of the state government, having its own personnel by-laws. AIDEA does have its own by-laws--but those by-laws do not refer to any personnel procedure related to hiring/firing, promotion, compensation, or pension.

Relations With Local Financial Institutions

For AIDEA to achieve its purpose, it must improve its financial delivery system by forging an effective and efficient working relationship with its financing partners--namely, local banks. Without banks' cooperation, the progress of AIDEA's operations would be seriously hampered. And for banks to genuinely partake in building up and diversifying Alaska's economy, they should understand the social and economic objectives of AIDEA and the needs of Alaska businesses. (Chapter IV presents specific suggestions for cooperation between AIDEA and local banks.)

Our investigations indicate there is serious discord between local banks and AIDEA. The current rift is understandable, and emanates from the difference in the nature of banks and AIDEA: banks are private, profit-driven institutions while AIDEA is a state bureaucracy whose main purpose is not to achieve a high rate of return but rather to create, without subsidization, a social and economic value added to Alaskans. AIDEA was created to bridge a gap in the local capital market by facilitating financing and carrying risk on behalf of both banks and local borrowers.

Recently, the rift between AIDEA and local banks has been deepened by four elements. First, the 1986 Tax Reform Act eliminated the deductibility of interest that banks pay to finance tax-exempt security holdings. That change discouraged banks from taking part in AIDEA's participation program, and cast some doubt on the future direction of AIDEA. Second, some local banks see as serious competition AIDEA's recent aggressive attempts to embark on direct financing of certain development projects, and its passive venture capital financing. Third, attitudinal barriers have been shaped by certain personalities. And, finally, the absence of a marketing plan by AIDEA to publicize its programs, including the export guarantee program, has hurt relations between banks and AIDEA.

Historically, AIDEA has been a target for local banks' criticism. After 1985, however, this wave of criticism rose considerably when world oil prices collapsed, compounding the adverse economic effects of state government overspending and private real estate overbuilding. Since then, most local banks (as well as AIDEA) have endured the results of their deep involvement in real estate lending. Some banks started looking for a scapegoat to blame. Another reason for the escalation of bank criticism of AIDEA in recent years is the 1985 change in the statutes which allows AIDEA to provide direct financing for development projects such as the Red Dog. The political pressure exerted by local banks led to the creation of AIDEA's SBA-like guarantee program.

Although some of the following specific criticisms are less relevant, we think that they should be documented here for any future probes of the problems with local banks:

(1) Some banks believe that the Alaska Housing Finance Corporation (another public corporation of the state) is mainly to blame for the ills of the Alaska housing market. They also believe that AIDEA loans helped create the glut in residential and commercial real estate, particularly in Anchorage. They feel that the state, through AIDEA and other institutions, should therefore help alleviate the situation. It is true that as January of 1986, the real estate portfolio made up 99 percent of AIDEA's total financing. However, we must remember that all of AIDEA's real estate projects were initially processed and approved by banks. By August 1990, the real estate portfolio had declined to 82 percent of AIDEA's total financing.

We believe that AIDEA should not have been involved in financing commercial real estate ventures. Rather, it should have concentrated on financing projects that would have provided value-added to the state economy.

(2) Some banks rightfully claim that the administrative fee AIDEA charges borrowers has been very high, offsetting the borrowing cost savings created when AIDEA issues bonds. Up to August 1990, AIDEA's overhead rate was 4 percent of the loan. Banks believe that AIDEA should provide funds at cost.

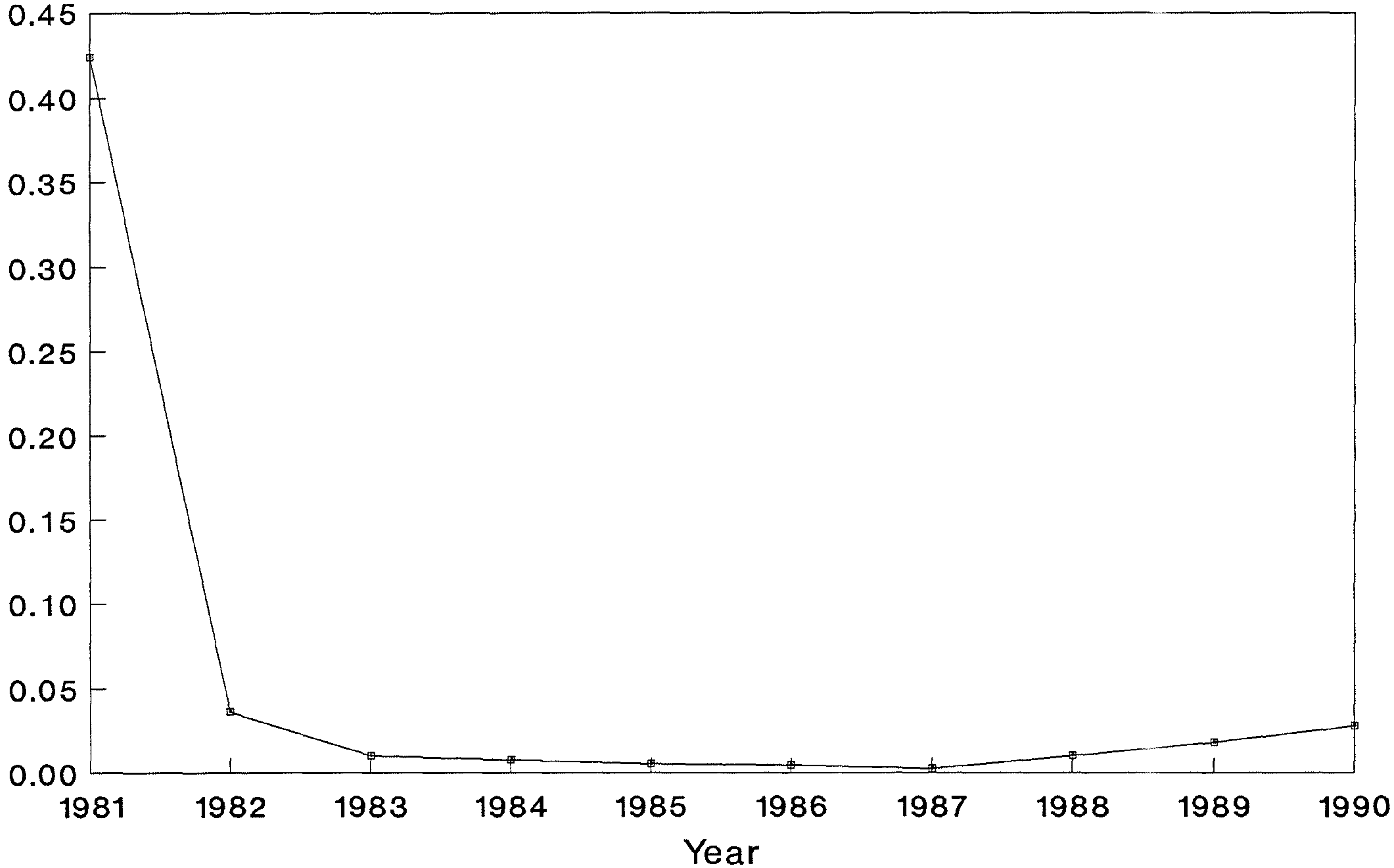
In defense of its position, AIDEA claims that its rate has been high because of the high expense of hiring consultants. Despite its current staffing limitations, AIDEA's learning curve has improved as a result of the past services of attorneys and consultants. Therefore AIDEA now hires consultants less frequently, thus cutting its overhead cost and passing the savings on to borrowers. Figure 6 shows that the professional fee/total expense ratio declined substantially, from 42 percent in 1981 to almost zero in 1987. It then started to increase slightly, reaching 3 percent in 1990. Since August 1990, AIDEA has reduced its fees to 1 percent in commitment fee plus 1.5 percent in administrative fee on taxable bonds and 2 percent on tax-exempt bonds--both averaging 2.75 percent of the loan.

