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REPRESENTATIVE
C.E. "SWACK" SWACKHAMMER

Alaska State Legislature



House of Representatives

SOLDOTNA

312 TYEE STREET
SOLDOTNA, ALASKA 99699
(907) 262-7841

JUNEAU

BOX V
JUNEAU, ALASKA 99811
(907) 465-2689

MEMORANDUM

TO: Membership Housing Finance Task Force

FROM: Rep. C.E. Swackhammer, Chair
Housing Finance Task Force

DATE: August 29, 1989

TOPIC: Legal Opinion and Scheduling the Next Meeting

Attached is a legal opinion I requested regarding soliciting and accepting bids for the AHFC RFP. As indicated, the process fundamentally rests with AHFC, however, there is a potential "window" for the task force's input.

It is my intention to include the review and selection process of a consultant as a part of the next meeting's agenda. Because of the pace, I have left the remainder of the agenda open to meet specific issues and needs which materialize.

The next meeting is scheduled for 3:00 PM, September 20, 1989, 5th Floor Conference Room, Anchorage L.I.O., 3111 C STREET. I look forward to continue working with you.

STATE OF ALASKA
THE LEGISLATURE

COPY

POUCH Y STATE CAPITOL
JUNEAU, ALASKA 99811
907 465 3800

LEGISLATIVE AFFAIRS AGENCY

MEMORANDUM

August 25, 1989

SUBJECT: Housing Finance Task Force - CSSCR 28(Fin) am
(Work Order No. 6-1099)

TO: Representative C.E. Swackhammer
Housing Finance Task Force

FROM: Michael F. Ford *M.F.*
Legislative Counsel

You have asked if the Housing Finance Task Force can solicit and accept bids for contract work, if the contract funds are program receipts of the Alaska Housing Finance Corporation. If the contract funds belong to A.H.F.C., then the recommended procedure is to allow A.H.F.C. to administer the bid process. The task force could certainly review the bids submitted and recommend that a particular bidder be chosen. This approach is legally preferable in that the funds being committed belong to A.H.F.C. and not to the legislature.

If the task force wishes to administer the bid process, then A.H.F.C. could contract with the task force to solicit bids and award a contract. In either case, applicable bidding procedures would need to be followed.

Please contact me if you have further questions.

MFF:mi
wkmi4/074

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MEMORANDUM

TO: Voting Membership, Housing Finance Task Force

FROM: Rep. C.E. Swackhammer, Chair
Housing Finance Task Force

DATE: August 29, 1989

TOPIC: Consultant Selection

It is obvious to me, after reading the legal opinion regarding the RFP-Process for the consultant, that the actual process should be completed through the AHFC. I do, however, think the task force should be involved in the selection process. For this reason, it is my intent to appoint a subcommittee composed of two task force members and two members of the AHFC Board of Directors.

I have discussed this with Mr. Behan. He agrees the task force should be involved in the eventual selection process.

If you are interested in serving on the proposed subcommittee, please let me know as soon as possible.

cc: Thomas C. Behan, Exec. Dir., AHFC

ISER PUBLICATIONS
AHFC FUNDED PROJECTS

REPORTS

The Effect of Changes in the Alaska Housing Finance Corporation Mortgage Programs, (Final Report), Matthew Berman and Lee Huskey, (November 1986).

Alaska's Economy and Housing Market, (Final Report), O. Scott Goldsmith, Matthew Berman, Lee Huskey, Linda Leask and Teresa Hull, (October 1987).

Estimated Demand for Mobile Homes in Anchorage 1987-1992, (Draft Report), ISER (December 1987).

Alaska's Housing Markets, 1988, Linda Leask (September 1988).

Stabilizing Alaska's Housing Markets, (Final Report), Matthew Berman and Linda Leask (March 1989)

PUBL. IN ALASKA REVIEW OF SOCIAL AND ECONOMIC CONDITIONS (ARSEC)
Alaska's Economy: What's Ahead? Scott Goldsmith, ARSEC 24,2 (December 1987): 20 pp. Based on materials from "Alaska's Economy and Housing Market" (October 1987).

Alaska's Housing and Recession, Scott Goldsmith, Matthew Berman, Lee Huskey, Linda Leask and Teresa Hull, ARSEC 25,1 (February 1988): 16 pp. Based on materials from "Alaska's Economy and Housing Market" (October 1987).

The Effects of Alaska's Economic Recession on Anchorage Households, Karen Pyle Foster, Linda Leask and Teresa Hull, ARSEC 25,2 (May 1988) 32 pp.

PUBLISHED IN THE SERIES, "ISER RESEARCH SUMMARY (RS)"
AHFC's Market Effects, 1980-1986, Matthew Berman and Lee Huskey, RS 32 (November 1986): 2 pp. Based on the November 1986 report, "Effects of Changes in the AHFC Mortgage Programs."

Alaska's Economy and Housing Market, O> Scott Goldsmith and Matthew Berman, et al, RS 36 (November 1987): 2 pp. Based on the October 1987 report, "Alaska's Economy and Housing Market."

The Future of Anchorage Housing Markets, Matthew Berman and Linda Leask, RS 42 (March 1989): 4 pp. Based on the March 1989 report, "Stabilizing Alaska's Housing Markets."

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C.E. "SWACK" SWACKHAMMER

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MEMORANDUM

TO: Membership, Housing Finance Task Force
FROM: Rep. C.E. Swackhammer, Chair, HFTF
DATE: August 18, 1989
TOPIC: AHFC RFP Proposal

Attached is the draft for the proposed RFP by the Alaska Housing Finance Corporation, as well as a cover memorandum from Mr. Paul M. Kapansky.

I hope you receive this in time to given it a preliminary review, prior to Wednesday's meeting.



520 East 34th St.
Anchorage, AK 99503
(907) 561-1900

P.O. Box 101020
Anchorage, AK 99510

August 9, 1989

MEMORANDUM

TO: Representative C. E. Swackhammer, Chairman
Housing Finance Task Force (HFTF)

FROM: Paul M. Kapansky *PMK*
Alaska Housing Finance Corporation

SUBJECT: Draft RFP

The attached RFP is for review to assure it is in accordance with the directions established by the HFTF.

The content is heavily weighted toward AHFC as SCR 28 appears to be. I realize the mission of HFTF is beyond that of the analysis of AHFC but I am unaware as to how broad the Scope of Services in the RFP should be to assist in that mission.

Please use the RFP as a format to finalize HFTF's intent of the RFP. If further assistance is needed, kindly advise.

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REQUEST FOR PROPOSALS

The State of Alaska Housing Finance Task Force (the "Task Force") is inviting proposals from financial consultants to assist in the analysis and evaluation of the financial condition of state assisted residential loan programs, guidelines governing each of the loan programs and the status and condition of any bonds sold to capitalize these loans.

Review

Offerors shall carefully review this RFP for defects and questionable or objectionable materials. Offerors' comments concerning defects and questionable or objectionable material in the RFP must be made in writing and received by AHFC at least 10 days before the proposal opening date. This will also help prevent the opening and the exposure of offerors' proposals upon which award cannot be made.

Offerors' comments should be sent to _____ at the address shown on the front of this RFP. A copy of the offerors' comments should be forwarded to Commissioner, Department of Administration, P. O. Box C, Juneau, Alaska 99811-0200.

Submission of Proposals

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To receive consideration, _____ copies of your proposal must be received at the following office:

Mailing Address

Address for Hand Delivery

Proposal must arrive at the Task Force's office no later than 4:00 p.m. _____, 1989. Failure to meet this submittal deadline with the required number of copies will result in disqualification.

The Task Force reserves the right to accept or reject any or all proposals in whole or in part. The Task Force may require proposals to be clarified or supplemented through additional written submissions. The Task Force may modify any of the terms of the RFP. If, before the award, the Task Force determines the modifications to be material, all responding proposers will be given an equal opportunity to modify their proposals in those specified areas designated by the Task Force.

Inquiries

All inquiries soliciting information regarding the proposal must be in writing and addressed to:

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All questions will be answered in writing. No questions will be answered that are received after _____, 1989.

This RFP does not in any way bind or commit the Task Force to reimburse recipients of this RFP for any costs involved in the preparation of a proposal.

Contractual Agreement

The basic agreement between the parties shall be within the framework of the State of Alaska's standard contract form.

A copy of the Contract is attached to this RFP and should form the basis, along with this RFP, for your proposal.

Preamble

The State of Alaska created a substantial public financing system designed to assist Alaskan home buyers and has provided more than \$1,000,000,000 of capital as well as bonding authority to initiate and sustain these loan programs. The management of these loan programs has been assigned to several agencies, including executive departments and public corporations. The Alaska residential housing market has evolved tremendously since most of these loan programs were established. Due to recent economic hardship, these agencies have taken possession of thousands of residential properties throughout the state. The scrutiny of the state's initial capital investment, outstanding bonded

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indebtedness incurred by these agencies, authorities, and public corporations, and the reinvestment of income earned from residential loans requires the expertise of the agencies, authorities, and public corporations currently involved.

In consideration of the aforementioned the 1989 Legislature established a Housing Finance Task Force to review and analyze the publicly-assisted residential finance programs, including but not limited to, housing loan programs managed by the Alaska Housing Finance Corporation and the Department of Community and Regional Affairs.

The task force is to report to the legislature by the 15th day of the Second Session of the Sixteenth Alaska State Legislature summarizing the financial condition of all state-assisted residential loan programs, guidelines governing each of the loan programs, and the status and condition of any bonds sold to capitalize these loans.

Of all state-assisted residential loan programs the Alaska Housing Finance Corporation ("AHFC/Corporation") is by far the dominant player; and, as such, attention should be closely focused on its current and future role in the market. The impact of the dominance of the Corporation is fundamental to the integrity of the Alaskan residential real estate market.

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Overview

Alaska Housing Finance Corporation is a secondary purchaser of mortgages made by private financial institutions or mortgage companies operating in Alaska. It does not loan money directly to borrowers. Most of the funds used to buy the mortgages are generated through the issuance of taxable and tax-exempt bonds.

AHFC is a public corporation and government instrumentality with the State of Alaska, Department of Revenue. It is governed by a Board of Directors comprised of the Commissioner of Revenue, the Commissioner of Commerce and Economic Development, and three other members who are appointed by the Governor, one of whom must be the Commissioner of another department within the executive branch of state government.

The Corporation's History

Alaska Housing Finance Corporation is charged with providing mortgage financing at the lowest rates possible to Alaskan citizens, while increasing the number of decent, safe and sanitary homes in the state. By adopting loan programs that are unique among state housing agencies and developing financing structures that have been in the forefront of those utilized in the capital markets, AHFC has been able to meet the diverse needs of Alaskan home buyers.

AHFC has been in operation for more than 18 years. From 1971 to 1975, AHFC purchased only federally insured mortgage loans for low-to moderate-income

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borrowers. Then state legislation passed in 1975 established a State Mortgage Insurance Fund which allowed the Corporation to purchase loans not federally insured; and while income limits and maximum loan amounts remained in effect, the number of eligible borrowers increased. As a result, AHFC grew to be about 25% of the statewide market.

In 1980, both federal and state legislation significantly changed AHFC's programs. With state legislative action income limits on AHFC programs were removed, loan limits were increased, mobile home and rural loan programs were established and the Home Ownership Assistance Program (HOF) was started.

Also, subsidized interest rates were established at 10% on the first \$90,000 of a loan (9% for veterans.) The legislature appropriated more than \$500 million to the Corporation to assist in implementing these changes. In the same year, Congress restricted the use of tax-exempt funds to first-time home buyers and limited the amount of tax-exempt mortgage revenue bonds which could be sold to \$200 million a year.

The net effect was that AHFC's volume surged. By 1981, when all the changes had been implemented, AHFC was purchasing 85% of all mortgage loans made in the state.

Further changes occurred in 1983 when the Alaskan voters adopted the Veterans Mortgage Program. This program allows AHFC to fund loans made to qualifying veterans with tax-exempt bonds.

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AHFC has often been on the cutting edge of new financing techniques. In 1981, AHFC was the first public agency to sell taxable bonds. In 1983 AHFC became the third largest issuer of taxable bonds in the U.S. corporate market.

In FY 1983, AHFC adopted the Alaska Building Equity Mortgage (ABE), to take advantage of shorter term, lower ~~and~~ rest taxable bonds. An ABE mortgage has a fixed interest rate, but the monthly payment increase by 5% in years four through nine. The increased portion of the monthly payment is applied directly to the outstanding principal balance and the loan is paid off in 16 to 18 years.

In FY 1984, an agreement was signed with the Federal National Mortgage Association (Fannie Mae) to swap Alaskan mortgages for Mortgage Backed Securities which raised the Corporation's bond rating to AAA on taxable issues. The agreement also eliminated the need for mortgage pool and special hazard insurance. Also, State Guaranteed Veterans Mortgage Bonds were restructured to extend the bond maturity to 30 or 35 years allowing AHFC to take advantage of prepayments by recycling them to make new loans.

During FY 1985 the Corporation became an issuer of Government National Mortgage Association (GNMA) mortgage certificates as a means of securitizing Veterans Administration guaranteed loans.

Due to the overall slowing in the state economy, FY 1986 offered new and different challenges to the Corporation. The price of oil started a dramatic decline in December, 1985, slowing economic activity, and national tax reform

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dramatically changed the way mortgages could be financed. AHFC responded to these changes by making loans assumable, establishing two refinancing programs and providing lower interest rates.

Also in FY 1986, AHFC loans were approved by the Federal Housing Administration, qualifying AHFC loans for FHA insurances. This program allowed moderate income borrowers who do not have the ability to make large downpayments the option of choosing FHA-insured loans when conventional loans do not meet their needs.

Many of FY 1987 activities centered on responding to Alaska's slowing economy and changing borrower needs.

Internally, AHFC's Special Credits Department expanded as foreclosures and delinquencies increased. Also, AHFC instituted a real estate owned broker program, employing private real estate firms across Alaska to market AHFC foreclosed properties.

Much of the FY 1987 activities which were due to the downturn in the state's economy continued in FY 1988.

Home Owners' Assistance Program

The most significant activity in FY 1988 was the implementation of the Home Owners' Assistance Program known as HOAP (pronounced hope.) Under this unique and unprecedented program thousands of Alaskan homeowners had the opportunity to

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make their house payments more affordable and in some instances avoid foreclosure.

HOAP began as a more formalized workout or forbearance program and grew into the more sophisticated refinance and assistance program. The program was developed in conjunction with companies that have either insured or secured a majority of the 45,000 loans AHFC owns. The Mortgage Guaranty Insurance Corporation (MGIC), the Federal National Mortgage Association (Fannie Mae) and several private mortgage insurance companies embraced HOAP in an effort to make mortgages more affordable and help those Alaskans experiencing temporary financial difficulties. Nowhere else in the nation have so many housing industry companies provided so much cooperation in helping people stay in their homes and in loss mitigation.

Other Activities

In an effort to continue financing new mortgages in FY 1988, AHFC signed a new contract with the Federal Home Loan Mortgage Corporation (Freddie Mac) for \$200 million. This contract helps to continue the availability of new financing for low-cost mortgages for Alaskans. In conjunction with this change, the Corporation has now switched to a 30-year, level payment mortgage structure. Due to the increasing workload from high delinquencies and foreclosures, AHFC staff expanded in FY 1988 and FY 1989. With staff doubling in size AHFC moved its headquarters to a larger office space.

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AHFC also focused its efforts on establishing marketing programs for repossessed mobile homes and foreclosed properties. By year's end, many new regulations and management guidelines were in place allowing for bulk sales of mobile homes and more efficient handling of foreclosed properties.

In an effort to help non-AHFC borrowers, the Corporation in FY 1988 expanded its Refinance Program to include refinance on non-AHFC loans. These loans, however, are not subsidized. The interest rate charged to the borrower will be at the Corporation's cost of funds.

PROGRAMS

The AHFC offers twelve mortgage programs to meet the financing and refinancing needs of Alaskan home buyers.

Home Owners' Assistance Program

This program helped borrowers who were either current or late in making their mortgage payments. Specifically, HOAP eliminated the scheduled increases in monthly principal and interest payments resulting in a 30-year mortgage and lowered the interest rate, if possible, resulting in a lower mortgage payment. If a borrower was experiencing a hardship HOAP may have provided advances to bring the loan current and perhaps provided assistance with the monthly mortgage payment for up to two years. Any assistance provided must be repaid by the borrower.

DRAFT**Taxable Mortgage Program**

This program is used by the largest number of Alaskan borrowers.

The program is available to all borrowers who cannot qualify for tax-exempt funds which are restricted for use to first-time home buyers or veterans. Up to \$199,850 may be borrowed for a single-family residence or \$255,650 for a duplex. If AHFC's interest rate is above 10%, the first \$90,000 of the loan is financed at the subsidized rate. The interest rate on any additional loan amount above \$90,000 is set at the Corporation's cost of funds.