(3) One bank believes that SBA's guarantee program is more flexible, less bureaucratic in handling applications, and more responsive to the needs of borrowers than AIDEA's program. In fact, AIDEA's business assistance program offers a higher guarantee limit--$1 million compared to SBA's limit of $500,000. Both SBA's and AIDEA's loan applications are processed similarly through local lenders. Banks would like to see AIDEA guarantee more loans in excess of the SBA limit of $500,000. These guaranteed loans can be used as collateral to attract private and government deposits, and the guarantee helps sell these loans on the secondary market at favorable terms.

(4) Another bank believes that AIDEA should be involved more in a guarantee program than in participation. It believes that while the former would create more competition among banks (thus helping borrowers), the terms of the participation program are set by AIDEA, and borrowers would have to accept AIDEA's terms, interest rates, and administrative and commitment fees.

(5) A number of banks maintain that AIDEA's niche lies in rural rather than urban financing. The banks' view has some validity, but they would also like to encourage AIDEA to invest in rural Alaska because they deem rural investment more risky. AIDEA could finance projects in rural Alaska industries like fishing and timber, which were able to survive the recession but which haven't been able to get financing because of the conservative approach of bankers.

FIGURE 6
Professional Fees/Total Expense Ratio
1981-1990



(6) Banks believe they are better equipped than AIDEA to determine the creditworthiness of prospective borrowers, and that therefore banks should have the final decision on making loans guaranteed by AIDEA. While the banks' lending expertise may outstrip that of AIDEA, we don't think that AIDEA should merely rubber-stamp bank decisions. In their disenchantment with AIDEA, some banks have pressured the steering committee of the Governor's Conference on Small Business to recommend support of House Bill 123, which would:[7]

a. increase the current AIDEA loan guarantees to 80 percent
b. require AIDEA to share in 80 percent of the collection and foreclosure expenses
c. let the banks control the collection and foreclosure status of the loans
d. raise the current 2 percent level for delinquency so local banks can participate in AIDEA's loan program.

(7) Some banks claim that AIDEA has inefficient management.

In responding to the criticisms outlined above, AIDEA raised the following points:

(1) Currently, all loan participations AIDEA purchases are originated by local financial institutions that have executed a Loan Participation and Servicing Agreement with AIDEA. The agreement mandates, among other things, the payment of a servicing fee to the originator, the collection of delinquent loans, and the remitting of payments to AIDEA. If an originator has more than 2 percent of its outstanding loan portfolio delinquent for 90 days or more, AIDEA may not purchase any loan participation from that originator. As a result, very few of AIDEA's current servicers are able to originate new loans for AIDEA to fund.[8] As it concentrates more and more on industrial development loans, AIDEA should seek necessary changes to allow it to deal with loan originators with somewhat higher rates of loan delinquency.

(2) The Tax Reform Act of 1986 has reduced the market for AIDEA's umbrella bonds by eliminating the "carrying interest deduction" for banks. In general, before the Tax Reform Act of 1986, banks could deduct from income 80 percent of the interest they paid on money borrowed for the purchase of tax-exempt bonds. Because this deduction was eliminated, financial institutions--who were the major users and beneficiaries of the program--do not find it as attractive as it was prior to the Tax Reform Act of 1986.[9]

(3) AIDEA's participation program helped smaller banks compete more effectively with larger banks for loan business. A small bank could, in effect, multiply its available funds by five (by putting up 20 percent of the loan amount), and yet by administering the loan, receive fees on AIDEA's 80 per cent and its own 20 percent.[10]

(4) Banks are looking at AIDEA as a conduit to dump risky substandard credits on the state to guarantee, letting banks reap all the benefits while AIDEA takes the risks. As the statutes indicate, AIDEA policy is governed by prudence and risk aversion--which has been warranted lately by Alaska's economic recession and high delinquency rate of loans.

Like AIDEA, local banks also have very conservative lending policies, brought on by the post-1985 collapse of oil prices and the deep involvement of local banks in real estate lending. In fact, some banks--such as National Bank of Alaska and First National Bank of Anchorage--

adopted very conservative policies prior to the economic recession. In light of recent bank failures, all local banks are reluctant to put even 10 percent of their funds at risk. The banking community is perceived as willing to lend only if it sees a deal as being very secure and highly collateralized. Therefore, start-up or working capital financing needs are not easy to meet through local banks.

The shortage of bank lending was cited by the Governor's Venture Capital Working Group as a critical area of concern. It cited two major gaps in capital--loans of less than $100,000, and loans in the $500,000 - $2 million range. The Small Business Development Center of the University of Alaska Anchorage estimates that 95 percent of loan applications fall in the $37,000 - $75,000 range, while the Governor's Conference on Small Business estimates the range as between $10,000 and $100,000. Bankers are reluctant to look at packages of that size, because of the high servicing requirements of small loan packages.

In addition to the very conservative lending policies that restrict the business community's access to local bank lending, the local capital market is constrained by lack of expertise in lending in certain industries of significance to the Alaskan rural economy, such as timber and fishing. Further, banks' high degree of concentration and oligopolistic structure hinders their operating and allocational efficiency.

We employed four measures of concentration, and all indicated that local banks increased their degree of concentration starting in the second quarter of 1986 and reaching a very high level in the second quarter of 1989, when many banks failed and few survived. The implication of high concentration measures is that local banks, as a group, may be oligopolistic (monopoly of the few) in structure and thus inefficient in loan pricing. It is expected, therefore, that they impose excessive lending interest rates locally, relative to the U.S. market, widening the spread between local borrowing and lending rates.

Relations With Local SBA

With the participation of financial institutions and the Small Business Administration (SBA), AIDEA's federally guaranteed loan program helped finance short-term accounts receivable, inventory, working capital, equipment, and some refinancing of existing debt. Here, AIDEA would provide up to $500,000 per borrower by purchasing from a lender a participation in a loan (usually 90 percent of the loan amount) guaranteed by the U.S. government or an agency or instrumentality of the federal government, including the SBA.

Our research indicates that AIDEA and the local SBA deemed this program a successful adjunct to AIDEA's bonding programs. According to AIDEA's 1987 annual report, the federally guaranteed loan program has not been as active as in previous years. This was due in part to the fact that the interest rate charged under this program was set by statute at the Moody's Aa corporate bond rate. This resulted in interest rates being above market rates in 1986 and 1987, contributing to the inactivity of this fine program targeted toward small businesses.

According to AIDEA's 1987 annual report, measures have been taken to rectify this situation. In 1987 the legislature amended some of AIDEA's programs. One of these was the Small Business and Export Federally Guaranteed Loan Program. This loan program was revitalized by placing an emphasis on purchasing loans made to small businesses for export-related transactions.

The SBA office in Anchorage believes that after the decline of oil prices in 1986, AIDEA stopped purchasing loan guarantees because of new policies and regulations designed to increase fiscal control over the program. Starting at that time, the federal government required all transactions and paperwork to go through a third party to avoid conflict of interest. Bradford Trust, a fiscal transfer agent in New York, was used in this process. But AIDEA claims that the added cost and trouble associated with the 120-day delay in transfer of remittances to AIDEA in Anchorage caused AIDEA to drop out of the program. The number of guarantees dropped from 503 in 1984 to 329 in 1985.

To solve this problem, the Alaska Legislature in 1988 created the Business Assistance Program, better known as the Loan Guarantee Program. This program was established to help bridge the guarantee gap created by the 1987 repeal of the federally guaranteed loan program. The new program provided a guarantee of up to $1 million for new loans or loans to refinance existing debt. This program was intended to enhance the ability of qualified businesses to borrow funds for reasonable commercial activities--either to start new projects or to refinance existing projects--in a tight money market.

Relations With Local Business Community

Like other state loan programs, AIDEA's problems with the local business community are educational, and stem from the absence of a solid informational plan--coupled with miscommunication that has led to competition over turfs with some economic development organizations.

AIDEA has not exerted enough effort to publicize its financing programs, and therefore prospective borrowing businesses are left uninformed about these programs. This problem is compounded by the multiplicity of state loan programs and the difficult regulations associated with them-- which discourage interest among local small businesses, the very community that these financing programs are intended to serve.

The Governor's Conference on Small Business, held in September 1989, highlighted this problem by pointing out that "regulations, in general, are difficult to read and understand. Many times an agency implements regulations which are contrary to or fail to follow the apparent intent of the legislature." The steering committee of the conference recommended that the state publicize its programs broadly, through local workshops, seminars, low-cost computer networking, local facilities, schools, libraries, PSA announcements, and mailings through the business license department, and by installing a toll-free number.

More directly relevant to AIDEA's programs are the recommendations of the Steering Committee of the Governor's Conference on Small Business. The committee recommended, among other things, the following:[11]

1. The state guaranteed loan program should be simplified and have a less costly documentation process.

2. The state should provide incentives to banks to make $10,000 - $100,000 loans to small businesses in rural communities.

3. The state should support House Bill 123, which would:

a. increase the current AIDEA loan guarantees to 80 percent
b. require AIDEA to share in 80 percent of the collection and foreclosure expenses
c. let the banks control the collection and foreclosure status of the loans
d. raise the current 2 percent level for delinquency so local banks can participate in AIDEA's loan program.

As far as the second recommendation is concerned, we would like to point out that the executive director of the Permanent Fund has suggested pooling small SBA loans to eliminate some of the banks' paperwork and risk. The SBA would package a series of small loans in sizeable enough portfolios to attract banks' participation and establish the viability of a "risk insurance" pool with each bank.

Another problem between AIDEA and the business community is related to the Anchorage Economic Development Corporation (AEDC), which has been trying to promote certain economic development projects in the city. For example, AEDC claims that it was instrumental in persuading the state government to kick in $6 million to encourage the Japanese company Seibu to expand Alyeska Resort (Seibu Alaska, Inc.) and thereby inject $50 million in financing to purchase land, build a 300-room hotel, construct a tramway, and improve the existing site and trail.

Now Alyeska is considering another stage of expansion, but AEDC claims this is being done with AIDEA and without a prior knowledge of AEDC. In defense of its position, AIDEA claims that it has coordinated efforts with the Heritage Land Bank and the Municipality of Anchorage. There are also some development projects that AIDEA has tried to promote without coordinating with AEDC.

Further, the president of AEDC believes AIDEA's staff should not be involved in political turfs or competing with economic development organizations, but rather should aim at fostering economic development and facilitating the process not only in Anchorage but in other Alaska cities. Previously, the AEDC president had suggested the state government establish a fund called the "Phoenix Fund," to be managed by AEDC, to help alleviate problems in the real estate market.

AEDC's chairman of the board attributes these problems to a clash of personalities between executives of AEDC and AIDEA. In view of these communication problems, we would like to recommend that AEDC and AIDEA should consider signing a protocol agreement that could be initiated by the Chamber of Commerce or the mayor of Anchorage. This protocol agreement could serve as a model for further agreements with economic development corporations in Fairbanks, Juneau, and other Alaska cities.

We also believe that should the board decide to continue with AIDEA as a development financing institution, AIDEA should conclude similar protocol agreements with the Alaska Regional Development Organizations (ARDORs). ARDORs are intended to facilitate economic development planning and program implementation at the regional and local levels. Currently, both AIDEA and ARDORs are coordinated through the Department of Commerce and Economic Development.

CHAPTER II: AIDEA AND VENTURE CAPITAL INVESTMENT

Background

Yielding to political pressure from some businesses complaining of a shortage of capital in the state, Governor Steve Cowper in early 1989 established the Venture Capital Working Group. The group was to consider a proposal aimed at emulating some other states and setting up a public venture capital fund in Alaska. The group decided, with a small majority, to establish a venture capital fund. The objective of this particular fund would be to attract non-Alaska venture capitalists to invest at least partially in Alaska projects. Tourism and primary industry were to be the targets of potential venture investors. The fund would mainly finance start-ups and early-stage projects.

It was expected that one-third of the capital of the proposed fund would be secured from private and state sources in Alaska, with AIDEA being a limited, passive partner. The other two-thirds would be contributed by venture capitalists from the Lower 48.

Despite the controversy surrounding the involvement of state government in establishing a venture capital institution, the state government entered, through AIDEA, into a limited partnership agreement with Polaris Fund. AIDEA's board voted in February 1990 to allocate $6 million to the fund. The fund's general partners committed to manage it and raise $24 million in private-sector money from institutional investors. So far, no funds have been raised by the general partners, and no investment projects have been approved.

Pitfalls of AIDEA's Involvement in Venture Investing

In assessing the involvement of AIDEA in venture capital funding, we present the following observations:

(1) In deciding to establish the fund, state and AIDEA officials presumed, based merely on anecdotal information, that there was a capital gap, particularly a venture capital gap, in Alaska's capital market. Although many studies have been published on the possibilities of establishing a venture capital fund, there has been no single formal study or survey commissioned so far to substantiate the claim of a venture capital shortage in Alaska.

Given the motives, nature, and modus operandi of venture capital businesses, whether inter-state, inter-regional, or international, and taking into account the allocational efficiency of deregulated capital markets in a free-market economy, we believe there is no venture capital shortage in Alaska. A shortage exists when the demand exceeds supply. Within the context of capital venture financing, the demand is defined simply as the aggregate demand for funds needed to finance highly profitable investment ventures. According to this definition, there is no demand for nonprofitable investment ventures. A profitable investment venture is one with an expected rate of return that substantially exceeds its cost of venture capital, or with a present value of cash inflow that substantially exceeds the present value of its cash outflow. In a free market economy, the market's allocational efficiency ensures that the demand for funds to finance viable, profitable venture businesses is met. In venture capital business, marginally viable--not to mention unprofitable projects--are therefore left unfunded.

(2) It is true that AIDEA's objective is economic development, not the realization of a high return on investment. But the objective of AIDEA's partners in the fund is not economic development as much as high return on investment. The fund's recent investment in *Alaska Men* magazine is a case in point.

(3) AIDEA's long-term objective of economic development might not be compatible with the short-term "exit" objective of most venture capitalists: the ability of the investor to liquidate the investment at a level yielding the highest possible capital gains during a reasonably short period of time. "The investor wants to eventually remove his or her funds, usually within five to eight years. The desire is to make our investment and get back to cash. That is how we are all judged in this business. So when you look at an investment opportunity, you have to say there has to be a day when I can get out," comments a venture capitalist, Donald Henry, in "Venture Capital Funds Economic Development."[12]

(4) The fund was established ignoring the consensus reached at the Venture Capital Network Meeting on Alaska's need for development rather than venture capital. The meeting was held in March 1988 in Juneau, and was attended by the director of the Alaska Division of Business Development, the assistant commissioner of the Department of Commerce and Economic Development, and the state venture capital specialist, as well as officials from National Bank of Alaska, the Small Business Administration, the Small Business Development Center of the University of Alaska Anchorage, and many local small businesses.

(5) The experience of the two local Small Business Investment Companies (SBICs), established by Key Bank of Alaska and National Bank of Alaska to offer funding for small venture businesses, indicates that the problems at hand are related more to the absence of profitable investment ventures in Alaska than to a venture capital shortage. The two SBICs have made most of their investments outside Alaska. The two sponsoring banks believe that there are currently no profitable Alaska venture businesses in which to invest. Given the prevalent conservative policy of the local financial institutions and the lack of skilled employees to monitor their prospective investee companies, we don't expect these banks to be involved in any local venture investment in the near future. It is rightfully claimed that this restrained policy is consistent with the "due diligence" associated with venture investment.

(6) Getting AIDEA involved in the fund does not guarantee the AIDEA objective of creating jobs in the state. There is no evidence that there was a study done to determine the employment impacts of AIDEA's investment in a venture capital fund. This is one of the serious strategic threats that could jeopardize the future direction of AIDEA.