Tax-exempt Mortgage Program

In the Mortgage Subsidy Bond Tax Act of 1980, Congress established a program under which individual states could issue tax-exempt bonds and use the proceeds to make loans to first-time home buyers. Under this program, borrowers must meet criteria established by the federal government to be eligible for the funds, including average area purchase price limits for the residence and not having an ownership interest in a principal residence in the last three years.

Home Ownership Assistance Program

By providing an additional subsidy, the Home Ownership Assistance Program (HOF) reduces the monthly mortgage payment that borrowers pay. Although the mortgage loan is written at the current interest rate, borrowers receive a subsidy. The

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subsidy is based on their income in an amount that would reduce the monthly payment to 28% of their income or a 6% interest rate loan, whichever is greater. Since an additional subsidy is provided, there are criteria for the program including the amount of total assets based on family size, and sales price limits. The limits insure use of the funds by families who could not afford to purchase a home without this assistance.

Federal Housing Administration

Mortgage loans are available with Federal Housing Administration insurance under FHA's 203b, 203b2 and 234c programs.

Down payments and qualifying guidelines are more lenient under this program.

Mobile Home Loan Program

AHFC offers a choice of a 10% down payment with a 20-year loan term or a 5% down payment with a 10-year loan term. The maximum loan amount is \$75,000.

Triplex/Four-Flex Program

Under this program an owner-occupant can borrow up to \$308,900 for a triplex or up to \$384,000 for a four-plex. There is a minimum of 15% down payment. For the Taxable Mortgage Program, the Corporation offers a subsidized interest rate

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on the first \$90,000 of the loan if AHFC's interest rate is above 10%. The interest rate on amounts over \$90,000 are at the Corporation's cost of funds.

Pledged Account Mortgage Program

A graduated payment mortgage is available through the Corporation's Pledged Account Mortgage Program (PAM). With a PAM mortgage, the borrower places a portion of the down payment in an interest-bearing savings account which is pledged as additional security. Money is drawn out of the account each month to pay a portion of the borrower's monthly mortgage payment. Since the borrower is qualifying on a lower first-year payment, borrowers can purchase a larger home in anticipation of their income increasing.

Second Mortgage Program

The Second Mortgage Program is divided into two categories; the Second for Purchase Program and the Second for Home Improvement Program. The Second for Purchase Program was developed to provide a vehicle for borrowers to assume an older first mortgage, where allowed, in order to maintain a lower average interest rate. The Second for Home Improvement Program was designed to aid borrowers who wanted to retain their present lower interest rate first mortgage but needed financing to make improvements that would suit their current housing needs.

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For the Second Mortgage Program, the total-financing-to-value ratio may not exceed 80%. The Corporation's loan maximums are \$99,900 for single-family residences and \$127,800 for duplexes.

Veterans Mortgage Program/State Veterans Interest Rate Preference and Federal Veterans Administration Loans

The Veterans Mortgage Program allows AHFC to fund the mortgage loans made to qualifying veterans with tax-exempt bonds.

The savings from the use of tax-exempt funds directly reduces the subsidy costs of operating this below-market mortgage program.

Loans under the program may be for single-family through four-plex residences, with loan limits and down payment requirements the same as under the Taxable Mortgage Program and The Triplex/Four-Plex Mortgage program.

The State of Alaska has offered lower interest rate home loan programs for veterans since before statehood, and currently offers a one percent lower interest rate on the first \$90,000 of a loan.

As a result of new federal restrictions on the Veterans Mortgage Program, many veterans who entered service after January 1, 1977, and who have been out of service for more than 30 years, will find this state program an option in the

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future. The lower interest rate may be applied to any of the programs of the Corporation except the Veterans Mortgage Program.

Also available to veterans is a loan guarantee by the Federal Veterans Administration which allows for a lower down payment when purchasing a home. The guarantee may be applied to all of the Corporation's loan programs, except the PAM.

Refinance Program

The Refinance Program allows mortgagors the opportunity to reduce their monthly mortgage payments and make the loans assumable.

Non-Conforming Property Program

The Corporation also purchases loans secured by properties for which typical financing cannot be obtained through other private, state, or federal lending programs. Although these properties are structurally sound and marketable, they have non-conforming features such as low ceilings or lack of conventional utilities. Single-family homes, duplexes, and mobile homes on lots are eligible for this program.

Condominium Projects

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Prior to purchase of loans secured by units within a condominium or FUD project, AHFC review all aspects of a project including the marketability of the units, the amenities offered in the project, and adequacy of the association's budget, among others.

The Corporation maintains an approved list of condc and FUD projects. Each project must submit annually a report, including information on reserve accounts, newly elected officers, and information on owner-occupancy, in order to maintain the project's approval.

Mobile Home Parks

AHFC will purchase mobile home loans in mobile home parks that have been approved by the Corporation. The approval process includes inspections, as well as receipt of copies of appropriate health approvals, municipal permits, copies of park rules, and rental agreements. More than 136 parks have been approved and must recertify annually to maintain park approval.

Providing the lowest financing available to Alaskan home buyers continues to be a major priority for AHFC.

Fiscal Information

Fiscal years 1988 and 1989 were difficult years for the Alaska economy and the Alaska housing market. Both population and employment continued to decline.

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The housing market was a reflection of the economy. Delinquencies continued to be in double-digit levels and foreclosures were at disturbingly high rates. At the end of fiscal year 1989, delinquencies exceeded 11% which was down from an all-time high of 17.6% in February, 1988. Foreclosures for fiscal year 1989 exceeded ____% of AHFC's portfolio and AHFC real estate owned totalled _____ as of July 31, 1989.

In fiscal year 1988 the Corporation had a net loss for the first time in its history. The net loss was not an operating loss, but resulted from a substantial increase in the Loan Loss Reserve, a decrease in the value of Real Estate Owned (REO) and a decrease in the estimated collectible value of receivables involving REO's and insurance claims for REO. The total charges of \$71.5 million against net income resulted in a net loss of 12.6 million. Additional charges were incurred in 1989 which resulted in an approximate net loss of \$_____million.

SCOPE OF SERVICES TO BE PERFORMED

The purpose of this study is to help the State, both the Legislature and the Administration, and AHFC management and Board, to determine the Corporation's role in housing and real estate in the future. The fundamental question is should AHFC return to its original charge of only providing housing to low- to moderate-income Alaskans in a more traditional government role, or should it take some other form or a combination of both. The study should take into

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account that AHFC's current mission is to help present and future Alaskan homeowners while preserving the integrity of the residential real estate market.

The services required are:

I Alaska Housing Finance Corporation

A. An analysis of the options and implications of:

1. Restructuring AHFC to accommodate its purpose
2. Reducing the size of AHFC
3. Privatizing all or a portion of AHFC
4. Returning AHFC to providing housing strictly for low to moderate income borrowers.
5. Phasing out all or a portion of AHFC's programs, i.e.
 - a. Eliminating the subsidy as of July 1, 1990, or phasing out the subsidy over time.
 - 1) What would be the effect on the real estate market, i.e. public perception, prices, demand, supply.
 - 2) How much cash flow would be produced from earnings.
 - 3) How much assets from bond retirements.

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- b. In the absence of AHFC programs, what would be the short- and long-term effect on the Alaska real estate market.
- 6. Selling AHFC in whole or in part, i.e. what is required? What are market values under various sale scenarios?
- B. An analysis of liquidity, reserves and earnings as they are required:
 - 1. By minimum bond covenants
 - 2. To maintain current bond ratings
 - 3. To maintain present programs
- C. An analysis of the housing demand in Alaska by:
 - 1. Region
 - 2. Price range:
 - a. Under \$135,000 (FHA limit)
 - b. Over \$235,000 (FHLMC limit)
 - c. Under tax-exempt limit
- D. An analysis of the potential for returns on the capital invested in AHFC by the state.

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E. An analysis of a proposal which would require AHFC to purchase mortgage loans from the housing assistance fund and:

1. The effects of this policy on each of the loan programs.
2. Whether the purchases should be at par value, and
3. If at market value an appropriate method for determining that value

II (Are there other services in other areas the Task Force wants included?)

Items which should be included in Proposal

1. The proposing firms experience in performing the services requested under Scope of Services.
2. Resumes of key individuals to be assigned to project.
3. Proposed approach and work plan defined by task and subtasks.
4. Proposed timetable.
5. Proposed fee. The fee must be a total fee as opposed to an hourly rate.

Evaluation of Proposals

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The Task Force will appoint an evaluation committee to review the proposals. Oral presentations, if necessary, will be decided upon and scheduled by the Task Force and, if scheduled, be considered in the evaluation of the proposals. The Task Force will award the contract to the proposer ranked highest by the evaluation committee within the specific areas.

- | | |
|--|------|
| 1. Firm's experience | (%) |
| 2. Qualifications of individuals assigned to project | (%) |
| 3. Proposed workplan and timetable | (%) |
| 4. Proposed fee | (%) |

Additional Information

1. Project must be completed by December 1, 1989.
- 2.
- 3.

A Proposal to the
State of Alaska
Housing Finance Task Force

**Status Review Concerning the
Alaska Housing Finance Corporation**

Presented by:

Ernst & Young

October 20, 1989

Ernst & Young

Suite 601
301 W. Northern Lights Boulevard
Anchorage - Alaska 99503
Telephone: (907) 279-1411

October 20, 1989

OCT 20 1989

Ms. Judith De Spain
Alaska Housing Finance Corporation
P.O. Box 101020
Anchorage, Alaska 99510

10/20/89

Dear Ms. De Spain:

Thank you for the opportunity to respond to your request for proposals to conduct an analysis and evaluation of the financial condition of the Alaska Housing Finance Corporation. Ernst & Young is pleased to submit this proposal in accordance with all the terms and conditions identified in your RFP.

As set forth in the scope of services to be performed in the RFP, our proposal provides for a thorough assessment of State assisted residential loan programs and the guidelines pertaining to each program. We have also provided for a full financial analysis of the status and condition of any bonds sold to capitalize these loans.

In addition to these basic requirements, our approach has re-organized work plan tasks to provide for a parallel analysis of each realistic alternative. In order that the Task Force be in the position to make truly informed decisions concerning the future direction and policy of the AHFC, we have defined an approach which accounts for human factors and needs as well as the evaluation of financial conditions.

To provide direct insight and assistance to the Task Force, we intend to apply a set of criteria to the evaluation of each option and alternative. We will assess the ease of implementation of a given option, evaluating it from the standpoint of the political implications of a proposed transition, and outlining the likely steps necessary to achieve desirable changes.

Ernst & Young understands the timeframe and commitments to the Legislature to provide an analysis for presentation in January, 1990. To meet the required timeframe and produce a final report by the end of this calendar year, we are assuming that the appropriate parties will be available to us from the State. This includes timely access to appropriate background materials, management, staff, and the Attorney General for potential legal opinions necessary to complete our comprehensive work within the timeframe as outlined in the RFP.

It is our intent to review thoroughly with you our approach and to make any necessary adjustments before initiating the project. This will ensure that the process we intend to follow responds to the expectations and needs of the Task Force and the Legislature.

Ms. Judith De Spain
October 20, 1989
Page 2

Ernst & Young is one of the largest professional management consulting firms in the world. Our proposed project team consists of professionals dedicated to the high quality standards upheld by our firm. We are equipped to provide you with a full array of professional skills and the technical capacity necessary to deliver a usable final report and product, couched in realistic terms, and fully responsive to your requirements.

We hope that the information contained in this proposal meets favorably with your anticipated outcomes for this important engagement. Should you have any questions, please feel free to contact Mr. Joe Hill or Mr. Jim Gibson in Sacramento, California at 916-443-6756, or Mr. Vere Harlow in Seattle, Washington, at 206-623-9000. As Partner-in-Charge of this effort, Mr. Hill is designated as the person legally authorized to bind Ernst & Young in any negotiations and to sign any resultant contract.

We look forward to the opportunity to discuss this project personally with you. Thank you for your consideration.

Very truly yours,

Ernst & Young

Ernst & Young

A Proposal to the
State of Alaska
Housing Finance Task Force

Status Review Concerning the
Alaska Housing Finance Corporation

Presented by:

Ernst & Young

October 10, 1989

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1. Background

1. Background

The State of Alaska has been at the cutting edge of providing aggressive public financing assistance to Alaskan home buyers. Through the vehicle of several publicly owned and operated entities, 85% of the state's home mortgages have been processed, and more than \$1,000,000,000 of capital and bonding authority applied to initiate and sustain a series of independent home loan programs.

Concerned over the future of the state's investment in the housing market, and responsible for setting policy direction, the 1989 Legislature created a Housing Finance Task Force. The charge of the Task Force is to review and analyze the publicly-assisted residential finance programs including those loan programs managed by the Alaska Housing Finance Corporation.

As the most dominant player among all the state-assisted residential loan program sponsors, the initial role and specific purpose of the Alaska Housing Finance Commission has dramatically changed since its inception in 1971. Originally intended to provide assistance to low-income potential homeowners, the Commission's programs have evolved to address a broadening population group and wider spectrum of home buying needs.

During its nearly 20 year history, the Commission has profitably functioned with more than sufficient cash flow and operating reserves. It is only due to very recent downturns in the Alaska economy that the residential housing market has changed, resulting in an increase in residential mortgage foreclosures and unprecedented outstanding bonded indebtedness held by the State.

It is the intent of this analysis that the Legislature receive documentation and usable information as to the impact of the Alaska Housing Finance Corporation on the integrity of the Alaskan residential real estate market. The study will provide direct insights and assistance to the State, the Legislature, the Administration, and AHFC management and Board to assist these parties in their determination of the Corporation's future role in housing and real estate. This will include a review of its current operating environment and loan program results, and development of alternatives which account for AHFC's mission in a changing economy and real estate market.

2. Introduction

2. Introduction

The State of Alaska has created and maintained a policy of assisting its residents in buying homes. Over the past 18 years the State has developed some of the most innovative programs in the country to provide affordable mortgage financing. As a result, many of its residents enjoy some of the lowest home mortgage interest rates in the country. At the same time, State investment in these programs has also dramatically increased.

At the center of these programs is the Alaska Housing Finance Corporation (AHFC). The AHFC was created in 1971 as a self-supporting public corporation to be a secondary purchaser of mortgages from private financial institutions operating in Alaska. As of June 30, 1988, the AHFC's loan portfolio contained 44,815 loans totalling \$3.76 billion.

The majority of this portfolio is financed through an inventive use of taxable and tax-exempt bonds and notes. The scale of the Alaska financing programs is apparent when one considers that only a few years ago, the AHFC was reported to be the third largest issuer of taxable bonds in the U.S. corporate market—in the past 16 years, the AHFC has issued \$6.64 billion in taxable and tax-exempt bonds.

While the growth of the AHFC and its programs can be traced in part to the State's interest in serving its residents, it also appears to be in response to changes that have been occurring in the Alaskan economy. When the price of oil dramatically declined in 1986, the Alaskan economy was severely affected. The AHFC responded to the situation by adapting its existing programs and developing others to support its citizens when many became unemployed. Through last year, the economy has continued to decline with population and employment dropping by an estimated 2-3% during FY 1988. Delinquencies and foreclosures in the housing market have resulted and housing values have continued to decrease.

The impact of these factors has led to the AHFC 1988 annual report disclosing a net loss of \$12.6 million — the first time in its history the Corporation has experienced a net loss. As stated in the report, the net loss was not an operating loss, but resulted from a substantial increase in the Loan Loss Reserve, a decrease in the value of its

real estate owned (REO) and a decrease in the estimated collectible value of receivables involving REO's and insurance claims for REO's. According to the report, however, there are a number of positive trends occurring which indicate the economy may have "bottomed out" and at least portions of the housing market have stabilized.

As the AHFC moves forward it will continue to face the challenges and opportunities presented by the Alaska economy. In its history of responding to these challenges and opportunities, it has created a variety of programs and financing structures which we understand are the primary focus of the study being requested. In the remainder of this section of our proposal we briefly review the major programs and financial instruments being used by the AHFC. Our approach and work plan for the study presented in the following section has been created to take into account the many unique characteristics of these programs and instruments.

Programs of the Alaska Housing Finance Corporation

AHFC's programs have evolved significantly since it began purchasing only federally insured mortgage loans for low-to-moderate income borrowers in 1971. At present, the AHFC provides thirteen mortgage programs which are briefly described below along with information on the level of activity of these programs in FY 1988.

- **Home Owner's Assistance Program (HOAP)** eliminates the scheduled increases in monthly principal and interest payments, resulting in a 30-year mortgage and lower interest rates, possibly resulting in a lower mortgage payment. It also provides for advances to bring loans current and assistance with monthly mortgage payments for up to two years for borrowers experiencing a hardship. A total of 363 HOAP loans were purchased in FY 1988.
- **Taxable Mortgage Program** for borrowers such as first-time buyers or veterans who cannot qualify for tax-exempt funds. Up to \$199,850 may be borrowed for a single family residence or \$255,650 for a duplex. The first \$90,000 of the loan is financed at a subsidized rate if AHFC's interest rate is above 10%, and any additional loan amount above the \$90,000 is set at the Corporation's cost of funds. A total of 1,018 borrowers used this program in FY 1988 representing 42.7% of total loans purchased.
- **Tax-Exempt Mortgage Program** for loans to first-time home buyers who meet federal eligibility criteria and are subject to other restrictions. There were 645 home buyers who used this program in FY 1988.
- **Home Ownership Assistance Program** reduces the monthly mortgage payment that eligible borrowers pay through a subsidy based on their income such that the

monthly payment is reduced to 28% of their income or a 6% interest rate loan whichever is greater. Forty-eight homeowners used this program in FY 1988.

- **Federal Housing Administration (FHA)** insurance programs under FHA's 203b, 203b2 and 234c programs which allow more lenient down payments and qualifying guidelines. AHFC purchased 861 loans in FY 1988.
- **Mobile Home Loan Program** allows a choice of a 10% down payment with a 20-year loan term or a 5% down payment with a 10-year term on a maximum loan of \$75,000. Nine borrowers used this program in FY 1988.
- **Triplex/Four-Plex Program** allows an owner-occupant to borrow up to \$308,900 for a triplex or \$384,000 for a four-plex with a minimum of 15% down payment. Six owner-occupants used this program in FY 1988.
- **Pledged Account Mortgage Program** provides a graduated payment mortgage where the borrower places a portion of the down payment in an interest-bearing savings account which is pledged as additional security. Funds are drawn from the account each month to pay a portion of the monthly mortgage payment. Four home buyers used this program in FY 1988.
- **Second Mortgage Program** is divided into two categories: the Second for Purchase Program to provide a vehicle for borrowers to assume an older first mortgage; the Second for Home Improvement Program for borrowers who want to retain their present first mortgage interest rate but need financing to make improvements. Seven borrowers used these programs in FY 1988.
- **Veterans Mortgage Program/State Veterans Interest Rate Preference and Federal Veterans Administration Loans** each offer veterans the following advantages: the first allows AHFC to fund below-market mortgage interest loans for qualifying veterans with tax-exempt bonds, and 349 veterans used this program in FY 1988; the second offers a 1% lower interest rate on the first \$90,000 of a loan and can be applied to any of the AHFC's programs except the Veterans Mortgage Program; finally, the FVA provides a loan guarantee program which allows for a lower down payment, and it was used by 340 veterans during FY 1988.
- **Refinance Program** allows mortgagors the ability to reduce their monthly mortgage payments and make their loans assumable. A total of 109 borrowers used this program in FY 1988.
- **Rental Program** is limited to refinancing loans already owned by the AHFC that required continued owner-occupancy so that the borrower could rent the property on a long-term basis. Though 137 loans were refinanced in FY 1988, this program was discontinued in the latter part of FY 1988.
- **Non-Conforming Property Program** involves purchasing loans for properties that are structurally sound but have non-conforming features (e.g., lacking conventional utilities) which reduces the possibility of obtaining financing from other loan sources. Thirteen loans were purchased in FY 1988.

In addition to these thirteen programs, the AHFC is also involved in condominium project loans and mobile home parks. In both cases, the AHFC inspects these

facilities and has other requirements that must be met before it will purchase loans in condominium projects and mobile home parks.

Financing Activities of the Alaska Housing Finance Corporation

AHFC has a history of pursuing the use of new financing techniques. It was the first public agency to sell taxable bonds in 1981. In FY 1983, it began using the Alaska Building Equity Mortgage to take advantage of shorter term, lower interest taxable bonds. In FY 1984, Federal National Mortgage Association (Fannie Mae) agreed to swap Alaskan mortgages for Mortgage Backed Securities, and more recently, the AHFC has arranged a swap process with the Federal Home Loan Mortgage Corporation (Freddie Mac). The AHFC has recently experienced a lower level of financing activity due in part to the downturn in the Alaskan economy. The major financing activities of the AHFC in recent years are briefly presented below.

- **Taxable Mortgage Program Financing.** A single issue for the Taxable Mortgage Program was sold in October, 1987 which combined issuance of: \$72.5 million medium-term notes with maturities of 2 to 9 years; \$8 million floating rate notes maturing in 10 years; and \$19.5 million Z-bonds.
- **Tax Exempt Mortgage Program Financing.** Collateralized Home Mortgage Bonds, 1987 Series B in the amount of \$50 million were sold in November, 1988. This issue was to refund an earlier series which was found to not have sufficient flexibility to accommodate 30 year loans converted to Freddie Mac participation certificates. Proceeds from this series will be used to continue funding the Tax Exempt Program for first-time home buyers.
- **Veterans Mortgage Program Financing.** The only financing for this program was the Collateralized Bonds 1988 First Series in the amount of \$50 million occurring in March 1988.
- **Home Owner's Assistance Program Financing.** This program was established in December 1987 with the issuance of a \$110 million multiple series transaction. The overall structure combined \$43 million of medium-term notes, \$12 million in floating rate notes, a 15 year term bond with 5 years of call protection, a 30 year term bond callable after 7 years, and a \$10 million Z-bond which does not pay interest until the rest of the bonds are paid off. A second financing for the HOAP was sold in April 1988 in the amount of \$75 million and was the AHFC's first true collateralized mortgage obligation (CMO).
- **Mortgage Backed Bonds.** AHFC sold \$62 million mortgage-backed bonds in September 1987 consisting of \$22 million of floating rate bonds and \$40 million fixed rate securities.

- **Short-Term Financing Facilities.** AHFC continued managing its liquidity through the sales of its Fannie Mae mortgage backed securities and GNMA certificates under REPO agreements.
- **Euro Commercial Paper Program.** This program was begun in April 1987 to supplement the AHFC's short term financing activities. During FY 1988 an aggregate of \$284 million of Euro Commercial Paper was issued with an average maturity of 3 months and an interest rate of 7.4%.
- **Euro Revolving Facility Agreement.** In addition to the above program, the AHFC entered into a revolving facility agreement with a number of international banking institutions, initially in the amount of \$150 million with provisions to permit an increase to \$200 million providing the AHFC additional access to various methods of short-term financing.

In conclusion, it is obvious the AHFC operates a wide variety of mortgage loan programs and is involved in an array of financing activities. The diversity and breadth of these programs and activities have been considered in the preparation of our approach to the project and our work plan which is presented in the next sections of our proposal.

3. Proposed Project Approach

3. Proposed Project Approach

The request for proposals lays out the tasks required of the consultant. Our approach generally follows these tasks, but they are re-ordered to reflect interdependence of tasks and actual scheduling. The scope of work is also expanded somewhat to ensure that all options receive comparable analysis.

We have divided the work into three phases:

Phase 1: Environmental Analysis

Phase 2: Strategic/Organizational Options

Phase 3: Financial Implications

Our phasing approach, and the detail within each phase, provides the Alaska Housing Finance Task Force with certain advantages, discussed below.

Advantages of our Proposed Approach

While it fully addresses all the work elements defined in the request for proposals, the approach we propose has several advantages:

- 1) Our approach defines the environment prior to beginning analysis. Especially, we place RFP Tasks II and III ahead of other tasks, in order to come to a full understanding of the financial, regulatory, market, and human needs situation in AHFC's service area prior to attempting any form of prospective analysis.

Advantage: Defining the environment first means minimal lost time due to re-analysis as research forces changes in assumptions. In addition, a thorough understanding of the situation means that the right questions are more likely to be asked from the outset of analysis.

- 2) Our approach defines strategic and organizational options through a two-step process. We propose that the options defined in the RFP be given a preliminary review, and then, in consultation with the Task Force, the options be refined, combined, or added to prior to final analysis.

Advantage: The strategic and organization options used in the final analysis will be thoroughly discussed and tested; no time will be wasted analyzing financial effects of obviously infeasible options, and we will have the greatest probability of inclusion of all promising avenues of action.

- 3) Our approach clearly separates the economic, organizational, and service provision impacts of each option from the fiscal impacts. Our approach addresses these areas separately, with a Task Force screening step prior to financial analysis.

Advantage: Our approach envisions ultimate use of information generated in cost-benefit analyses. In other words, program cutbacks may generally have negative effects in the economic and service provision areas, but they may have positive impacts in the financial area. A clear separation of costs from benefits facilitates weighing one against the other to arrive at appropriate public policy.

- 4) Our approach evaluates all identified options using the same set of criteria. In order to choose among alternative paths, apples-to-apples and oranges-to-oranges comparisons must be made. Our approach ensures that identical criteria are used to evaluate options in all areas—economic, organizational, service provision, and financial.

Advantage: Decision-makers will be able to easily compare the potential effects of each proposed course of action in each affected area. Trade-offs will be easily identified and quantified.

Description of the Proposed Approach

The following, which discusses our approach briefly, is further expanded in Section 4, the Work Plan.

Phase 1: Environmental Analysis

This phase includes those tasks which define the environment within which strategic and organizational options must be evaluated:

- **Regulatory**—Those regulations and policies which currently govern AHFC's operations, or which would govern any operations under a new structure, for instance if program elements were sold, spun off, or otherwise privatized;
- **Legal**—Applicable State and federal laws which might affect the proposed sale or privatization of portions of AHFC's activities;
- **Financial**—The bond covenants and prudent business practices which affect or govern AHFC's liquidity, reserves, assets, profitability, future cash flows, program needs, and bond ratings;
- **Market**—The supply/demand situation in AHFC's geographic area of responsibility, including anticipated market changes by geographic segment and housing market segment and special housing needs; and
- **Needs**—Those human needs, both current and expected, which lead to a perceived demand for AHFC programs.

A thorough understanding of AHFC's environment in these terms will simplify the evaluation of strategic and organizational options, and will make possible reasoned and defensible assessments of the options open to AHFC.

This phase includes RFP Task III.

Product: The product of this phase will be a thorough definition of AHFC's environment in the regulatory, legal, financial, market, and human needs areas.

Phase 2: Strategic/Organizational Options

This phase includes Task I of the request for proposals. It deals with the analysis of a number of potential changes in direction for AHFC, and analyzes the probable effects of these changes.

It is critical to the structure of our proposal that:

- All options must be considered within the same framework if dependable comparisons are to be made; and
- This phase addresses only the organizational and service provision aspects of each option—financial impacts are analyzed separately in Phase 3, below.

We intend to pursue the definition and analysis of options as follows:

- 1) Review the options with the Task Force to gain the benefit of latest thinking and to sharpen the definitions of each option (*e.g.*, option B is currently "Reduce the size of AHFC". This definition must be expanded upon before meaningful analysis can take place). Options currently defined include:

- Restructure AHFC to accommodate its purpose
- Reduce the size of AHFC
- Privatize all or a portion of AHFC
- Return AHFC to providing housing strictly for low to moderate income borrowers
- Phase out all or a portion of AHFC's programs
- Sell AHFC in whole or in part.

In each case, more specific definition of the option will be required prior to analysis; that re-definition is included in this phase.

- 2) Develop a list of evaluation criteria and review with the Task Force, to include items such as:
 - Effects of each option on the housing market (demand, supply, prices)

- Effects of each option on services available to groups currently served by existing programs
 - Effects of each option on size and organization of AHFC
 - Effects of each option on public expenditures (direct and indirect)
 - Implementation costs
 - Legal considerations
 - Other evaluation criteria as appropriate.
- 3) Perform an analysis of each option within the environment defined in Phase I, above, using these evaluation criteria.
 - 4) Review the organizational and service provision impacts with the Task Force to determine if:
 - One or more of the options should be discarded at this point;
 - One or more of the options should be combined for the financial analysis; and/or
 - One or more options should be added to the list for consideration.
 - 5) Complete the organizational and service provision analysis taking into account any changes from step 3.
 - 6) Review the analysis with the Task Force to determine the final list of strategic options to be submitted for financial analysis (Phase 3, below).

This phase includes RFP Task I, except for Tasks I.E.1.b., I.E.1.c., and I.F. It also includes RFP Task II.A.

Product: At the end of Phase 2, we will have come to a final decision as to the strategic and organizational options open to AHFC, and will have defined the organizational and service provision impacts of each.

Phase 3: Financial Implications

The result of Phase 2 will be a final list of strategic and organizational options which the Task Force believes are feasible from a regulatory, economic, organizational, and service provision point of view. The next step is to analyze each option from a fiscal point of view.

The issues to be addressed in this phase are, for each option:

- 1) Effects on future cash flows to AHFC;
- 2) Effects on bond covenants;
- 3) Potential effects on bond ratings; and
- 4) Potential effects on returns on capital invested in AHFC by the State.

Another issue to be addressed in this phase is the proposal that AHFC be required to purchase mortgage loans from the Housing Assistance Fund, currently administered by the Alaska State Building Authority. Since there is a possibility that some of these loans may be non-performing, the work will include an analysis of fair market value for such loans and effects on AHFC's various loan programs of the purchase.

This phase includes RFP Tasks I.E.1.b., I.E.1.c., I.F., Task II.B., II.C., Task IV, and Task V.

Product: At the completion of Phase 3, and the project, the Task Force will have an analysis of all identified strategic and organization options available to AHFC, and the potential impacts to AHFC and the State in the areas of organization, service levels, housing markets, housing needs, and finance.

4. Work Plan

4. Work Plan

Phase 1: Environmental Analysis

Phase 1 of our proposed work plan includes those tasks necessary to begin the project, and to define the various aspects of the environment within which decisions regarding AHFC programs and organization are to be made.

Task 1: Initiate project

We will meet with the Task Force and, if appropriate, with AHFC staff to determine:

- Project details with respect to timing, review processes, on-site work areas, available data sources, and format of deliverables;
- Task Force goals and objectives with respect to the study; and
- Persons to be interviewed during the course of the study, and availability of these persons during the approximate periods anticipated for the interviews.

During this meeting, we will update our understanding of the project with the Task Force to determine if there have been any changes in policy direction or additional options to be considered in Phases 2 and 3.

Task 2: Assess regulatory environment

We will review with AHFC staff State and federal regulations governing the activities of AHFC's programs and financing for these programs. This review will include definition of requirements for various mortgage-backed securitization activities through organizations such as GNMA, FNMA, and FHLMC, and underwriting/insurance requirements of organizations such as FHA and VA. It also will include State and AHFC requirements for bond issuance under the HOAP and related programs.

Task 3: Assess legal environment

Since the options include scenarios under which certain AHFC programs and activities might be sold, spun off, or privatized, we will research applicable State and federal laws to determine what considerations might impede or facilitate such actions. We anticipate obtaining legal opinions, if required, from the State Attorney General's office; if this cannot be arranged, independent legal counsel may be necessary. (Cost of independent legal counsel is not included in our proposed fee.)

Task 4: Assess housing market

We will implement a program to assess current and anticipated demand for housing in Alaska by region, as follows:

- South Central (Anchorage, Mat-Su, Kenai Peninsula, other South Central);
- North (Fairbanks and other North);
- Southeast (Juneau, Sitka, Ketchikan, and other Southeast); and
- Other.

This demand assessment will segment demand in each area by price range:

- Under \$135,000 (FHA limit);
- Over \$235,000 (FHLMC limit); and
- Under the tax-exempt limit.

To the extent possible, and in the interests of completing the study quickly, we will use trend and current demand estimates developed by organizations such as HUD and ISER, both of whom have pertinent data available. Where primary research can quickly generate additional useful data, we will undertake such research, using AHFC staff as available for data gathering.

Task 5: Assess financial requirements

In order to evaluate the effect of various options on AHFC's financial condition, we will review AHFC's liquidity, reserves, and earnings as required by:

- Bond covenants;
- Maintenance of current bond ratings; and
- Maintenance of current programs.

This review will have to be accomplished, in large part, by program. We intend to address these issues as follows:

Bond covenants—Review with AHFC financial staff to determine reserves, debt service coverages, liquidity, and other factors required to avoid default or other undesirable consequence;

Bond ratings—Interview representatives of Moody's, Standard & Poor's, and possibly other rating agencies to determine what State actions with regard to options considered in this study might affect bond ratings; and

Current programs—Review with AHFC staff any forecasts of program utilization, and calculate prospective financing requirements for these programs.

Task 6: Assess human needs

No decisions regarding AHFC programs can be made without reference to current needs for the services these programs were designed. Accordingly, we will work with AHFC staff to determine, by program:

- Demographic descriptions of groups most affected by each program;
- Estimated sizes of these groups;
- Alternatives available to these groups; and
- Likely degree of hardship caused by cessation of programs.

Task 7: Review Phase 1 results with Task Force

At this point, we will meet with the Task Force to share our understanding of AHFC's environment:

- Regulatory

- Legal
- Financial
- Housing
- Human needs.

We will discuss any issues which have arisen and seek guidance as appropriate.

This meeting will likely be lengthy, since it will include the activities of Tasks 8 and 9, below.

Phase 2: Strategic/Organizational Options

In Phase 1, we set the environment. In Phase 2, we will evaluate options potentially available to the State within that environment.