(7) Our concern emanates also from the fact that the fund is to invest "partially" in Alaska projects. The rationale behind this policy is understandable, since it is designed to lure non-Alaskan venture capitalists, who might have a bias towards Alaska, to inject private capital into the fund. However, the policy does not specify what is meant by "partial" investment and whether investing in Alaska is compulsory.

Moreover, the policy does not say what would happen if the general partners of the fund don't find a single successful proposal originating in Alaska: should the fund then invest 100 percent of its money in non-Alaskan projects, or should it wind up its operations? Given the continued presence of many economic, managerial, financial, geographical, and technological limitations associated with venture capital in Alaska, and given the uncertainties surrounding the Alaska economy, it is highly possible that the fund might not find a single viable investment in Alaska. Consequently, we would see a flight to other states or foreign countries of all the venture capital contributed by AIDEA. In that case, the probability is high that AIDEA would violate its own purpose of creating employment in Alaska. Many public venture capital funds in the Lower 48, including the Massachusetts Technology Development Corporation, require that the investee company must produce a significant increase in employment.

(8) Getting state government involved, even passively, through AIDEA, was done without due consideration of the discouraging experiences of the Alaska Renewable Resources Corporation (ARRC) and later the Alaska Resources Corporation (ARC). From its inception in 1972, the ARRC functioned like a venture capital fund that was managed ineffectually by an academician and government officials who lacked seasoned managerial expertise, technical knowledge and "due diligence" insight to oversee its projects. In 1982, legislators changed the name of the ARRC to the ARC, which inherited not only the financial assets and investment portfolio of ARRC but also its tarnished image. In 1984 the legislators acknowledged the immense magnitude of the problems the ARC inherited from its predecessor, and decided that it should be terminated on December 31, 1989.

(9) Many other U.S. states have established public, or public/private funds, but their economic, industrial, and technological stages are not similar to those of Alaska. Other states have research institutions and universities that appropriate huge amounts of money to industrial and technological research. This advantage is one of the most attractive to venture capitalists.

(10) A very important deficiency is that AIDEA's present staff lacks managerial and technical expertise needed to deal with a very specialized field such as venture capital investment.

Constraints on Alaska's Access to Venture Capitalists

The experiences of Alaska entrepreneurs seeking venture capital in the Lower 48 have been disillusioning. Given the state-of-the-art of venture capital, the constraints to access are formidable, yet understandable. The cardinal objective of venture capitalists is to achieve a return on their venture investments substantially higher than what they could get by investing in non-venture instruments. A rate of return of 50 percent to 100 percent, and an "exit" in five years are not unusual targets. With massive impediments, realizing that kind of return in Alaska can be impossible.

Based on our research; the findings of studies done by Belden Hull Daniels and Elain Wurster; and the minutes of the Venture Capital Network Meeting of March 11, 1988 in Juneau, the following are the impediments to Alaska's access to venture capital:

(1) Venture capital firms have found great investment opportunities in their own states, and therefore have little interest in investing in other states. Technology-based investee companies provide the most attractive deals for venture capital firms in the western United States. In fact, the technology-based businesses have been able to attract venture capitalists not only from other U.S. regions, but also from Europe and Japan.

(2) Venture capital companies have not been interested in investing in Alaska because they have a negative perception of the state--its harsh qualify of life, shortage of skilled labor and seasoned management, and lack of a university setting appropriate to entrepreneurial development.

(3) Some venture capitalists believe that Alaska's high labor costs would render potential projects uncompetitive and unattractive to Lower 48 venture capital groups.

(4) Some venture capitalists find Alaska business plans neither unique nor promising enough to be worth the extra effort and expense called for.

(5) Some venture capitalists believe that Alaskans lack national business connections and networks with the Lower 48. This problem is formidable, since many venture capital companies seriously consider proposals referred to them informally by their banks, previous entrepreneurs, lawyers, and other venture capital companies.

(6) Geographic distance and transportation costs are further deterrents to venture capital investment in Alaska. The ability to carry out fact-to-face negotiations during investment planning stages is a prerequisite for venture capital firms. Burrill and Norback (1988) point out that the geographic proximity of the entrepreneur's business to the venture capital company in which he is interested may be a factor to consider.[13]

Although some venture capitalists will invest anywhere as long as they receive a very high rate of return, in some cases they will not invest in businesses more than an hour's travel time by car or plane, or further than they can travel to and from on the same day. Investors seek easy access to the investee company to attend board meetings, to stay abreast of the company developments, and if necessary, to exercise hands-on management. Wurster (1989), a venture capital specialist in the business development division of the Alaska Department of Commerce and Economic Development, arrived at similar conclusions. Wurster pointed out that "after meeting with numerous venture capital firms in New York, the Bay Area, and Seattle, it became apparent that our geographical distance--and the commensurate time--preclude any consideration of Alaskan proposals unless they are of the AIDS-cure caliber."

Recognizing the problem stemming from the absence of offices of venture capital firms in Alaska, Wurster pointed out, "In our rounds with potential investors, we found a general wariness concerning investment in Alaska. Several factors contributed to this reluctance: heavy losses suffered by many in the real estate arena; the ARRC experience; and, less obviously, the lack of understanding of how a venture capital fund actually operates."[14]

The fact remains, Alaska is distant from the centers of finance. In addition, our areas of potential profitability (natural resources and tourism) are alien to most venture capitalists. Further, our image as an ice- and snow-covered state replete with igloos and dogsleds persists in the minds of some of even the most sophisticated.

(7) A crucial factor remains to be considered by any prospective non-Alaskan venture capitalists considering investing in Alaska. This is the "exit" time: the time at which the investor would be able to liquidate an investment at a level yielding the highest possible capital gains. Given the uncertainties surrounding the oil industry in Alaska, a diligent venture capitalist might consider an investment in Alaska as less liquid or illiquid because finding a

future buyer for an Alaska investment might be more less certain than in other states. Venture capitalists do not like to be locked into this situation.

Recommendation

Based on the above discussion and analysis, the performance of the Polaris Fund, and the limitations of AIDEA's staff, we believe that AIDEA should not have become involved in venture capital investing. The Board might like to consider the possibility of transferring the $6 million currently in the Polaris Fund to the Alaska Science and Technology Foundation.

The foundation objective is to foster technological development in the state--and such development is an essential component for attracting venture capitalists from the Lower 48 and foreign nations. Most U.S. venture capital has been used to finance the following industries: computer hardware and systems, software and services, genetic engineering, medical and health care, electronics, and telephone and data communications. Here we would emulate the experience of Massachusetts Technology Development Corporation (MTDC), which was established to address the then-existing capital gap for expansion of early-stage technology companies. Like MTDC, the return on investment in the short run would not be a great consideration, but developing technological infrastructure for the state is very important for luring venture capitalists to Alaska.

CHAPTER III: AIDEA'S EXPORT ASSISTANCE PROGRAM

This section reviews the legislative background of AIDEA's Export Assistance Program, discusses its limitations as perceived by local bankers and the SBA, analyzes the reasons behind its lack of competitiveness with similar facilities at the U.S. Export-Import Bank (Eximbank), and highlights the problems facing similar guarantee programs in other states.

Legislative Background

In June 1987 the legislature expanded the scope of AIDEA by entrusting it with the task of establishing an export assistance program. The program would provide existing and prospective Alaska exporters, particularly small- and medium-sized exporters, with loan guarantees. Export loan guarantees would be provided to eligible businesses after local financial institutions approved loans.

The program would provide two guarantee windows. The first would serve like a performance bond to the exporter. It would be a short-term (270 days) pre-shipment export guarantee covering 90 percent of each eligible transaction or $1 million--whichever was less--provided that the post-shipment credit risk was either insured or covered by a letter of credit, and secured by an appropriate security. The lender would have to retain a 10 percent risk participation in the loan.