Task 8: Define strategic options

In the same meeting as Task 7, we will present to the Task Force our proposed lists of strategic options.

The options list will be as originally stated in the RFP, modified by Task Force guidance from Task 1, and by our subsequent findings during the environmental assessment. The options list currently includes:

- Restructure AHFC to accommodate its purpose;
- Reduce the size of AHFC;
- Privatize all or a portion of AHFC;
- Return AHFC to providing housing strictly for low to moderate income borrowers;
- Phase out all or a portion of AHFC's programs; and
- Sell AHFC in whole or in part.

The list will be tightened during discussions with the Task Force. Part of our work at this point will be to define each option narrowly enough that costs and benefits can clearly be assigned.

Task 9: Define evaluation criteria

In the same meeting, we will present a draft list of evaluation criteria (excluding financial) which will be used to evaluate the options. These criteria currently include:

- Effects of each option on the housing market (demand, supply, prices);
- Effects of each option on services available to groups currently served by affected programs;
- Effects of each option on size and organization of AHFC;
- Effects of each option on public expenditures (direct and indirect);
- Implementation costs;
- Legal considerations; and
- Other evaluation criteria as appropriate.

Working with the Task Force, we will finalize this list and assign weights to each criterion.

Task 10: Assess market impact by each option

For each option, we will estimate the housing market impact in Alaska with respect to supply, demand, and market pricing. This analysis will be especially important for options which consider placing AHFC REO directly on the market, because of the significant negative effect such action might have on overall housing prices.

Task 11: Assess service provision impact by each option

For each option, we will assess the impacts on AHFC users both current and potential. Again, a key point here is AHFC's non-conforming loan programs; alternatives to AHFC may not be easily available for borrowers under these programs, especially because of Alaska's unique geography and isolated situations.

Task 12: Assess organizational impact by each option

For each option, we will assess the likely organizational impact within AHFC. The objective will be to identify options which offer significant

savings in terms of staffing and organization costs, or which offer program savings because of potential synergies through a reorganization.

Task 13: Assess public expenditure impact by each option

For each option, we will estimate the likely impact on current and future public expenditures in Alaska. Such impacts may be direct (substitution of one subsidy for another, where a parallel program exists outside of AHFC), or indirect (where failure to provide housing may cost the State money in other areas under existing programs).

Task 14: Estimate implementation cost by each option

Certain options, especially privatization or major service cutbacks, will certainly have high implementation costs. To the extent possible we will identify and quantify these costs, which may include items such as additional staff, special studies, etc.

Task 15: Summarize findings

We will summarize our findings in matrix format for Task Force review. The matrix will list options along one axis, and evaluation criteria along the other. Each cell will contain a numerical score defining the impact of each option with respect to each criterion.

We will also use the weights developed in Task 9 to assign overall scores to each option, and to rank them. This will be a very preliminary indication of the relative attractiveness of each option, but without respect to financial benefit.

Task 16: Review Phase 2 results with Task Force

During this review, we will present our summary of findings to the Task Force and participate in an open discussion. Questions to be answered at this meeting will be:

- Which options are truly feasible? Are certain options so politically unpalatable, difficult of execution, or costly that they should be discarded now?

- Can some options be combined? Would a combination of options add to benefit without increasing costs?
- Are there additional options to be considered?
- Are the criteria scores meaningful? Are adjustments required in view of the experience of the Task Force?
- Should the weights change?

After the Task Force has agreed on answers to these questions, we will complete our analysis (Task 17, next).

Task 17: Preform residual analysis and finalize option list

Based on the results of the Phase 2 meeting, we will analyze any new options or option combinations, revise criteria scores and weightings, and re-cast the evaluation matrix. Copies will be sent to the Task Force along with our Phase 2 summary, but no further meeting is planned at this point.

Phase 3: Financial Implications

In Phase 3, we conclude the scope of study by providing the financial analysis to accompany the environmental and options analyses already completed.

Task 18: Review bond covenants by issue/series

Working with AHFC staff, we will review major bond covenants by issue and, where applicable, by series within issue. The purpose will be to identify those areas where changes in AHFC's scope, mission, or programs may bring AHFC's financial condition into conflict with the requirements of the covenants. Such conflicts may occur in the areas of earnings, cash reserves, funding of special bond reserves, ongoing debt service coverage, net asset values, etc.

Task 19: Construct computer models

To evaluate the financial impacts of program or organizational changes, we will construct a number of computer models to simulate "what-if" scenarios. Since the options to be considered will already be fully defined, constructing these models will be relatively easy.

They will include such input variables as future default rates by class and program, future service demand by program, interest rate climate, etc. The intent will be to include as input variables those aspects of the future environment most likely to cause significant changes in AHFC's financial condition.

Output variables will include liquidity position, period earnings, and borrowing requirements. Again, the intent will be to identify output variables most likely to indicate the health of remaining AHFC programs under any scenario.

Task 20: Estimate future cash flows and ROI's by option.

Using the computer models from Task 19, we will establish three scenarios—"Pessimistic", "Moderate", and "Optimistic". Then, for each scenario, we will simulate AHFC's financial operation over the next three years under each of the options identified in Phase 2. Outputs will include cash flows and annual return on State funds invested, by program where identifiable. Graphic presentations will be prepared for ease in communicating results.

Task 21: Interview bond rating sources

Based on the results of Task 20, we will informally discuss each potential scenario with representatives of bond rating sources such as Moody's and Standard & Poor's. The purpose will be to establish which option, under which scenario, might affect the ratings of State-associated bonds, whether AHFC or otherwise. It is possible that any State action which appears to impair timely interest or principal payments on AHFC bonds (for instance, HOAP issues) may have a parallel impact on ratings of other State issues.

Task 22: Summarize findings

We will summarize our findings by option in a manner parallel to the previous presentation in Phase 2. The summary will concentrate on:

- Financial results of each option under the three scenarios; and
- Potential impacts on bond ratings of each option.

Other issues will undoubtedly have arisen as well, which will be discussed in this summary.

Task 23: Review status of Housing Assistance Fund loans

We will evaluate the proposal that AHFC purchase mortgages from the Housing Assistance Fund. While the transfer of assets from a State entity (the Alaska State Building Authority) to a State corporation (AHFC) possibly will have no net impact to the State (on the "out of one pocket, into another" theory), there may be significant impact on AHFC's published financial position if:

- The mortgages are purchased at par value;
- Significant numbers of mortgages are discountable because of non-performance or other factors; and
- This discount is reflected in subsequent audited financial statements.

For this reason, it will be necessary to review the status of the mortgages to determine whether or not discountability is a factor. To do this, we will select either the entire pool of mortgages slated for purchase, or a representative sample if the pool is quite large. We will then prepare evaluation criteria for discountability and guide AHFC staff in evaluation of each mortgage. This will result in an aggregate potential discount factor for the pool.

Task 24: Establish yield level for fair market value determination

To convert the mortgage par values to fair market value, it will first be necessary to convert the potential discount factor from Task 23 to a percentage yield figure. This yield figure will be the sum of the expected yield for a "comparable performing" mortgage and a risk premium. The two numbers will be derived as follows:

- The yield of a "comparable performing" mortgage will be determined from published current mortgage rates and from interviews with established residential mortgage brokers. The spread of published numbers and opinions should be quite small, so there will be little problem establishing a satisfactory figure.

- The risk premium will be more subjective and will be established by reference to current estimates of the capital market pricing line, which relates perceived risk to required rates of return. Our initial estimates will be confirmed through interviews with mortgage brokers and others associated with risky secured obligations.

The product of this task will be an "expected yield" for securities which approximate the cash return patterns and risk characteristics of the aggregate of Housing Assistance Fund mortgages slated for purchase by AHFC.

Task 25: Determine fair market value

The fair market value of the Housing Assistance Fund mortgages will then be determined by discounting the aggregate future cash flows resulting from the mortgages by the expected yield derived in Task 24.

Task 26: Review Phase 3 results with Task Force

This will complete our scope of work under the Request for Proposals. We will summarize Task 3 results in the following manner:

- Significant bond covenants affecting options for AHFC;
- Description of computer models used to measure financial impacts of the options;
- Descriptions of the three scenarios under which the financial impacts were estimated; and
- Estimated future cash flows and ROTs for each option under each scenario.

This summary will complement the Phase 2 analysis, which covered the legal, organizational, market, service provision, and public expenditure aspects of each option.

In addition, our summary will include the assessment of Housing Assistance Fund mortgages, and their estimated fair market value at the yield rates determined.

Task 27: Prepare draft final report

Subsequent to Task Force review of our Phase 3 findings, we will prepare a final report in draft form. The format of this report will follow the structure of the work as presented in this proposal:

- Environmental Analysis;
- Strategic/Organizational Options; and
- Financial Implications.

All relevant findings, analysis, and presentations will be shown in a clear, concise, and organized fashion. Graphical exhibits will be used generously.

Since the request for proposals did not ask for recommendations, we do not intend recommending specific courses of action unless asked. However, the analysis contained in the report should provide information in a clear and even-handed way that will support efficient decision-making.

Task 28: Prepare and deliver final report

After Task Force review of the draft report, we will make any needed changes and deliver ten bound copies plus one set of camera-ready originals.

5. Project Organization

5. Project Organization

This section describes our overall project organization, discussing the key functional areas our team members will address, summarizing the qualifications of our personnel, and the specific role we envision each team member will play. The project team proposed for this engagement will be composed of seasoned professionals from Ernst & Young. Our personnel assignments complement the work elements contained in the request for proposals, with the skills and experience of our individual team members corresponding to the various tasks as outlined in the proposed work plan.

Description of Key Functional Areas

Our consultant team is qualified in several key functional and programmatic areas relevant to this effort. The most pertinent of these are described as follows:

- **Familiarity with Housing Issues**—This study requires demonstrated knowledge and experience in bond-financed housing, assessment of affordable housing needs, and an analysis of current and alternative housing subsidy programs. Our team consists of individuals who have provided this type of assistance through strategic planning for housing authorities, development of state wide housing plans, analysis of housing requirements, and awareness of housing programs and strategies.
- **Experience in the Real Estate Market**—Our project team members have extensive experience in the field of real estate advisory services. Three of our team members have demonstrated expertise and understanding of the real estate appraisal industry, loan purchaser problems associated with home equity loans, familiarity with real estate owned and foreclosed properties, and other applicable areas.
- **Financial Analyses Capabilities**—This proposal requires the evaluation of the current financial status of the AHFC and its individual loan programs in order to develop alternatives for retaining, refining, or otherwise changing existing programs in response to future market needs. Our team has the necessary

capacity to evaluate the current operating environment of AHFC, and to perform a comprehensive analysis of liquidity, reserves, and earnings affecting bond covenants and ratings.

- **Public Policy Analysis and Development Experience**—The ultimate audience for the results of this study will be the Alaska legislature, the decision-makers who will determine future policy direction for the AHFC. Our consultants are accustomed to working with elected officials. We will prepare a succinct report which summarizes the results of our research efforts and highlights alternatives for consideration by the Legislature. The financial impacts of our recommendations will be summarized, along with other major factors important for the Legislature to evaluate in its deliberations concerning state housing policy.
- **Strategic Planning and Organizational Analysis**—Preliminary recommendations resulting from the assessment of AHFC's current operations and future alternatives will require strategic insight and analysis. Our team is accustomed to forming key strategic decisions in light of such factors as the availability of financial resources, likely political support, effects on constituents, and probable organization or structural changes. Our work with the Task Force will draw from our strategic planning methodology and approach, which has often been successfully applied to housing issues.

The structure of our proposed team fully addresses each of these important topical areas.

Individual Roles of Team Members

This section describes the role of each team member and their associated qualifications as proposed in our project organization.

1. Partner-in-Charge: Joseph F. Hill

At Ernst & Young, the Partner-in-Charge is responsible for the overall success of the engagement. The Partner-in-Charge ensures that all work is performed in accordance with our agreement, that the work and deliverables meet the firm's quality standards and project requirements, and that there is overall client

satisfaction with our performance. In addition, the Partner-in-Charge ensures that the engagement obtains the necessary resources and attention of the firm.

Joseph F. Hill, Director of the Government Operations group for the northern portion of our West Region Consulting Practice, has over twenty years of operating and consulting experience with government.

2. Technical Director: O. Andrew Orien

For this engagement, we have assigned a Technical Director, M. O. Andrew Orien. Mr. Orien, an Audit Partner in our Anchorage office, has extensive experience in valuation of residential loan portfolios and is familiar with the securitization process for pooled loan portfolios. He has recent experience advising the North Pacific Rim Housing Authority and Alaska Pacific (now Key Pacific Mortgage).

Mr. Orien's valuation experience and his local familiarity with AHFC's position and the Alaska housing finance situation will be invaluable in this engagement.

3. Project Manager: James Gibson

The Project Manager has the responsibility for supervising all work performed under this contract, including:

- Quality control and review of all products;
- Detailed planning and scheduling;
- Determining specific knowledge and skills needed and assigning team members to specific project tasks;
- Review of project documentation, interim reports, and the final report;
- Progress monitoring and reporting; and
- Participating directly in task activities.

In addition, our Project Manager will serve as the primary point-of-contact for the Task Force, working with you to insure proper communication and timeliness of all tasks performed under this contract.

Our Project Manager will be Mr. James Gibson, a Director of the firm's Northern West Region Economic and Financial Consulting Practice. He offers eighteen

years of experience in applied financial, economic, and market analysis to this project. Mr. Gibson will also serve as our primary contact with the Task Force.

4. Lead Technical Consultants:

To meet the requirements in the outlined work plan, we have assigned professional, technical consultants to assume lead responsibilities in the major research areas of real estate, financial analyses, housing policy, and strategic/organizational issues. The following individuals will have primary roles in conducting the necessary data collection, research, and analysis of your current operating environment and financial status, development of alternatives, and assessment of the policy implications and projected results of the alternatives. These lead consultants include:

Real Estate Leader: Vere Harlow, Senior Manager. Mr. Harlow is Director of Ernst & Young Seattle's Strategic & Financial Services Group. He is also Chairman of Ernst & Young Seattle's Real Estate Focus Group, a ten-member team concentrating on consulting, tax, and accounting services to the real estate industry. In managing several recent real estate-related engagements, Mr. Harlow has been responsible for assessing current market conditions in specific areas and projecting demand and development trends.

Real Estate Second: Ron Morris, Senior Consultant. Mr. Morris, Senior Consultant in Real Estate for the West Region Corporate Services consulting group, has extensive experience in real estate demand and feasibility studies for office, hospitality, and single-family properties. He is experienced in basic research, demand projections, and financial analysis.

Financial Analysis Leader: Ed Kaempf, Senior Manager. Mr. Kaempf, a Senior Manager, serves as Director of our Northern West Region Analysis Services Group. Mr. Kaempf has 12 years of quantitative analysis experience with a special focus on real estate.

Financial Analysis Second: John Micheltmore, Senior Manager. Mr. Micheltmore, with over eight years of auditing and financial analysis experience, will work closely with Mr. Kaempf. He brings a specialty in the financial analysis of both single and multi-family housing projects and issues.

Policy, Strategic and Organizational Issues Leader: Margie Harris, Manager. Ms. Harris is a member of our Northern West Region Government Operations Practice, with a 15 year history of public sector and non-profit management experience. She has been project manager for the Seattle Housing Authority Strategic Plan, (now being updated) and has direct experience in the development of state-wide low-income housing incentive programs involving bonding, low-interest loans, and tax credits. Ms. Harris has also recently completed a housing needs study for the Seattle-King County area and is presently facilitating a Home-Ownership Committee process for the City of Seattle, Department of Community Development.

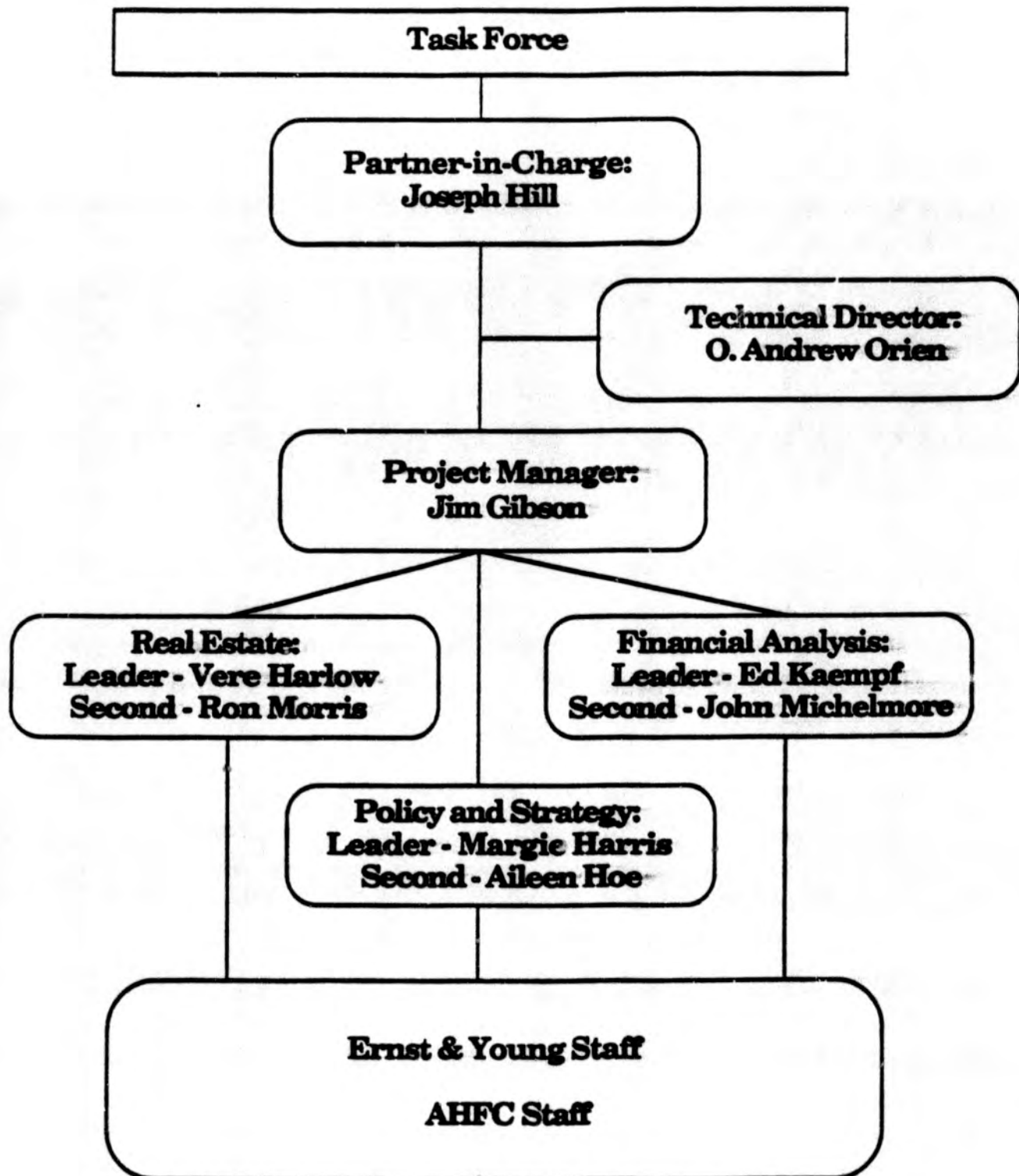
Policy, Strategic and Organizational Issues Second: Aileen Hoe, Manager. Ms. Hoe is a member of the Management Consulting Group of our West Region with demonstrated experience in both the development of financial projects and organizational alternatives specific to housing authorities. She brings a structural analysis capability to the team from the perspective of conducting numerous management reviews of government agencies, including housing authorities.

The combined roles of these individual team members address all essential elements and skill areas required to perform the work plan tasks necessary to this engagement. Detailed resumes of all team members identified in this section are provided in Section 8.

In addition to the persons identified above, Ernst & Young will assign other staff and management resources as required to provide the best and most useful study for the Task Force. No substitutions for management personnel will be made without Task Force consent.

A schematic of our proposed project organization is shown on the next page.

Project Organization



6. Schedule and Fees

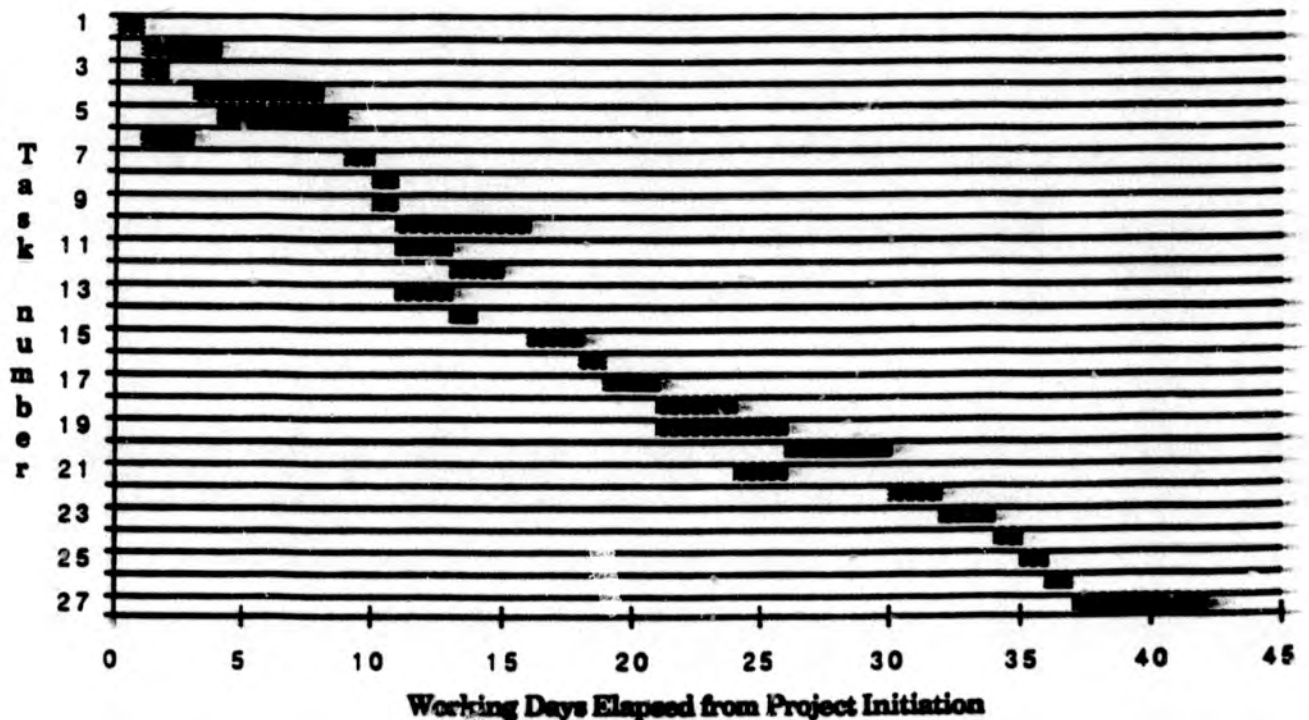
6. Schedule and Fees

Project Schedule

Our project schedule is shown below. Although the number of professional hours involved in this engagement is quite high, some tasks may be performed concurrently. Accordingly, and with full concentration of our resources, we estimate that the draft final report (Task 27) can be delivered 42 working days from project initiation—if all information requested is readily available and personnel required for interview are available at scheduled times through the performance period.

We emphasize that the schedule below contains no slack time.

Estimated Project Timeline



Project Budget

Our total budget for this engagement is \$194,285. This includes both professional fees and out-of-pocket costs reasonably anticipated, including transportation and per diem costs for consulting resources where required.

7. Ernst & Young Qualifications

7. Ernst & Young Qualifications

Ernst & Young is a general partnership which provides management consulting, accounting, and tax services to a wide range of public and private sector clients throughout the world. We are one of the largest professional services organizations in the U.S. and in the world, with a reputation for high quality professional work and distinguished client service.

The firm was created in 1989 by the merger of the two "Big Eight" public accounting firms of Arthur Young & Company, founded in 1894, and Ernst & Whinney, founded in 1903. Ernst & Young is organized on an international basis with over 200 offices in major metropolitan areas throughout the United States, including our office in Anchorage. Worldwide, we have offices in over 100 countries. In total, the firm has 70,000 employees, including more than 3,200 Management and Information Systems consultants.

Our size provides the strength and resources of a multi-national organization, but our system of local practice development offices and expertise guarantees personal services to all of our clients. Ernst & Young brings together the varied experience of financial and real estate analysis, strategic planners, and policy analysts who hold a professional commitment to excellence in service to our clients.

Ernst & Young offers a specialized line of services to state and local governments through our government operations practice serving the Western United States. These services feature practical, proven, and structured methodologies which emphasize a participatory approach involving our client's management and personnel. Distinct from other firms providing similar services, we tailor our approach and our services to the particular concerns, needs, environment and requirements of our every client.

The following section provides a sampling of our qualifications and experience in the three primary areas of importance to this project:

- A. Financial Analyses;
- B. Real Estate; and
- C. Strategic Planning, Organizational and Housing Policy.

A. Financial Analyses

Skills in financial analysis are fundamental to providing the Task Force with a dependable view of future financial results under the variety of options considered. At Ernst & Young, we have used sophisticated computer modeling techniques for many years to simplify the process of testing multiple scenarios for our clients. But in this process, we have never lost sight of the fact that solid and accurate research is required to support the calculations, and that poorly thought out assumptions will destroy the validity of any calculation, however sophisticated.

Below is a sampling of our experience performing financial analysis relevant to this engagement.

State of California Department of Real Estate

We were engaged to determine the actuarial solvency of the recovery account and developed a flexible, long-term method of funding the account. We also developed a base of historical data related to recovery account activities and balances, determined state costs of the Recovery Account Program for the current fiscal year; evaluated and prepared a plan to implement a recovery account monitoring and tracking system; and designed and implemented an automated, microcomputer-based recovery account cash forecasting system. In addition, we projected the status of the recovery account over the following four years and over the following five to ten years; evaluated the financial impact which mortgage loan brokers claims would have on the recovery account over the following four years and the following five to ten years; and determined possible changes to current funding mechanisms, including the ratio of

education and research account funds to recovery account funds, and the license fee.

City of Sacramento—Economic Assessment of Alternative Revitalization Strategies

We provided economic analysis of alternative revitalization strategies for downtown Sacramento. The planning objectives of the City and results of the urban design plan were integrated to produce program objectives and corollary mechanisms for implementation which were tailored to the specific characteristics of the Sacramento central business district. The resultant products included an overview of the office market, a summary incentive programs used by other cities, preliminary recommendations for Sacramento downtown support program and preliminary projections of office demand for the Sacramento downtown and metropolitan area.

City of Fontana—Redevelopment Agency Review of Impact Fees

We reviewed the City of Fontana's existing impact fees for a designated planned community (Southridge) which was projected to have over 9,000 residences at buildout. We assessed the adequacy and equity of current developer charges, and calculated new impact fees where appropriate.

National CTA for Housing Management

Ernst & Young was asked to join the client in assessing needs of the Puerto Rico Urban Renewal and Housing Corporation. Specifically, Ernst & Young was assigned to evaluate the manual and automated procedures in financial management areas, to develop a concept for financial systems development, and to set out a plan to effect improvements in their financial operations. PRURHC was the second largest public housing authority in the U.S. (60,000 units, \$45 million budget) and was considered by HUD to be "operationally troubled."

Chicago Housing Authority

The CHA needed to fully understand its 1987 cash requirements for the upcoming meetings with HUD. Ernst & Young was asked to assist the CHA in determining an estimate of 1987 cash requirements and supporting cash flow

estimates. The engagement involved working with CHA management to instruct their staff on developing estimates for cash flow line items. Ernst & Young independently conducted a limited review of staff estimates. We confirmed cash requirements for 1987 and provided findings and recommendations to senior management.

New York City Housing Authority

We have worked with the Housing Authority for over three years in developing and implementing a new financial management system. For the past year we have assisted the Authority in supporting the operation of the system. The Authority later asked us to provide a reduced level of assistance for an additional five months.

City of Chicago - Department of Housing

Ernst & Young analyzed the department's accounting and financial reporting procedures. The following areas were considered; Purchasing, budgeting, accounts receivable, personnel control, general ledger, programmatic reporting, and cash flow projections.

Carolinas Council on Housing

Ernst & Young provided accounting services quarterly and annually for this group. This included accounting certification, rate analyses, loss projections and asset-liability matching.

Columbia Association

We evaluated the current organization and operations, the isolation of key problem conditions and constraints and the development of practical and cost effective recommendations for improvement. We also developed creative strategies to secure significant operational savings which could be applied to new and expanded services while not increasing associated administrative costs.

B. Real Estate Industry

Our professionals have the industry background to provide first-rate service. Our involvement in the real estate industry has been recognized in many ways:

- Members of our Real Estate Advisory Group have performed numerous valuation engagements for financing. Clients we have served in this capacity include Security Pacific National Bank, Citicorp Industrial Credit Corp., and Federal Asset Disposition Association. Ernst & Young has actively assisted investors in taking advantage of low-income housing credits. We have worked with California Equity Fund (CEF), one of the leading non-profit low-income housing development programs, and the first national program to make widespread use of the credit. We also assisted this non-profit provider of low-income housing in identifying Fortune 500 investors. These investors were solicited to raise funds for the construction and development of low-income housing in California.
- We have frequently conducted seminars that deal with such key industry topics and issues as financial sourcing and transactions, mergers and acquisitions, the Tax Reform Act of 1986, and utilizing the low income housing credit. We also have presented seminars for the foreign investor. Recent examples included:
 - "The Real Estate Industry: Building a Winning Team for Maximizing Global Opportunities," an *Institutional Investor Seminar* co-sponsored by Ernst & Young and held in Tokyo.
 - An International Investors Symposium, co-sponsored by Ernst & Young and the Braemer Group and held in Atlanta. Ernst & Young professionals and representatives from Salomon Brothers, London & Edinburgh Trust, Sanwa Bank, Prudential Development Company, Lloyds International Bank, and Swiss Bank Corporation spoke on such topics as "Foreign Banks - The Next Wave," "Japanese Investment in U. S. Real Estate," "The Tax Implications of the 1986 Tax Act on the Foreign Investor," and "The International Investor Discovers Atlanta."
- We are active members of the Urban Land Institute. Other professional organizations in which we actively participate include International Association of Corporate Real Estate Executives; International Real Estate Institute; Mortgage Bankers Association (including representation on the

Internal Management Committee); National Association of Home Builders; National Association of Industrial and Office Parks; National Association of Realtors; and the Real Estate Securities and Syndication Institute.

- Ernst & Young real estate professionals frequently testify as experts on matters relating to real estate accounting and auditing.
- Our Real Estate Advisory Group produces a number of publications which address the tax, accounting, and operational issues of current interest to the real estate community. Among them is *Real Estate Alert*, which provides over 20,000 readers with timely information on new developments in the industry and in our practice, and *The Ernst & Young Real Estate Report*, a quarterly audio cassette on current developments in the real estate industry. In addition, we are co-authors of *The Dow Jones-Irwin Guide to Commercial Property Development*. On an as-needed basis, we also issue other publications to treat significant developments in greater technical detail.

Ernst & Young is, therefore, a recognized leader in serving the real estate industry. We are the real estate advisors to such industry leaders as Public Storage, Rockefeller Group, Cushman & Wakefield, Daniel Realty, Paine Webber Properties, Mobile Land Development, Trammell Crow, Grubb & Ellis Company, Balcor, and Pulte Homes, as well as hundreds of small to mid-size real estate clients. We serve the full spectrum of real estate companies, from traditional developers and builders, to today's new and emerging organization, including real estate investment trust, syndications, and master limited partnerships.

Below is listed a representative sampling of our real estate experience.

California Department of Real Estate—Evaluation of Licensee Interaction with Respect to the Marketing of REO's

This study was undertaken to examine licensee interaction with respect to the marketing of real estate owned/foreclosed properties (REO). This study arose primarily from concern about the increasing inventory of commercial and residential properties acquired by lenders as a result of record loan foreclosures during the early 1980's. The goal of this study was to assess and evaluate new techniques and methods for marketing and disposing of REO properties through

improved lender/owner and licensee interaction. Recommendations were developed for improving licensee interaction in the REO marketing and disposal process.

California Department of Real Estate—Evaluation of Real Estate Appraisal Industry

The purpose of this project was to conduct an evaluation of the past history and future outlook of the California real estate appraisal industry. Recent legislative actions regarding appraisers and appraisals at both State and Federal levels provided the basis for a study of this nature. Major study tasks included: (1) conduct of interviews with relevant federal regulatory and legislative officials, real estate appraisal industry trade association, mortgage lending and insurance institutions, and realty companies, (2) development, administration, compilation, and analysis of 1,500 surveys distributed to relevant industry-related professionals, and (3) development of viable alternative recommendations regarding the appraisal industry.

California Department of Real Estate—Study of Home Equity Lending by Mortgage Loan Brokers

The project examined (1) the business practices, and (2) borrower and lender problems associated with home equity loans made or arranged by mortgage loan brokers (MLB's) in California. The project involved telephone and personal interviews with these principals of home equity transactions in order to develop recommendations regarding the business practices of mortgage loan brokers. A major mail survey was made of over 5000 MLB's in order to solicit comments on the proposed recommendations.

Morgan Stanley & Co. Inc.

We were engaged to verify the mathematical accuracy of computations relating to a bond issue prepared by our client. We verified cash flows and yields using locally developed software.

YMCA of Metropolitan Madison, Inc.

We examined the financial projections for a new YMCA facility to be located in downtown Madison, Wisconsin. These projections were to be used to support the issuance of Development Revenue Bonds by the City of Madison.