The second guarantee window, the post-shipment export guarantee, was tailored after the California model. Its terms and mobilities would be the same as those of the first window, except this guarantee would cover only 180 days. To be eligible for the two guarantees, exports would be required to have at least 25 percent Alaskan value added, and be domiciled in Alaska.

Reasons For Inactive Demand

Since the legislature created the program in 1987, no guarantees have been provided to any business. The reasons for that lack are discussed below.

Poor Marketing

AIDEA has not exerted enough effort to publicize its mainstream programs, let alone its Export Guarantee Program. Based on our investigation, it seems that not only are exporters left uninformed about this program, but local banks and the SBA are also unsure about the modalities of the program. Apart from holding an educational seminar with Eximbank and FCIA, AIDEA has undertaken no aggressive marketing activities to educate the local business community about this program. And even the seminar was mainly about the programs related to Eximbank and FCIA, rather than about AIDEA's export program.

The absence of more aggressive marketing activities is attributable to the following:

(1) Lack of a marketing plan.

(2) AIDEA's frequent staff turnover and inadequate training, and lack of a powerful and influential AIDEA officer who could persuade the local banks to be more receptive to the program.

(3) Attitudinal barriers between AIDEA and the local business community, particularly with lending institutions.

Problems With Local Banks

Local banks are not currently receptive to AIDEA's export loan guarantee program for the following reasons:

(1) The high default risk of business. According to local bankers, there are three types of businesses seeking export financing. The first type is a well-established business with a solid track record, experienced management, strong capital base, and assured cash flows. This type of businesses enjoys a low default risk coupled with a high degree of creditworthiness that would give it ample access to capital from local banks at a reasonable cost. Consequently, this type of business doesn't need an export financing guarantee from AIDEA. The second type is a newly established business which lacks a track record, and suffers from poor management, inadequate capitalization and uncertain, unsubstantiated future cashflows. Local banks are understandably not interested in financing this kind of risky businesses.

The third type of business lies in between the first two in terms of risk. AIDEA's program would find its niche in guaranteeing loans sought by this type of moderately risky business. However, this program is costly for prospective borrowers. In addition to FCIA's insurance cost, AIDEA's guarantees include facility and usage fees that represent additional financing cost over and above the going market interest chargeable by the lending bank. In this case, the total financing cost (FCIA's insurance cost, the lender's interest cost, and AIDEA guarantee fees) might burden the business cashflow in the short-run, hampers its growth, and even cripple it in the long-run--results that would hurt local job creation.

(2) Limits on the guarantee. Another limitation of AIDEA's export guarantee program, according to local bankers, is that it would not guarantee financing for the procurement of capital assets (machinery and equipment), or of infrastructure that would help in the production or processing of exportable goods. Local banks believe AIDEA's program assumes that all Alaska exporters are exporting finished products, raw materials, or human services. The pre-shipment guarantee does not guarantee the pre-production and production stages, which local banks avoid financing. Another constraint is that approval of the pre-shipment guarantee is contingent on having the post-shipment credit risks insured or covered by a letter of credit.

(3) Interest rates and fees. Although it does not impose ceilings or limitations on the interest rate and fees a lender may charge, AIDEA says that lenders should "understand that the purpose of the program is to help small- and medium-sized businesses be more competitive by providing the lowest cost financing possible". This implies that local banks should subsidize interest for local businesses. This is naturally inconsistent with the nature of the banking business, whose objective is to maximize wealth for proprietors, partners, or

shareholders. Bankers believe that if AIDEA is interested in facilitating financing for eligible export businesses, it should consider the possibility of extending interest subsidies to them.

(4) Amount of guarantee. Unlike the Eximbank program, AIDEA's guarantee is limited to $1 million, according to some bankers. Local bankers are not aware of the fact that while AIDEA's guarantee limit is the same as that of Eximbank's working capital guarantee, it is double the amount of SBA's revolving line of credit.

Duplication With Eximbank and SBA Programs

Although AIDEA's program was tailored to mimic the California Export Finance Program, we found that the only similarity between the two programs is the naming of the pre-shipment and post-shipment guarantees. We also found that AIDEA's program is structured more like Eximbank's Working Capital Guarantee Program and SBA's Export Revolving Line of Credit Program (ERLC). Nevertheless, AIDEA's program does not have a unique feature that would be competitive with Eximbank's or SBA's program. Although AIDEA's and Eximbank's programs have similar purposes, operating guidelines, fees, and terms, there are many competitive features in the Eximbank Program. These features include:

(1) Unlike the AIDEA program, the Eximbank program allows exporters to apply directly to Eximbank for a preliminary commitment for a guarantee, which they can then use when approaching various lenders to secure the most attractive loan package.

(2) If the exporter obtains FCIA insurance, it would be easier for the exporter to then get a guarantee directly from Eximbank rather than from AIDEA, because of the strong relationship between FCIA and Eximbank.

(3) Eximbank's guarantee amount for existing small businesses is unlimited, whereas AIDEA limits the guarantee amount to $1 million.

(4) Eximbank specifies exactly what type of security is acceptable for its program. AIDEA does not specifically indicate the security required, but rather leaves it to AIDEA's staff to determine if a security is appropriate.

(5) AIDEA requires that an eligible export transaction must have at least 25 percent in Alaskan value added. In certain cases, this might preclude FCIA from providing insurance to AIDEA's eligible transaction, as the FCIA-Eximbank agreement requires export transaction to have 50 percent in U.S. content. In these cases, exporters may request coverage through their insurance brokers, which might be more costly than FCIA insurance.

(6) Lenders can commit Eximbank's guarantee on loans up to $300,000 on a discretionary basis. AIDEA's program does not have any similar provision.

(7) Eximbank's guarantee of $1 million can be combined with the SBA's Export Revolving Line of Credit of $500,000 in order to more effectively reach small businesses with its working capital authority. Unlike the SBA and California programs, AIDEA does not have a similar agreement with Eximbank. Additionally, AIDEA's export guarantee program does not spell out certain restrictions contained in the Eximbank programs--such as that guaranteed

funds cannot be used to pay existing debt or for exports to certain countries, including South Africa.

General Stagnant Demand

According to the SBA office in Anchorage, there is not currently demand for SBA's Export Revolving Line of Credit (ERLC), despite the attractive feature for exporters of being able to combine Eximbank's Working Capital Guarantee with the ERLC. Exporters may qualify anyway under the general guarantee program of SBA.

We believe that all the problems described above are attributable to the fact that in initiating the export guarantee program, AIDEA did not undertake a thorough study identifying the market demand for export guarantees in the state. Had AIDEA made such a study, it would have saved the state a lot of money and effort. The experience of the local SBA office substantiates the absence of reasonable demand for export financing guarantees.

Discouraging Experience of Other States

According to a survey commissioned by the Alaska Center for International Business at the University of Alaska Anchorage, 27 states have passed legislation for export finance programs. However, the majority of the programs have not been operational for more than an average of three years (see Table 3). Six states, including Alaska, began operation in 1988 and four additional states were to begin in 1990.

Of the twenty-three states that have established legislation (not including the four states that were to initiate programs in 1990), ten are completely underused--i.e. these export finance authorities have not administered a single proceeding since their establishment. By the end of 1989, three states with defunct programs were to have eliminated export finance legislation from their statutes.

The following are the common reasons cited for the underuse and lack of activity in the state export finance programs:[15]

(1) Many state export finance agencies have poorly marketed their programs and have not generated enough demand. Simply, smaller exporters, banks, and the general business community are unaware of the financial assistance programs that their states have set up.

(2) Limited state funding prevents agencies from sufficiently accommodating exporters' needs.

(3) A major barrier to greater use and availability of state programs is the lack of knowledge and training in international trade credit insurance, guaranteeing, and financing.

(4) Many export finance state agencies have not established strong relationships with local banks that could participate in the state loan guarantee programs. There is a need for well-known and influential persons to head these programs, to persuade financial institutions to help make them work.