Analysis of the Future Outlook for Common Interest Developments

This report concentrated on the primary factors that ensure and enhance the market values of Common Interest Developments (CID's), namely the active support of home owners in the CID, and the proper financial planning and funding of the CID by its Home Owner's Association. The study examined and made recommendations in the following areas: (1) developer setup budgets and government documents, (2) lawsuit and arbitration issues, (3) licensing, training, and education deficiencies by home owners, board members, and other professionals, (4) liability concerns by board members, and (5) CID marketing deficiencies by developers. Telephone and on-site interviews were conducted with home owner trade associations, real estate attorneys, title company representatives, developers, lenders, local government planners and regulators, appraisers, and property managers. A state wide mail survey was made of over 400 CID consumers, providers and regulators in order to solicit comments on the proposed recommendations.

Analysis of Specialized Licensure and Education for Non-Residential Licensees

The principle goal of this study was to evaluate the need, feasibility, and advisability of requirements for brokers and sales persons employed in California mortgage banking and loan brokering, property management, business opportunity brokerage, commercial and industrial brokerage, and time-share sales. Surveys were conducted of licensees who are active in these specialty fields, enabling us to produce a profile of licensees who provide services in one or more of these specialized real estate fields. A cost and benefit analysis was then performed to determine which system of specialized licensure and education, if any, could deliver more benefits for an overall lower cost to the consumer, when compared with the current system of real estate licensing. Recommendations for the Legislature necessary to accomplish the improvement

and continuation of support programs were included along with the method of implementing the programs and systems needed to fulfill these recommendations.

C. Strategic Planning, Organizational and Housing Policy Experience

Ernst & Young has provided expertise on a wide range of housing issues and matters of public policy, including low income housing needs analyses, provision of case studies for low income housing publications, and assessments of affordable and frail and elderly housing markets. Additionally, we have provided technical expertise in the evaluation of several redevelopment, revitalization, urban and suburban development projects. Many of these projects called for recommendations consistent with local and state housing policy and land use plans.

The following is a sampling of our engagements, demonstrating our familiarity with strategic planning, organizational and policy issues related to housing.

Dimeo Enterprises—Low Income Housing Analysis

Ernst & Young conducted an analysis of refinancing alternatives for eight buildings that contained low income housing. The buildings were eligible for Section 8 low income housing subsidies and the study analyzed the potential for using Section 8 rehabilitation loans.

Urban Land Institute—Low Income Housing

We provided five case studies for an Urban Land Institute book on low income housing. We also contributed a chapter on the role of low income housing tax credits in financing projects developed through public/private partnerships.

Sacramento Housing and Redevelopment Agency—Affordable Housing Needs Assessment

We conducted a needs assessment to determine the role of housing rehabilitation as a tool in providing affordable housing. The report contained two major components including: (1) an affordable housing needs assessment, and (2) a rehabilitation needs assessment. Within the affordable housing needs

assessment, questions regarding the current and projected affordability of owner and renter-occupied housing were addressed. Specifically, the demand for, and supply of affordable housing by county income level, and the influence of housing market trends on the future supply of affordable housing were discussed.

Sacramento Housing and Redevelopment Agency—Frail and Elderly Housing Market Analysis

We prepared a demographic profile of the elderly population in Sacramento County, showing population trends and projections by location. The "at risk" elderly population was described, accompanied by an analysis of the geographic areas with the highest concentrations of this population sub-group. The concept of the frail and elderly then was defined, and estimates of the size of the frail and elderly population were projected to 1990.

The demand for housing for the frail and elderly also was analyzed. The market area and the mobility of the elderly in general was described. Managers or administrators of 28 residential care facilities and 35 independent facilities for the elderly were surveyed. Information on absorption, vacancy, and rent levels was assessed, emphasizing the characteristics of residential care facilities.

Seattle Housing Authority

Ernst & Young was engaged to facilitate the development of a five-year strategic plan for the Seattle Housing Authority. Using the E&Y/FOCUS approach to strategic planning, E & Y conducted a planning retreat with the Management Team to develop a common mission, goals, objectives, and priority programs. Subsequent work sessions resulted in management and budget training and the preparation of a draft strategic plan for public comment. This engagement included extensive public involvement activities with SHA constituents, residents and social service providers as well as an employee survey.

Local Initiatives Support Corporation

Ernst & Young was retained by the Local Initiatives Support Corporation (LISC) in Seattle to perform an analysis of housing needs for the Seattle-King County area. The analysis included extensive data collection on existing low-income

housing, eligibility criteria, monthly costs, and gaps between available supply and demand. The study resulted in a final report containing individual summary matrices of available housing units vs. need, organized by special needs population groups. The report received widespread distribution, and has been cited as a reference in policy and budget decisions affecting the future of local housing programs.

City of Seattle, Department of Community Development

Ernst & Young has been retained by the City of Seattle, Department of Community Development to assist in the facilitation of a Home Ownership Committee. The Committee is comprised mainly of residents in an area of the City impacted by the completion of Interstate 90. The goal of this effort is to insure that local residents have the opportunity to provide input to the City's plan to increase home ownership opportunities among long-time local tenants of housing currently owned by the Washington State Department of Transportation.

City of Santa Rosa

Ernst & Young was engaged by the City of Santa Rosa to conduct a management audit of the Housing Authority & Redevelopment Agency.

Portland Bureau of Community Development

We reviewed and developed an understanding of HUD, city and program statutes, regulations and rules, files and identified other potential problems or weaknesses in processes and guidelines. We also reviewed a completed policy and procedures manual, prepared a report of conclusions and recommendations and developed detailed work plans for organization management and staffing. Our work also included a review and quarterly follow-up of reviews of progress and effectiveness of policies and procedures implementation actions.

Portland Bureau of Community Development

Ernst & Young assisted in a quarterly compliance review, conducted a review of updates and amendments to the policy and procedures manual and tested compliance with selected prescribed procedures.

Hawaii Housing Authority

We were engaged to conduct a performance review of the single family mortgage purchase revenue bonds program and home mortgage purchase revenue bonds program (HULA MAE Loan Program). The objectives of this performance were to evaluate the HULA MAE program's operations to ascertain that amounts authorized had been authorized or were being utilized for the purposes for which such authorizations were made and to evaluate the effectiveness of the HULA MAE program in accomplishing legislative intent.

County of Kauai

We conducted a procedures review of the development branch of the Hawaii Housing Authority. This included a general assessment of the branch operations and its administration of the program and the development of a procedural guide.

8. References

8. References

Several references to Ernst & Young's recent housing finance and real estate work follow. We urge you to contact these references to assure yourselves of the quality of our performance, and that the value of our consulting and advisory services is held in high esteem by our clients.

- **Mr. Karney Hodge, Director**
California Housing Finance Agency
Director, National Council of State Housing Agencies
1121 "L" Street, 7th Floor
Sacramento, CA 95814
Phone: (916) 324-4638
- **Paul Isaki, Special Assistant for Policy**
Office of the Governor, State of Washington
3rd Floor, Insurance Building
Olympia, WA 98504
(206) 586-0820
- **The Honorable Emilio Cantu, Senator**
Ways and Means Committee
Washington State Senate
Olympia, WA 98504
(206) 786-7680
- **Kanellos J. Astor, President/CEO**
Washington State Convention and Trade Center
720 Olive Way, Suite 1515
Seattle, WA 98101
(206) 464-5414
- **Brent Donaldson, President**
Liquidity Fund Investment Corporation
1900 Powell Street, Suite 730
Emeryville, CA 94608-1831
(415) 652-1462
- **Richard Wollock, President**
Johnstown/Consolidated Institutional Advisors, Inc.
2000 Powell Street
Emeryville, CA 94608-1831
(415) 652-7171

- **Tom Lackman, Chief Financial Officer**
Storek & Storek
484 Ninth Street
Oakland, CA 94607
(415) 444-3300
- **Jim Cote, President**
Grubb & Ellis Securities Corporation
One Montgomery Street, 32nd Floor
Crocker Center - West Tower
San Francisco, CA 94104
(415) 956-1990

9. Project Team Member Resumes

FIRM POSITION

Mr. Hill is the Director of Government Consulting for the Northern half of our West Region. Mr. Hill has twenty-five years of operational and consulting experience in the government and private sectors.

EDUCATION AND PROFESSIONAL ACHIEVEMENTS

- He was educated at St. Mary's College and John F. Kennedy University, majoring in Public Administration.
- He has also taken specialized legal courses at the Golden Gate Law School.

RELEVANT EXPERIENCE

- **California Department of Real Estate - Partner-in-Charge** on a study of licensee interaction with respect to the marketing of real estate owned/foreclosed properties (REO). This study arose primarily from concern about the increasing inventory of commercial and residential properties acquired by lenders as a result of record loan foreclosures in 1986/87. The goal of this study was to assess and evaluate new techniques and methods for marketing and disposing of REO properties through improved lender/owner and licensee interaction. A broad range of ideas and recommendations were made for improving licensee interaction in the REO marketing and disposal process.
- **California Office of Statewide Health Planning and Development -The California Health Facility Mortgage Insurance Program** has over \$1.5 billion (1987) in outstanding insurance contracts for health facility construction loans. The objective of this study was to review and analyze all federal, state, and industry regulations, policies, procedures, practices, and market conditions concerning life care facilities which impact solvency of the program. The study evaluated financial risk and exposure to the program which life care contract facilities represent, and made recommendations concerning financial operation of the program.
- **California Debt Advisory Commission - Partner-in-Charge** on an engagement to develop and implement a state and local debt issue data base. The project included report definition, specifications and data base design, resulting in screen, query language, data standards, dictionary, and performance

recommendations. DBMS vendor evaluations resulted in an Informix DBMS operating under UNIX.

- **Solano County** - Partner-in-Charge of a project to analyze and structure financing of eighteen capital facility projects. The objective of this project was to structure specific financing instruments which the County could use to fund a variety of new construction and remodeling building projects. The study included the following tasks: (1) review and preparation of projected year-by-year costs for each capital outlay project, (2) development of projected case inflows from County sources which could be used to fund the building projects, (3) analysis of a wide range of municipal financing instruments, and (4) preparation of specific financing instruments for each building project, including issue size, financing costs, and project drawdown schedules.
- **Land Developer** - Partner-in-Charge on a study to determine the feasibility of converting apartment property to a parking lot development. The engagement included income and cash flow analyses for different joint ownership structures.
- **City of Fremont, California** - Partner-in-Charge of a project to develop a comprehensive Capital Improvement Program (CIP) for the City. The study included an analysis of revenue, alternatives, development impact charges, and debt financing alternative, as well as the development of specific capital improvement policies and plans. An automated CIP model was developed, and multi-year cashflow projections were prepared.
- **California Department of Real Estate** - Project Manager to conduct a study of home equity lending by mortgage loan brokers. The principal goal of this study was to develop information on mortgage loan broker home equity lending practices and borrower and lender problems experienced as a result of these practices. A major mail survey of California mortgage loan brokers was conducted. The study provided recommendations for regulations to address problems with home equity lending by mortgage loan brokers in California.
- **California Department of Real Estate** - Lead Consultant to examine mortgage financing services in California. The objective of the study was to examine current practices and probably future developments in the use of computers and telecommunications technology in delivering mortgage financing services. The study includes determination of systems employed, transaction types, service providers, contractual relationships formed, general costs and benefits, and consumer experiences with applications of the technology. The final report will address changes in the industry and in consumer attitudes resulting from the use of automation.

FIRM POSITION

Dr. Gibson is a Director in our West Region Management Consulting Group, with a specialty in economic and financial consulting. Dr. Gibson has successfully directed, managed, and participated in over 170 individual client engagements during the course of his consulting career. He has eighteen years of experience in applied financial, economic, and market analysis and has been with Ernst & Young for eleven years.

EDUCATION AND PROFESSIONAL ACHIEVEMENTS

- Advanced Training in Economics, Graduate School of Industrial Administration, Carnegie Mellon University, 1988
- Ph.D. in Resource Economics, Iowa State University, 1976
- Nominated to Phi Kappa Phi National Honor Society at I.S.U.
- Attended I.S.U. on a Full Research Scholarship
- Nominated for the National Science Foundation Graduate Fellowship, University of California, Davis, 1971
- B.S. in Applied Economics with High Honors, University of California, Davis, 1971
- Received U.C. Davis Department of Agricultural Economics Citation for outstanding Graduating Senior.
- National Association of Business Economists
- National Economists Club
- American Economics Association
- Western Economics Association
- National Association of Forensic Economists
- American Agricultural Economics Association
- Phi Kappa Phi National Honor Society
- Gamma Sigma Delta Honor Society of Agriculture
- Sacramento Economics Roundtable

RELEVANT EXPERIENCE

- **California Department of Real Estate - Project Director on an engagement to conduct an analysis of the escrow industry as it affects real estate licenses. The study examined and compared different regulatory constraints confronting alternative providers of escrow services, and identified and explained the regional variations in escrow business practices between northern and southern California. A major component of this study involved conducting a statewide survey of 2,500 industry-related professionals for the purpose of determining the effects of differing escrow industry business practices on the consumer and the real estate industry.**
- **California Department of Real Estate - Project Director on an engagement to study the past performance and future outlook of the real estate appraisal industry. Major study tasks included: (1) conduct of interviews with relevant federal regulatory and legislative officials, real estate appraisal industry trade associations, mortgage lending and insurance institutions, and realty companies, (2) development, administration, compilation, and analysis of 1,500 surveys distributed to relevant industry-related professionals, and (3) development of viable alternative recommendations regarding the appraisal industry.**
- **California Department of Real Estate - Project Director on a study to assess the (1) business practices, and (2) borrower, lender, and loan purchaser problems associated with home equity loans made or arranged by mortgage loan brokers (MLBs) in California. The study involved telephone interviews with these principals of home equity loan transactions in order to develop recommendations regarding the business practices of mortgage loan brokers. A major mail survey was made of over 500 MLBs in order to solicit comments on the proposed recommendations.**
- **California Department of Real Estate - Project Director to study licensee interaction with respect to the marketing of real estate owned/foreclosed properties (REO). This study arose primarily from concern about the increasing inventory of commercial and residential properties acquired by lenders as a result of record loan foreclosures in the early 1980s. The goal of this study was to assess and evaluate new techniques and methods for marketing and disposing of REO properties through improved lender/owner and licensee interaction. Recommendations were developed for improving licensee interaction in the REO marketing and disposal process.**
- **California Department of Real Estate - Project Director to review California's continuing education program, including testing requirements. Study tasks included: (1) obtaining broad-based public input regarding the continuing education programs for real estate licensees in other states, and (3) preparing**

recommendations concerning the California real estate license continuing education program.

- **California Department of Real Estate - Project Director** to conduct an actuarial study of the real estate recovery account. This study included providing short- and long-term projection of recovery account activities, such as cash flows and State of California real estate license activity. The projections were based on statistical and econometric analysis. A detailed cash forecast model and a microcomputer on which to run the model were delivered to the Department at the conclusion of the study.
- **California Department of Real Estate - Project Manager** on a study to evaluate the Continuing Education Program for the real estate industry. The objective of this engagement was to evaluate the real estate continuing education program for real estate licensees. The evaluation included an estimation of approximately thirty million dollars in costs incurred by licensees and identification and estimation of the private and social benefits derived from the program. The study also assessed the adequacy of policies, procedures, and practices, used by the Department in its administration of the program.
- **California Department of Real Estate - Staff Advisor to the Commissioner.** Developed a master work plan and schedule for reform of the statewide real estate subdivision process.
- **California Department of Real Estate - Project Manager** to develop, through research, data required by the client for establishing minimum criteria for all real estate license preparatory courses. The study involved the formulation and application of a major mail survey. The detailed survey was designed to systematically sample from a population of over 300,000 licensees in order to allow statistical inferences.
- **Solano County - Project Director** to provide financial services for funding of County facilities. The goal of this project was to identify funding sources for construction and capital improvements of approximately \$42 million of County facilities. Potential financing scenarios were developed which considered and evaluated feasible combinations of public and private financing and ownership. The recommended funding approach included sized, lease-purchase financings, using certificates of participation. An implementation plan was prepared for obtaining funds necessary to meet assumed capital project costs.

OTHER QUALIFICATIONS

Dr. James Gibson joined Ernst & Young in 1978 after serving two years as a Principal Resource Economist for Harza Engineering Company, Chicago, Illinois. In this capacity, he was responsible for performing economic, environmental, and social analyses of major international projects in the field of energy development.

land and water development, agricultural development, regional development, and environmental quality.

Dr. Gibson's previous experience also included employment as an Instructor and Research Associate in Economics at Iowa State University. He taught economic courses in natural resources and was involved in applied research on land and water resource allocation problems, including the economic evaluation of multi-purpose reservoir projects, pesticides, energy, environmental policies, and agricultural land uses.