TABLE 3. STATES THAT HAVE PASSED LEGISLATION FOR EXPORT FINANCE PROGRAMS

	Legislation			Funding		Proceeds	
State	Passed	Operational	Type of Authority	Level	Source	# Issued	Value
Alaska	1987	1987	Type II	50.0M	Bonds	0	0
Arkansas	1988	1988	Type II	50.0M	Bonds	0	N/A
California	1984	1985	Type I	4.0M	Appropriation	127	100
Colorado	1984	1984	Type II	0	No Appropriation	N/A	N/A
Connecticut	1987	1987	Type I		Appropriation	0	0
Illinois	1983	1985	Type I	100.0M	Bonds	82	35
Indiana	1983	1988	Type I	2.0M	Line of Credit	*2	N/A
Iowa	1988	1988	Type II	1.0M	Appropriation	20	*3
Kansas	1989	1990	Type II	.75M	Appropriation	N/A	N/A
Kentucky	1988	1988	Type II			N/A	N/A
Louisiana	1979	1985	Elimination of Program			N/A	N/A
Maine	1988	1988	Type II—Insurance Program		Appropriation	N/A	N/A
Maryland	1985	1985	Type I		Appropriation	30	9
Massachusetts	1988	1988	Type II—Insurance Program			0	N/A
Michigan	1985	1986	Type II		No Funding	0	N/A
Minnesota	1983	1984	Type I	2.0M	Appropriation	44	15.5
Mississippi	1984	Nonoperational	Elimination of Program			N/A	N/A
Missouri	1989	1990	Type I		Appropriation	N/A	N/A
Nevada	1985	Nonoperational	Type II	50.0M	Bonds	*1	N/A
New Jersey	1988	1989	Type II	.75M	Appropriation	1	N/A
Ohio	1983	1988	Type II—Insurance Program			N/A	N/A
Oklahoma	1986	Nonoperational				*1	N/A
South Carolina	1983	1985	Type II	Limited	Appropriation	0	0
South Dakota	1989	1990	Type II		Appropriation	N/A	N/A
Tennessee	1983	Nonoperational	Elimination of Program			N/A	N/A
Texas	1989	1989	Type I	2.0M	Appropriation	N/A	N/A
Utah	1981	Nonoperational	Elimination of Program		Appropriation	N/A	N/A
Virginia	1989	1989	Type I—Insurance Program			N/A	N/A
Washington	1989	1989	Type II		Appro/Private Sources	N/A	N/A
West Virginia	1986	1986	Type II	50.0M	Appropriation	*4	N/A
Wisconsin	1985	1985	Type II	50.0M	Appropriation	*4	N/A

Type I: New creation of export finance authority or department. Type II: Delegate authority to an existing organization. N/A = Not Available

*1 Current program under study by state.
*2 Indiana has set up eleven new transactions that will be initiated when the authority becomes operational.
*3 The Iowa program issues up to $5,000 per transaction.
*4 Look up the state in Report II: Survey for more detail.

Source: State-assisted Export Finance Program: Review and Analysis, Alaska Center for International Business, University of Alaska Anchorage.

Recommendation

Because of the lack of local demand attributable to poor marketing of the program, unreceptiveness of local banks, duplication with Eximbank and SBA programs, lack of a program niche, inadequate expertise among AIDEA staff, and in view of the discouraging experience of programs in other states, we recommend AIDEA's Export Assistance Program be discontinued. Should the need arise, local exporters seeking help would be referred to local federal and state agencies specializing in international trade. These agencies would be able to advise these exporters to contact the FCIA and Eximbank. These agencies include: U.S. International Trade Administration, governor's Office of International Trade, and the UAA's Alaska Center for International Business.

CHAPTER IV: OPTIONS FOR FUTURE ORIENTATION AND OPERATIONS

Previous chapters discussed the accomplishments and limitations of AIDEA, given its relationships with state government, local financial institutions, the local SBA, and the local business community, and considering its present statutes, regulations, and by-laws. This chapter discusses the options available for AIDEA's future orientation and operations. Specifically, this chapter attempts to answer the following intertwined questions:

(1) Should the need be established for AIDEA's continuation as a financial institution, what should be its goals and mission, given the nature of the Alaska economy, the financing needs of Alaska businesses, and the linkage with the state government, local banking and business environment?

(2) If AIDEA is to continue, what should be its function, given the goals and mission indicated above? Should it be debt financing, equity financing, or guaranteed financing?

Is There a Future Need For AIDEA?

The need for any entity, whether profit-driven or non-profit, to continue operating is intrinsically tied to its mission and goals. We concur with the general consensus in the business community and the state government that AIDEA's mission should continue to be to promote, develop, and advance the general prosperity and economic welfare of the peoples of Alaska; to relieve problems of unemployment; and to create additional employment. Further, AIDEA, should encourage diversification, taking into account economic "viability" and without compromising the economic and social "desirability" of investment projects under consideration. In other words, maximizing profits should not be AIDEA's only criterion for financing projects.

The need for AIDEA to continue functioning as a financial institution does not stem from a shortage of capital in the local capital market. There does not seem at present to be a shortage of liquid funds in Alaska. The principal banks (the weaker ones having gone under or been absorbed during the late 1980s recession) have very strong equity/debt ratios and unusually high deposit/loan ratios: they are awash with money. Apart from the Permanent Fund's $11 billion or so, AIDEA itself has about $331 million available for commitment; other state funds (housing, municipal finance), have smaller though still substantial sums squirreled away, and their bond ratings are strong.

AIDEA recognizes that its role in enhancing the Alaska economy is currently in a period of transition. For the past decade, AIDEA concentrated mostly on supplying secondary market financing for retail and commercial office buildings through its bond programs. To a lesser extent, AIDEA also provided similar financing to business enterprises. Currently, there is little demand for the role AIDEA has historically filled. In 1987, AIDEA's federally guaranteed loan program was repealed. In 1990, AIDEA's business assistance program was repealed. The export assistance program is inactive, and AIDEA's involvement in venture capital investing is still controversial.

As a result, AIDEA is

> ". . . focusing attention on promoting basic primary sector development. . . . Development projects which expand or create new business have a much greater overall economic impact than simply providing financing for the commercial/service sector of the economy. While the economic benefits of each individual project are small compared to the oil industry or state spending, each has a significant positive economic impact on a regional basis. If enough of these projects materialize, there will be an identifiable effect on the state's economy. Some of the proposed projects, however, may never become reality for a variety of reasons. These include the lack of economic feasibility, absence of local government or public approval, environmental or regulatory problems or any combination of these and other factors."[16]

We believe that AIDEA should continue to be a public corporation of the State of Alaska, but that it should look and function like a development finance institution (DFI). AIDEA's purposes should continue to be to promote, develop and advance the general prosperity and economic welfare of Alaskans; to relieve problems of unemployment; and to create additional employment. But it should do so by functioning as a full-fledged DFI.

We argue against privatization or liquidation of AIDEA. Local banks and private investors would not receive privatization of AIDEA favorably. The huge liquidity of local banks offers convincing evidence of the paucity of profitable investment projects in Alaska. Without a reasonably high and stable rate of return for investors, the stock of the privatized institution would be lackluster. Also, AIDEA's privatization and subsequent entry into the banking market would dilute the profit margins of existing banks and adversely affect AIDEA's own operations.

The need for AIDEA to continue as contributor or facilitator to bring economically "viable" and "desirable" projects to life, emanates from many factors, including:

(1) The economic trends indicate that fishing, timber, minerals, and tourism are growing parts of Alaska's economy. Alaska exports from fishing, timber, and minerals increased by 87 percent during the period 1986-1989. AIDEA financing is needed to parallel this growth. But, AIDEA has to tailor its financing programs to meet the emerging economic needs as well as the needs of local financing partners.

(2) One of the existing limitations of AIDEA is the absence of attempts to carve a niche which would distinguish its functions from those performed by local banks and the SBA. One possible niche that AIDEA could capitalize on would be long-term financing--a method that banks generally abhor, but which is badly needed, particularly for large projects.

(3) Given that the objective of private lending institutions is maximizing their profits, AIDEA could act as a catalyst to affect the direction of state economic development, achieving economic and social aspirations of the state.

(4) There is a dire need for a state institution like AIDEA to facilitate the financing of projects in rural Alaska, and this is another niche AIDEA could capitalize on. Future expansion and diversification of the basic sectors in Alaska will take place in rural areas, because much

of it will depend on the fish, timber, and scenic resources concentrated there. Local banks are leery about financing projects in rural Alaska.

Objects of Investment

During the early years, and especially the period of the oil boom, the real estate over-building boom, and general expansion of the state's economy, the volume of AIDEA financing grew apace. That financing reached a peak of $873 million in loans and $523 million in other investments outstanding ($331 million in cash and government investment securities, $170 million investment in the Red Dog mine, and $22 million investment in real estate), and $839 million of total assets in 1990. From 1985 on, new AIDEA commitments declined to almost zero, except for Red Dog financing, and AIDEA's current activity consists mostly of the administration of Red Dog financing and the gradual recovery or foreclosure and sale of old loans.

AIDEA's liquid funds have been rebuilt to some $331 million, but potential objects of future investment remain ill-defined. The Red Dog project promises to be viable and beneficial to the immediate locality, and some smaller schemes are under review: the Skagway ore terminal, the Healy coal/power project, the Wishbone Hill coal transport project, and the Unalaska fishing dock.

No clear-cut strategy seems to emerge for shifting away from the essentially colonial economy to a more modern mode, except for one possible breakthrough project--the proposed aircraft maintenance facility at Anchorage. Some marginal, though not insignificant, diversification possibilities have been suggested--further, or more varied, fish processing, and downstream industrialization of timber. The latter in particular seems worth pursuing. Why should the value added in the manufacture of various end products from raw logs accrue largely or wholly to non-Alaskans? Virtually every country on the Pacific Rim now prohibits or tightly restricts log exports in favor of the local wood products industry. Alaska should do likewise, and should promote lines of furniture, flooring, paneling, and other items that would be inherently attractive in export markets and would bear an Alaskan identity.

Other diversification possibilities include more intensive agriculture, taking advantage of Alaska's excellent growing conditions for quick-maturing crop varieties--not vast expanses of grain for export or for feed in large-scale meat production, but relatively small farm units producing a variety of vegetables, fruits, and fodder for the local trade. Other possibilities include fisheries products targeted at specialized niches in export markets; Native arts and handicrafts; a more diversified tourism industry, especially a longer season (e.g. winter sports) and with Alaskans playing a greater entrepreneurial and managerial role; and small-scale mechanical shops to serve the expanding needs of the foregoing activities. All these could help diversify and stabilize the economy and create employment, given the requisite initiative and technical and management competence.

Ideas such as these have been floating in the Alaska intellectual atmosphere for a considerable time, but few of them have led to full-fledged investment proposals and still fewer to successful realization. There appear to be serious gaps in development promotion and planning between the idea, the serious discussion, the firm commitment, and the practical performance stages. This situation is not peculiar to Alaska, of course, but it does seem curious that a society having so many resources--natural and financial--such a generally open, enterprising culture, and ready access to such ample technical know-how, should have remained so relatively undeveloped in this important aspect of investment initiative. Is it possible that, despite all that is said about Alaska's development potential, there really aren't many viable projects?

In several urban Alaska centers, business people have organized promotional groups precisely to remedy the foregoing deficiencies. Representatives of these Economic Development Corporations insist that their cities do have numerous high priority investment needs that are not being met, and for which budgetary funds are not available. However, they do not seem to have put forward well-prepared proposals--projects whose technical feasibility is reasonably demonstrated, costs and returns reliably estimated and acceptable--for serious appraisal by financing agencies.

Similarly, the Alaska Department of Community and Regional Affairs cites undefined needs for capital for "budding enterprises providing goods and services to a near 'third world developing nation' within...Alaska"--its rural hinterland, where obstacles to normal commercial lending are indeed formidable. The department's Rural Development Division has established a revolving loan fund to assist the start-up or growth of some firms in these areas, and suggests that it could do much more given more funding. But again, the inventory of tangible, viable projects is conspicuously sparse.

Some explanations have been suggested for this lack of ready, worthy project proposals. Some believe that the agencies or groups that are potential sponsors of specific urban or rural investments are so pessimistic about gaining access, on reasonable terms, to institutional finance (especially in light of the drastic credit crunch of the late 1980s) that they have little heart to make the effort. Others suggest that these potential sponsors are ill-informed as to the project types that would pass muster and the criteria for approval, hence put forward inappropriate or poorly studied proposals--and when these proposals are rejected their belief in institutional negativism is confirmed. Another possible explanation is that potential sponsors have inadequate technical expertise to carry out the requisite technical and economic/financial analyses and demonstrate feasibility. Or it may simply be that a combination of such factors discourages would-be sponsors from undertaking the lengthy, arduous tasks involved in careful preparation and rigorous evaluation of projects, with no assurance of eventual success.

AIDEA's staff recently provided us with the following list of prospective projects they are considering: Winter Creek Development (Alyeska Ski Resort Expansion); Windy Craggy Mine; Echo Bay & A.J. Mines; Alaska Airlines Hangar and Cargo Facilities; Federal Express Aircraft Maintenance Hangar Facilities; Delta Western S/E Tank Farm; BP North Slope Waste Facilities; and Baker Aviation Aircraft Hangar and Terminal Facilities.

Another final comment is in order. AIDEA should concentrate on financing industrial development projects and should not be involved in financing real estate, unless such financing leads to development of specific projects producing a value added to the Alaskan economy.

AIDEA's Role

If it is correct that there are a substantial number of latent, potentially sound and viable projects, and if these projects are not taking practical shape and being implemented due (in part) to the reasons outlined above, we return to the second question posed earlier: Would AIDEA be a necessary or useful contributor or facilitator to bringing such projects to life, and if so in what ways?

To start with, and as mentioned earlier, there does not at present seem to be a shortage of liquid funds in Alaska. So it would seem that any projects that meet the criteria of local financial institutions and can pay market rates should not have any great problem finding financing without resource to AIDEA. That conclusion, however, may be inaccurate for several reasons:

(1) **AIDEA's ability to adapt financing terms to project needs.** Many projects (e.g., start-up enterprises, or infrastructure involving heavy initial costs and low returns at first but increasing over time) need term loans with a long amortization period, perhaps reduced or nil payments on principal, or even capitalization of interest, during the early years. Banks generally don't like term loans--they are happier with exposures limited to no more than five years--and loathe the idea of foregoing current interest payments. Mortgage banks do make term loans, and municipal bond financing is usually for much longer periods, but these generally are for purposes other than industrial and export promotion.

By contrast, AIDEA's primary mission is just such promotion, and it has the ability to structure its financing in almost any way that would enhance a project's feasibility and success, so long as the sums come out positive in the end. For example, it might join with a bank (or banks), each providing part of the funds required--but the banks would be repaid over a short time while AIDEA would hold the longer maturities, possibly accepting smaller principal payments at the start compensated by suitably higher ones later on, when the project's cash flow was adequate. Early years' interest might be added to principal in some cases, to be paid with a bonus later.

(2) **AIDEA's ability to offer favorable interest rates.** A very important part (93 percent) of AIDEA's financing in its heyday was through issuance of tax-exempt bonds, but the federal tax law changes of 1986 sharply restricted use of these instruments. The lush financial resources available to the state government during the 1970s and early 1980s also permitted developments of all kinds to obtain loans at below-market rates from a variety of state programs. A number of these sources dried up or were much depleted in recent years, but this kind of low-cost money is still widely viewed as the norm, or perhaps as indispensable, for medium- to long-term investments.