PUBLICATIONS

- Gibson, James A. and Timmons, John F., "Land Use Inventory and Projection Model with Application to Iowa and its Subregions." Center for Agricultural and Rural Development Report 82, Iowa State University, October 1978, 351 pages.
- Gibson, James A., "On the Allocation of Prime Agricultural Land." Journal of Soil and Water Conservation, Vol. 32, No. 6, November-December 1977, pp. 271-275.
- Gibson, James A., "A Review of Recent Extensions of Linear Economic Models to Regional Environmental Quality Analysis." Journal of Environmental Systems, Vol. VI, No. 2, 1976-1977, pp. 147-172.
- Gibson, James A. and Timmons, John F., "Information Needs and Models for Land Use Planning." American Journal of Agricultural Economics, Vol. 58, No. 5, December 1976, pp. 902-908.
- Gibson, James A., "Possible Impacts of United States' Domestic Environmental Policies on Less-Developed Countries' Trade, Investment, and Foreign Aid." Journal of Environmental Affairs, Vol. III, No. 1, Spring 1974, pp. 109-127.

In addition to the above referred professional journal papers, Dr. Gibson has published numerous general audience articles on a broad range of economic and finance topics.

FIRM POSITION

Mr. Harlow is Chairman of Ernst & Young's Seattle Real Estate Group. The Real Estate Group, including ten professionals from audit, tax, and management consulting, assists Ernst & Young clients in all aspects of real estate activity.

Mr. Harlow recently returned to Seattle from Arthur Young Hong Kong, where he was Executive Director, Arthur Young Management Consultants Ltd. He was heavily involved in commercial real estate development in Hong Kong and in the People's Republic of China.

EDUCATION AND PROFESSIONAL ACHIEVEMENTS

- BA, Finance (with Honors), California State University
- MBA, California State University
- Financial Management Honor Society
- Author of articles on China investment (Puget Sound Business Journal) and on China's electronics industry (Journal of the American Chamber of Commerce)
- Expert testimony on facility ownership and financing, Legislature of the State of Washington
- Lecturer on Financial Feasibility and Investment Criteria in Seattle, Juneau, Denver, Hong Kong, and in the PRC (Guangzhou, Fuzhou, Dalian)

RELEVANT EXPERIENCE

While in Hong Kong, Mr. Harlow developed a set of client services known as "Project Development Services", provided to developers, construction companies, and financial institutions. These services included:

- Performance of financial feasibility studies;
- Coordination with architects and quantity surveyors in detailed project definition, costing, and space allocation;
- Provision of negotiating support with respect to public sector involvement (primarily in the PRC, where development projects are usually public/private joint ventures); and
- Development of financing packages and financing cooperation arrangements.

Mr. Harlow managed professional service teams in one or more of the above areas with respect to several major projects, including:

- Central Plaza (Tianjin) Hotel (PRC, US\$36 million)
- Guangzhou World Trade Center (PRC, US\$176 million)
- Zhaoqing Star Lake Resort Hotel (PRC, US\$20 million)
- Repulse Bay residential development (Hong Kong & Shanghai Hotels project, US\$30 million).

Other development-related projects included pure demand studies and feasibility studies for manufacturing facilities.

Since his return to Seattle, Mr. Harlow has been working closely with Ernst & Young's Hong Kong office to connect Far East construction companies and financial institutions with local developers and others in North American commercial project development.

He has also managed several real estate-related engagements for Ernst & Young clients, including:

- A multi-firm consulting project to determine the feasibility of a 1,500 acre planned community near Bayallup, Washington.
- A study of the financial impacts of various redevelopment alternatives for the Union Station site in Tacoma.
- A facility siting and life-cycle cost analysis for the University of Washington.
- A detailed analysis of the potential fiscal impacts on the State of expanding and assuming full ownership of the Washington State Convention and Trade Center.
- Development of a cost accounting system and other services for the Washington State Convention and Trade Center.
- Financial analyses supporting a UDAG grant/loan application for a major retail complex.
- Reconnaissance of a proposed 400-acre industrial park in Pennsylvania for a local interested investor.
- Feasibility study for an 80-unit vacation condominium project in Anchorage.
- Financial projections for a major real estate holding company in Seattle.
- Project development services for a \$3 million manufacturing facility in Seattle.
- Financing alternatives study for a proposed 500,000 square foot State office facility.
- Due diligence for a proposed purchase of a major class-A office building in downtown Seattle.
- Demand study for a proposed major class-A office building in downtown Seattle.

Prior to transferring to Hong Kong, Mr. Harlow was practice manager for financial planning and control for Arthur Young Seattle. In this capacity, he performed a number of feasibility studies and other engagements for both public and private clients in the Northwest.

FIRM POSITION

Mr. Morris is a senior staff consultant in Ernst & Young's Seattle-based Real Estate consulting group. His primary responsibilities include market research and financial modeling/analysis on both public and private ventures with emphasis on real estate and tourism-related projects.

EDUCATION AND PROFESSIONAL ACHIEVEMENTS

- BA, Accounting, Western Washington University
- Member American Society of Travel Agents (ASTA)
- Member Pacific Area Travel Association (PATA)
- Member National Association of Industrial Office Parks (NAIOP)

RELEVANT EXPERIENCE

- Performed market research and analysis to support the development of international marketing strategies for a one billion dollar proposed Washington State ski resort. The analysis, with emphasis on Europe, Canada and the Pacific Rim, included developing a profile of the target consumer groups and their preferred product mix and set of amenities. The market research was also used to support a five year forecast of the level of inbound travel to the Pacific Northwest of these international visitors.
- Developed a financial model and conducted primary and secondary market research to support a feasibility study for a restaurant to be located in a major Colorado State destination ski resort. Analyses included study of competition, study of potential demand, and overall assessment of the project characteristics. The assignment also involved projecting future revenues and expenses for this restaurant.
- Performed research and analysis for a major Caribbean economic and marketing study sponsored by the U.S. Agency for International Development. The objective of this study was to determine the feasibility of a regional Caribbean campaign targeting North America.

- Performed research and analysis on critical assumptions and developed a financial model to support economic and operational analyses and business plans for a start-up cruise line.
- Performed research on critical assumptions to support financial analysis of a multi-million dollar start-up "hotel alternative" venture in the State of Alaska. Analyses included study of hotel occupancy and rental rate sensitivities and their impact on the hotel pro formas.
- Performed detailed financial analysis of the potential fiscal impacts on the State of Washington expanding and assuming full ownership of the Washington State Convention and Trade Center. Structured and performed market research and directed a nationwide telephone survey and data collection study of the major convention centers throughout the United States.
- Performed a due diligence study in support of an acquisition by a foreign buyer of a 450,000 square foot, \$100 million, Class "A" commercial office building in Seattle, Washington. The study included an analysis of historical, current and projected operating revenues and expenses.
- Performed research on critical assumptions to support a market demand and pricing study for a 300,000 square foot Class "A" commercial office building to be located in a major U.S. metropolitan city on the West coast. Analyses included study of historical absorption, vacancy and rental rates for comparable office space. This analyses was then used to estimate and project future demand and rental rates for this project.
- Conducted detailed financial analysis, developed financial models, and conducted research on critical assumptions to support a life-cycle cost analysis and a decision by the State of Washington to construct/own or lease a \$110 million office building.
- Directed market research and land valuation study for a financial feasibility analysis of a \$88 million 1,500 acre real estate project in South Puget Sound. Research model included interviews with real estate professionals, government officials and prominent business people.
- Performed "sensitive information" market research and analysis for a major foreign raw materials production facility planning to establish facilities in the United States. The research model included extensive interviews with corporate executives.
- Developed financial models and conducted primary market research to support the economic and operational analyses, strategic and business plans of a \$15 million fisheries project in the Bering sea.

- Extensive auditing and systems analysis experience with automated accounting information systems for public and private enterprise. Auditing was performed in accordance with Generally Accepted Accounting Principles.

FIRM POSITION

Mr. Kaempf is a Principal in our West Region Management Consulting Practice where he currently serves as Director of our Northern California Analysis Services Group. He has twelve years of quantitative analysis experience and has managed over thirty separate engagements for California State Government agencies and departments. He joined Ernst & Young nine years ago as an EDP specialist after several years experience as a systems analyst.

EDUCATION

- B. S. in Computer Science, University of Oregon, 1974
- B. S. in General Science, University of Oregon, 1975
- M.B.A. in Operations Research, University of Oregon, 1979

RELEVANT EXPERIENCE

- **California Department of Real Estate - Project Manager** of a study to assess the (1) business practices, and (2) borrower, lender, and loan purchaser problems associated with home equity loans made or arranged by mortgage loan brokers (MLBs) in California. The study involved telephone and personal interviews with these principals of home equity loan transactions in order to develop recommendations regarding the business practices of mortgage loan brokers. A major mail survey was made of over 500 MLBs in order to solicit comments on the proposed recommendations.
- **California Department of Real Estate - Project Manager** to conduct an actuarial study of the Real Estate Recovery Account. This study included providing short- and long-term projections of recovery account activities, such as cash flows and State of California real estate license activity. The detailed projections were based on advanced statistical and econometric analyses.
- **California Department of Real Estate - Project Director** to design and implement a microcomputer data base system to monitor legal claims made against the Real Estate Recovery Account. Major tasks performed included identifying needs of Department attorneys which manage the claims, designing data input and query screens, and writing a series of dBASE III programs.

- **California State Department of Education, Office of Food Distribution - Project Manager** of a detailed cost analysis of California's statewide surplus commodity distribution program. Among other activities, the study included:
 - Development of a detailed survey questionnaire administered to more than 2,000 participating local agencies in California and conduct of on-site interviews at 50 selected agencies.
 - Development of detailed costs for OFD services, including all state pro rata and departmental indirect charges and comparison of OFD costs and services with those of private sector food distribution firms and with programs in four other states.
 - Analysis of the cost and other trade-offs of contracted versus in-house warehousing and distribution and evaluation of a three-county pilot project in the Fresno area that utilized contracted services in lieu of state services.
- **State of Missouri, Environmental Improvement and Energy Resource Authority (EIARA) - Project Manager** on an engagement to conduct a comprehensive Statewide Resource Recovery Feasibility and Planning Study. The overall mission of this study was to determine the amount of solid waste produced, identify existing disposal practices, determine markets for secondary materials, and evaluate alternative technologies. Major study tasks included the following:
 - Performed a statistically-valid analysis of the solid waste stream in Missouri, and estimated the composition of solid waste by twenty-six categories (e.g., newspaper, corrugated paper, leaves and grass clippings, and aluminum beverage containers)
 - Conducted a comprehensive survey of all 157 refuse disposal facilities in the State, and prepared detailed findings on: (1) tipping fees required to cover the costs of operation, (2) amount of refuse received at the facility and its source, (3) remaining capacity at Missouri sanitary landfills, (4) plans for new or expanded facilities, and (5) amount and type of materials recovered at the facilities
 - Conducted a survey of all markets for secondary (recyclable) materials in Missouri and eight surrounding states, and markets for energy recovered from solid waste in Missouri
 - Evaluated the available and emerging technologies for resource recovery, and determined the economics of alternative technologies.

- **Diepenbrock, Wulff, Plant & Hannegan** - Project Manager on a litigation project involving a major retailer. There were three separate phases . First, an independent random sample was designed and conducted to determine the proportion of sale items which were marked at a price higher than the advertised sale price. Then an analysis of the District Attorney's own survey of sale item price marking was performed. Finally, a review and detailed analysis of present price marking procedures were conducted.

FIRM POSITION

Mr. Micheltmore is a Senior Manager in our West Region Management Consulting Group. He has over eight years of auditing and financial analysis experience with government, non-profit, and private sector clients. Mr. Micheltmore specializes in residential housing issues, both single-family and multi-family projects.

EDUCATION

- Certified Public Accountant
- B. S. in Accounting, California State University, Chico

RELEVANT EXPERIENCE

- **California Housing Finance Agency** - Project Director of the firm's annual financial audit of the Agency. The Agency's portfolio consists of \$2.5 billion in loans to single-family homeowners and \$500 million in loans to multi-family property owners.
- **California Housing Finance Agency** - Project Director of several engagements to issue comfort letters associated with the Agency's bonds.
- **California Housing Finance Agency** - Project Director of our annual single compliance audit of the Agency in regards to requirements of the Department of Housing and Urban Development. This work involves various procedures to determine compliance with various HUD requirements including tenant qualifications, political activities, civil rights, cash management, internal control, Davis-Bacon Act, schedules for receipts and disbursements, relocation assistance, and allocation of indirect costs.
- **Various Housing Construction Subcontractors** - Project Director of annual financial reviews of subcontractors to various housing General Contractors.
- **Real Estate Construction and Development Firm** - Project Director of our annual financial audit of one of Sacramento's largest home builders.
- **Savings and Loan** - Managed the real estate portion, including evaluation of REOs, for a large Sacramento-based savings and loan.
- **Real Estate Investment Firm** - Coordinated the review and client assistance for a large real estate advisory and property management firm. This included

development of a system to generate reports for the State of California Public Employee Retirement System, for whom this private firm managed all real estate investments.

- **Coordinator** - tax compliance and planning opportunities for several companies in the real estate industry.
- **Project Director** - in charge of a project designed to establish ownership of properties and allocation of property value amongst members of an affiliated group.

FIRM POSITION

Ms. Harris is the Manager of our Northwest Government Operations practice, specializing in services to state and local governments and non-profit organizations. She has over 15 years of both public and private sector management experience. Her expertise is in long-range strategic planning, management reviews and audits, organizational development, and public policy analysis.

EDUCATION

- Bachelor of Science, University of Michigan, School of Natural Resources, Ann Arbor, Michigan

RELEVANT EXPERIENCE

- City of Seattle. Department of Community Development—Ernst & Young is currently assisting the Department of Community Development in its efforts to define new homeownership strategies for residents of the Interstate 90 corridor. A twelve-member Homeownership Committee comprised largely of neighborhood residents is working with the Department to develop a plan to enable local renters to purchase state-owned homes they now occupy. E&Y is facilitating the community process for insuring neighborhood involvement in the preparation of City and State homeownership plans.
- Project Manager, Seattle Center Strategic Plan, Seattle, Washington. At present, developing a five-year strategic plan with the City Council, management, and employees of this 74-acre park, entertainment and cultural facility. Entails a comprehensive, participatory process to clarify the overall mission and purpose of this City of Seattle Department by developing of goals, objectives, strategies, and action plans. Emphasis on implementation of the strategic plan through the budget and ongoing operating plans.
- Project Manager, Seattle Housing Authority Strategic Plan, Seattle, Washington. Developed a five-year strategic plan with the Board of Commissioners and management team of the Seattle Housing Authority. Clarified and reinforced priority roles and opportunities for the Authority through the development of a shared vision, mission statement, goals, and objectives for the organization. Approach emphasized development of action plans and management tools to integrate agency budget and departmental

- operating plans with strategic plan implementation. Included public meetings and other extensive opportunities for employee and community participation.
- Senior Management Consultant hired to conduct a series of management audits for the City of Bellevue, Washington. First audit analyzed purpose, structure, organization, and operation of the Property Services Division of the Public Works Department. Identified key issues and developed recommendations to maintain and improve service delivery and functions of the Division.
 - Project Manager for a Relocation Study for the Fred Hutchinson Cancer Research Center, Seattle, Washington. Analyzed the necessary requirements for relocating the Administrative and Development Divisions of the Research Center. Approach included interviews, information gathering and analysis of space and work requirements. Developed recommendations to preserve communications and enhance operations during a period of transition to a new location.
 - Co-Manager of project to conduct a comprehensive management audit of the Bremerton Fire Department, Bremerton, Washington. Included analysis of organization structure, efficiency and response times, budget matters and revenue sources, as well as personnel issues. Identified opportunities for improving delivery of services and enhancing Department operations.
 - Joint Project Manager for the development of a Housing Needs Report for the City of Seattle and King County, Washington. Commissioned by the Local Initiative Support Corporation, the Report identified housing types along a continuum, from emergency shelters to independent housing alternatives. The gap between available housing units and need for such housing was identified. Emphasis was placed on the specific needs of special population groups.
 - Consultant, Management Review of Personnel and Fiscal Office, Oregon Research Institute, Eugene, Oregon. Analyzed structure, operations, and personnel classifications of the fiscal office of a large not-for-profit behavioral research organization. Included personal interviews with organization management and Board members, analysis of findings, and development of recommended alternatives.
 - Research Assistant, Management Audits of Fire Department, Police Department, Planning Department, and Mechanical System operations, City of Bellevue, Washington. Collected and analyzed comparative data through interviews, surveys, and literature review. Analyzed functions, organizational structure, number of personnel, and budget allocations for these city agencies. Compiled and analyzed data for reports.