The profligate decade of the 1980s is over, however, and we are entering a period of enforced, severe financial stringency of indefinite duration. This does not mean, as yet, any major hardship for most Americans (or Alaskans), although those at the low end of the income scale will have a hard, maybe even harder, existence; nor does it mean the cessation of investment for economic growth and welfare. But insofar as such investment is funded by state agencies which, like AIDEA, are required to be self-financing, and to replenish or increase their resources as needed through commercial borrowing, the investment must reasonably anticipate an internal rate of return (i.e. amounts earned net of operating costs) sufficient over time to service the debt at the going interest rate--generally close to commercial rates. Or, if a lower return seems likely but the project is still deemed important to some public objective, AIDEA financing might be topped up by a specific government subsidy either to capital cost or to the interest rate.

Even without such an explicit government subsidy AIDEA might sweeten the financial package in various ways. The possibility of its taking the longer maturities in joint lending operations, or adjusting principal payments to the estimated earning capacity of the project or capitalizing interest, was suggested earlier. Another device would be to make part of a loan at a somewhat reduced rate as quasi-equity--i.e., with an option for a specified share in the profits of the enterprise "if and when" it became profitable, or in the form of a convertible debenture. AIDEA's flexibility and discretion in adapting the form of its financing to the specific needs of the operation are what principally distinguish it from other institutions in Alaska's rather stodgy financial sector.

These other institutions are not, by and large, competitors with AIDEA; they have distinct spheres of operation, and different types and terms of financing. But there should be substantial scope for fruitful collaboration: joint financing, already mentioned, in which AIDEA's longer maturities or quasi-equity could complement the banks' shorter term loans, while the bank funding would stretch and leverage AIDEA's own resources; sale to banks of maturing loans from AIDEA's portfolio to replenish its resources when that may be needed down the road; mutual referrals of clients who seem more suitable for another institution's kind of financing; sharing of information on creditworthiness, on project possibilities, on problem projects; and others. Such a relationship would require development of cordial and continuous contact and communication between the banks and AIDEA, which is not evident at present; to the contrary, their relationship seems cool, if not antipathetic.

Project Definition and Preparation

We conjectured earlier that among the factors inhibiting the emergence of viable projects ready for financing might be (a) lack of knowledge about the types of projects eligible for consideration and the criteria governing their approval; and (b) inadequate local expertise in the skills needed for project preparation. AIDEA should be able to help in both respects.

Past communication between AIDEA and community organizations has been unsatisfactory. A priority requirement is for AIDEA to undertake a vigorous campaign of mutual communication with these organizations. AIDEA needs to inform them of its receptivity to project proposals and to inform them of its proposal criteria, and to get a better appreciation of the needs of the local community, both for particular investments and for loan terms.

When promising but insufficiently studied projects are put forward, AIDEA could advise the sponsors as to where to find the information or technical expertise necessary to complete it. In exceptional cases, for especially meritorious project possibilities, it might help to finance feasibility or design studies. In any case, it could help to work out suitable financing packages, as outlined earlier.

AIDEA Financing Criteria and Policies

The principal characteristics of AIDEA financing are indicated in the preceding discussion, but it may be useful to summarize them explicitly here--and also to make clear that the principles set forth below are intended to apply to the future, perhaps modifying prior practices in some respects.

(1) AIDEA financing should normally take the form of loans, which may involve quasi-equity features, as discussed earlier.

(2) Equity investment is permitted and may be a useful promotional instrument. AIDEA may become an equity investor through conversion of the quasi-equity portion of loans. Or it might finance a start-up or major expansion of an enterprise that could not initially carry a heavy burden of fixed debt, but promises handsome returns later on. At an even earlier stage it might help to finance a feasibility or design study for an especially promising project, taking a potentially rewarding equity stake in compensation for the funds risked. For come major resource development projects, sponsors may feel a need to directly involve some state agency as an investor, as clear evidence of governmental endorsement (and would prefer an autonomous entity such as AIDEA to budgetary funding). In general, AIDEA would hold a minority share; in the rare case, if any, where it was a majority share holder it should never take on project management but rather should contract it out to an experienced private operator.

(3) All financing, loan or equity, should be expected, on the basis of reasonable analysis and assumptions, to yield a return over time sufficient to cover AIDEA's cost of money plus its administrative expense and a modest margin for reserves. This return, in the outer years of a long term project, might be subject to a substantial discount to reflect the cost of money outstanding for a long period.

(4) Projects that cannot be expected to yield a high enough return, but which are nevertheless considered important for public policy reasons, may be financed by AIDEA--provided that the government makes a supplemental subsidy, either to the project's capital cost or to the debt service payments, sufficient for AIDEA to receive its normal return.
For example, a suitable project might be one that would produce just modest returns to AIDEA, but create jobs or broaden the tax base in a community. To avoid endless requests for subsidies, state and AIDEA officials would need to develop stringent standards for assessing projects that might fit into this "desirable" category of projects.

(5) Joint financing with banks should be encouraged, with AIDEA taking the longer maturities and using other devices as appropriate to help tailor the total finance package to the project's needs. AIDEA should take advantage of the banks' loan supervision systems, so long as their loans are still in force, to reduce the administrative load on its own limited staff.

(6) AIDEA should welcome offers or opportunities to sell its loans or portions of loans to other institutions or to the general public, when it can do so advantageously. For example, sales to banks of late maturities of long-term loans as earlier amortization payments bring them within the time span acceptable to banks; sales to the public of mixed packages representing a cross-section of its portfolio; or similar sales to the Permanent Fund. The objectives of such transactions would include replenishing loan funds; enhancing AIDEA's

cooperation with other financial institutions; and broadening the securities market in Alaska, thereby making the secondary market more liquid and establishing AIDEA's credit standing on a more solid and attainable base.

ENDNOTES

1. "Alaska's Potential Tax Revenues," Institute of Social and Economic Research, University of Alaska Anchorage, *Fiscal Policy Paper No. 3*, February 1990.

2. See *The Wall Street Journal*, October 10, 1990.

3. "The Employment Objective," in *Guidelines for Project Evaluation*, United Nations Industrial Development Organization, Vienna, Project Formulation and Evaluation Series, No. 2, United Nations, New York, 1972, pp. 85-98.

4. Scott Goldsmith, *Analyzing Economic Impact in Alaska*, Institute of Social and Economic Research, University of Alaska, 1981, pp. 10-45.

5. Table 1 is based on updated information published in the 1989 annual report. It shows a striking uniformity in the distribution of total financing, number of projects financed, and number of jobs created or retained related to each region. For example, northern Alaska garnered 3.5 percent of financing, 3.3 percent of number of projects financed, and 3 percent of the number of jobs created or retained. These numbers are less inflated than those provided by AIDEA internal staff.

6. See "Economic Evaluation and Finance Plan For The Proposed Delong Mountain Transportation System," Final Report, SRI International, California, prepared for Alaska Industrial Development and Export Authority, July 1985.

7. Final Report, Governor's Conference on Small Business, Anchorage, Alaska, November 1989, pp. 7-18.

8. Annual Report, Alaska Industrial Development and Export Authority, 1987, Anchorage, Alaska.

9. Annual Report, Alaska Industrial Development and Export Authority, 1987, Anchorage, Alaska.

10. Tim Bradner, "AIDEA: Keeping Capital in Reach," *Alaska Business Monthly*, September 1988, pp. 22-31.

11. Final Report, Governor's Conference on Small Business, Anchorage, Alaska, November 1989, pp. 7-18.

12. See *Area Development*, June 1989, pp. 23 and 100.

13. Burrill, G. Steven, and Norback, Craig, *The Arthur Young Guide to Raising Venture Capital*, Liberty House, Blue Ridge Summit, PA, 1988, pp. 17-25.

14. Wurster, Elain H., *Venture Capital in Alaska: Questions and Answers*, Division of Business Development, Alaska Department of Commerce and Economic Development, August 1989.

15. *State-Assisted Export Finance Programs: Review and Analysis*, Alaska Center for International Business, University of Alaska Anchorage, 1989.

16. Annual Report, Alaska Industrial Development and Export Authority, 1989, Anchorage, Alaska, pp. 2-3.