- Coordinator, User Fee Seminar, Portland, Oregon. Conducted seminar on User Fees for local government officials, focusing on alternate ways for city and county governments to recover costs of local services. Included presentation of research findings concerning fee options for specialized services.
- Senior Advisor to member of City Council, Portland, Oregon. Management responsibilities for priority projects in community and economic development, energy conservation, parks and recreation, and public works. Researched, formulated, and implemented city policies, developed recommendations, and presented findings to City Council. Reviewed and prepared city ordinances and state legislation, coordinated press conferences and community workshops, and wrote major speeches. Responsible for long-range staff planning and strategy sessions. Investigated City Council teambuilding opportunities. Served as liaison to city bureaus, community organizations, and businesses. Resolved citizen and constituent concerns.
- Program Manager, Energy Conservation Act, Portland, Oregon. Secured over \$2.5 million for the City of Portland as payment for energy conservation programs and accomplishments under the Northwest Regional Power Planning and Conservation Act. Saved city taxpayers upwards of 50% on associated energy costs.
- Project Manager, Public Involvement Strategy for the Northwest Power Planning Council, Portland, Oregon. Designed and implemented public information campaign concerning the development of the Region's first energy conservation plan strategy. Publicized and coordinated public meeting and workshop series, conducted individual interviews and facilitated community work sessions. Analyzed public opinions and prepared written comment summaries for inclusion in the final plan.
- Project Manager, Waterfront Development, Portland, Oregon. Prepared and implemented a detailed workplan for the revitalization of Portland's downtown riverfront, including major park property development and waterfront tourist attractions. Completed groundwork for the construction of an esplanade park, and a major stream-powered tour boat. Coordinated related policy and land-use decisions, and enlisted private business and community support.
- Project Manager, Methane Gas Pipeline, Portland, Oregon. Initiated public-private partnership resulting in profits to the city from the sale of surplus methane gas. Secured buyer to purchase the gas, a usable by-product of sewage treatment. Led negotiations with all parties, prepared contractual agreements, obtained financing and tax credits, prepared press materials, and monitored project construction. Project received distinguished Governor's Energy Conservation Award.

- **Project Manager, Steam Plant Closure, Portland, Oregon.** Facilitated the orderly closure of a local utility's downtown steamplant operation. Developed the strategy and planned the stages for over 700 customer conversions to new heating systems. Designed a low-interest loan program to assist low-income people and non-profit organizations.
- **Liaison to Central City Plan, Portland, Oregon.** Represented member of City Council during development of comprehensive plan for Portland's central core area. Included participation in steering committee meetings and public workshops. Contributed to development of written policy, goals and objectives to guide future housing, recreation, transportation, natural resources and other facets of urban growth.
- **Facilitator, City of Portland Energy Office, Portland, Oregon.** Designed and facilitated two planning sessions for the staff of the City of Portland Energy Office. Included preparatory interviews and discussions with meeting attendees, agenda setting, and group facilitation. Determined work plan priorities, projects and schedules in the context of meeting local energy policy goals and objectives.
- **Consultant, Portland Energy Conservation, Inc., Portland, Oregon.** Designed and facilitated planning retreat for newly-established, non-profit energy conservation organization. Conducted individual interviews with staff and designed planning agenda. Designed system for ranking work priorities and developed corresponding work plans and schedules.
- **Outreach Services Director, Western Solar Utilization Network, Portland, Oregon.** Responsible for preparation, management, and implementation of annual operating plan for 13-state regional solar energy commercialization program. Facilitated planning sessions for 22-person staff to design innovative strategies for achieving solar energy goals. Allocated \$2.5 million annual budget to priority projects. Included monitoring and evaluation of program effectiveness using work plans and quarterly reports. Represented organization during federal and regional policy, planning and budget discussions.
- **Conservation Program Supervisor, Oregon Department of Energy, Salem, Oregon.** Responsible for preparation, management and implementation of annual state energy conservation plan. Included development of statewide strategies to achieve federal conservation goals. Designed and facilitated strategy sessions for conservation staff to determine program and budget priorities. Included development of work plans and quarterly reporting systems. Designed two strategic planning retreats for all department managers, and coordinated preparation and follow-up with management consultant and facilitator.

- Project Director, Public Information Campaign, Oregon Department of Energy, Salem, Oregon. Identified constituency impacted by the passage of seven new energy laws and designed statewide outreach and marketing program. Designed and facilitated small group workshops and two statewide conferences geared toward public acceptance and participation in new incentive programs.

FIRM POSITION

Ms. Hoe is a Manager in our West Region Management Consulting Group. She has extensive experience in developing financial projections using computer modeling techniques. She also brings direct experience in working with housing issues and related public policy.

EDUCATION AND PROFESSIONAL ACHIEVEMENTS

- Bachelor of Arts Degree with honors from the University of Hawaii
- Master of Business Administration Degree from Kansas State University

RELEVANT EXPERIENCE

- Project Manager in an engagement to assist in reorganizing the Hawaii Housing Authority (HHA) into two separate entities: HHA, and the Housing Finance and Development Corporation. Assistance included assessing the existing operations and organization, developing reorganization alternatives, preparing detailed position organization charts and cost estimates, preparing revised functional statements and the formal memorandum requesting reorganization approval from the Governor, and suggesting changes to job classifications for selected positions.
- Other engagements for the Hawaii Housing Authority (HHA) and the Housing Finance and Development Corporation (HFDC) include:
 - Project Manager on a project with the Hawaii Housing Authority (HHA) to recommend an organizational structure and staffing for housing financing programs designated to fund single family mortgages.
 - Project Manager to conduct a comprehensive management review of the Hula Mae Loan Program. The objective of the review was to provide the Board of Commissioners and HHA management with an assessment relating to the implementation and administration of the Hula Mae Program. During this engagement, we identified several areas requiring

attention, developed key questions relating to monitoring and internal control, and reviewed management and lender reporting systems.

- Project Manager for the detailed management review of the Land Reform Branch of the HHA. The objective of this engagement was to determine how well the program's objectives were being met as well as a general operating and performance review of the Land Reform Branch. Our review subsequently led to another engagement which focused on the development of a procedural guide which documented operational procedures followed in all aspects of the various programs conducted by the Land Reform Branch.
- Project Manager for an engagement involving conducting a performance review of the Development Branch. The objectives of this project were to determine how well the branch was performing and to identify and make recommendations to improve the management and control of development projects, including a review of existing systems.
- Project Manager for an engagement to update the Accounting Manual for the Finance and Accounting Office of the HHA. This project included a review of existing accounting systems documentation, identification of areas requiring updating and documentation of policies and procedures for those areas to reflect current tasks and functions performed.
- Lead Consultant to assist a local real estate developer in the review of the feasibility of the first large-scale mixed use complex to break ground in the Kakaakosection of Honolulu. The first phase of this \$100 million development resulted in construction of seven low-rise buildings totaling over 510,000 square feet for office and commercial use. As part of our engagement, we reviewed projections of cash flow, tax benefits and profit and loss from operations for eight years.
- Consultant on our engagement with the Hawaii High Technology Development Corporation and the County of Hawaii to develop a marketing strategy and plan for the proposed Hawaii Ocean Science and Technology Park. The project involved identification of potential tenants, determination of demand, price strategies, as well as development of an overall strategy for marketing the Park.
- Project Consultant to conduct an evaluation and analysis of the State of Hawaii's organization/reorganization review processing system for the Department of Budget and Finance (B&F). The project involved: reviewing statutes and administrative directives governing organizational change; conducting interviews with all State executive departments to discuss their internal procedures and experiences with B&F's review process and the requirements of the Department of Personnel Services for implementing organizational changes; analysis of B&F internal records of organizational change reviews conducted; identification of improvements to the existing system; development of

a new administrative directive, proposal documentation and procedures guide for use internally and by executive departments.

In a separate follow-up engagement, we are providing assistance to the Division in developing specific classification specifications and position job descriptions for new classes/positions in order to implement the reorganization of the Division.

- Project Manager for a project for the Department of Human Services to provide assistance in developing alternatives for an overall reorganization of the Department including all programs on Oahu and the neighbor islands and all staff office. We conducted interviews with management throughout the Department and on the neighbor islands, developed an explicit set of reorganization criteria, and developed alternative conceptual organization structures. Following selection of a conceptual design by the Department, we developed preliminary position organization charts and developed estimates of the impact on the Department's budget.
- Project Consultant for a project to provide assistance to a local real estate trading company in the design and implementation of a property management information system to manage their portfolio of properties.
- Project Consultant on a City and County of Honolulu project to conduct a feasibility study for contracting out public services to private companies. The scope of work included a review of all services performed by City personnel and a joint selection of five specific services identified as having the potential for being contracted out. Then, a detailed analysis of the five services was performed from which statement of work, quality assurance plans and cost comparisons were prepared.

**STATE OF ALASKA
LEGISLATURE**

**HOUSING FINANCE
TASK FORCE**

**Evaluation of Policy Options
Concerning the Future of the
Alaska Housing Finance
Corporation**

January 12, 1990

Ernst & Young

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Sacramento, California 95814
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Fax (916) 443-0774

January 12, 1990

Representative C. E. Swackhammer
Chair, Housing Finance Task Force
Alaska State Legislature
Room 521, Capitol
P. O. Box V
Juneau, Alaska 99811

Dear Representative Swackhammer:

Ernst & Young is pleased to present this Draft Final Report on our analysis of the Alaska Housing Finance Corporation's future role in providing financing for Alaskan homebuyers. An Executive Summary is presented in this report which summarizes the background for this study, and highlights our findings.

We wish to thank both you and your Legislative Assistant, Mr. Carl Nickel, for not only your own continued support throughout this study but for the help you provided us in identifying and obtaining assistance from individuals throughout State Government. We owe Mr. Nickel a special thanks, as he was especially helpful in our research efforts and coordinating many requests for information.

Members of the Housing Finance Task Force, including Vice Chair Senator Patrick Rodey and Representative Randy Phillips, also provided us advice during the study. We wish to thank the members.

During this study we have enjoyed the full cooperation of AHFC's Board Chairman, Mr. Robert Mintz, and AHFC's Chief Executive Officer, Mr. Thomas Behan. We also wish to express appreciation to the many AHFC management and staff for their help, advice, and cooperative spirit during this study. This especially includes Mr. Mark Cameron and Mr. Paul Kapansky. Without their availability during this study's compressed time schedule, completing this project would have been impossible.

This study's schedule required we complete the final report within 42 working days of project startup. Although the schedule was abbreviated, we are confident that our analysis of policy options focuses on all the important issues raised during the study.

Representative Swackhammer
January 12, 1990
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We look forward to presenting our findings to the Task Force in person. Our Project Director, Dr. James A. Gibson, members of the project team (Messrs. Edward R. Kaempf, John Michelmore, and Vere Harlow), and our legal subcontractor (Delaney, Wiles, Hayes, Reitman & Brubaker, Inc.) are all prepared to address any comments or questions which the Task Force, AHFC, or the interested public may have concerning this report.

Very truly yours,

cc: Senator Patrick Rodey, Vice Chair
Senator Rick Halford, Member
Representative George Jacko, Jr., Member
Representative Randy Phillips, Member
Senator Mike Szymanski, Member

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EXECUTIVE SUMMARY

Ernst & Young

EXECUTIVE SUMMARY

The State of Alaska Legislature established the Housing Finance Task Force in 1989 to review and recommend changes in publicly-assisted residential finance programs, including those loan programs managed by the Alaska Housing Finance Corporation (AHFC). This study was commissioned to provide information regarding potential changes in AHFC programs, and included addressing the following concerns of the Task Force:

- Availability of a return on the State's \$1 billion investment in AHFC, without impairing AHFC's financial condition
- Affect on AHFC's financial standing from a change in the subsidy policy
- Impact on AHFC's financial position and on the State's housing market, due to changes in the AHFC subsidy and/or a return of AHFC to its original legislative intent
- Feasibility of "privatizing" AHFC.

The results of our analysis are summarized in following subsections of this Executive Summary:

- *AHFC Present Activities*
- *AHFC Financial Position and Availability of Funds*
- *Policy Option to Change AHFC Subsidy*
- *Policy Option to Return AHFC to Original Legislative Intent*
- *Policy Option to Change Ownership of AHFC*
- *Conceptualization of an Idealized AHFC.*

A. AHFC PRESENT ACTIVITIES

The Legislature created AHFC in 1971 to provide housing for low-income Alaskans. Since that time, the Legislature has progressively expanded AHFC's role, where the Corporation now provides financing for the varying housing needs of all

qualified Alaskan homebuyers. AHFC's core activities are selling bonds and purchasing home loans originated by Alaskan lending institutions.

During fiscal year 1988/89, AHFC purchased 2,740 new loans. One half of these new loans were purchased under the tax-exempt, first-time homebuyers program. In addition to purchases of new loans, AHFC also refinanced 6,316 existing AHFC loans in the same fiscal year. In total, AHFC purchased approximately 9,000 loans totalling almost \$900 million.

Over the past five years AHFC's purchases of new loans have dramatically declined while refinancings have significantly increased. In total, AHFC loan purchase activity has increased slightly in the past five years.

B. AHFC FINANCIAL POSITION AND AVAILABILITY OF FUNDS

In June of 1980, legislation was passed which allowed the State to subsidize interest rates on mortgage loans purchased by AHFC. In connection with the legislation, the State contributed monies to AHFC to provide for the overcollateralization of these loans so that qualified residents could obtain interest rates on mortgages below market rates.

Through fiscal year 1983/84, just over \$1 billion was contributed by the State to AHFC. Of this amount, \$808 million was contributed for the overcollateralization purposes described above. The remaining \$225 million was provided for various other specifically identified purposes. The Corporation has not required a direct State capital infusion since 1984.

The Corporation's ability to operate as a going concern depends on both its liquidity and solvency. The concept of liquidity includes AHFC's ability to meet necessary cash flow payments. Currently, the Corporation is experiencing liquidity problems as reflected in the most recent year's net loss of income. The concept of solvency includes AHFC's equity strength and general credit worthiness. The financial community still generally views the Corporation as financially stable because of the solvency of its balance sheet.

However, further extraction of Corporation assets, in any form, may have a serious impact on Corporate financial health.

Under the current AHFC practice of using general obligation financing, if funds were appropriated from the Corporation, a precedent would be set and the bond programs would likely be less solvent and credit worthy. Additionally, if funds were withdrawn, the State could conceivably run the risk of being held responsible for any resultant future losses in the bond programs.

AHFC had retained earnings of over \$300 million as of June 30, 1989. However, these cumulative earnings were principally a result of interest earned on State contributions, and that without prior State contributions the Corporation would reflect a deficit to-date.

As of June 30, 1989, AHFC had \$519 million of net Corporate assets not pledged as collateral for specific bond indentures. The \$519 million equity balance is only as strong as the Corporation's assets. Based upon our review, it appears that a fairly significant portion of these assets may not be liquid, if collectible or realizable at all. In addition, a significant portion of the mortgage loans maintained in the Corporate Operating and General accounts were either already pooled, or scheduled for pooling, to be subsequently pledged to a bond issue. Although these receivable balances (pooled loans) represent valid and collectible assets, the principal intent is to place these balances into a bond issue. Finally, AHFC's short-term borrowing agreements require minimum equity balances be maintained, which AHFC has met.

Therefore, after deducting from the \$519 million equity balance those assets considered non-liquid, and adjusting for current borrowing arrangements, we estimated AHFC had only \$10 million in unrestricted net liquid assets as of June 30, 1989. Virtually all of AHFC's \$519 million equity balance is thus restricted.

C. POLICY OPTION TO CHANGE AHFC SUBSIDY

For virtually all AHFC loan programs, a subsidy is provided to the borrower if the cost of AHFC's funds used to purchase a loan is greater than ten percent (nine percent to veterans). By law, this subsidy cannot exceed three percent. With the current level of

market interest rates, there is no subsidy on tax-exempt programs, an approximate 0.75 percent subsidy on the taxable program, and an estimated two percent subsidy on the Home Owners' Assistance Program.

We believe the subsidy program is presently not desirable because it presents a major drain on increasingly scarce AHFC assets and it prevents the re-entry of outside capital into the Alaska market. The cessation of the subsidy will not only make possible some long-term future return on prior State appropriations, it also will provide a great stride towards long-term fiscal responsibility for the Corporation.

Furthermore, a unique window of opportunity exists now to eliminate the subsidy because AHFC's cost of funds is generally below the ten percent threshold rates (although some slight subsidy is in effect for the taxable program), demand for mortgages is low as compared to the last couple of years, the price of housing appears to be at or near the bottom, and market interest rates are expected to remain stable in the short-term.

However, we wish to emphasize that elimination of the subsidy as of a set date (June 30, 1990) is only appropriate under the conditions noted above. A significant time delay in implementation could result in changed market and economic circumstances. Therefore, as a possible backstop, a ratchet mechanism may be wise to consider. That is, eliminate the subsidy through revised legislation as of a set date (again June 30, 1990 seems to be appropriate), but provide for the ability to extend this date if conditions are not actually favorable at that time.

We addressed the impact of changing the subsidy as to its effect on the housing market, AHFC, and the State (appropriated funds). Below is a summary of what we determined to be the impacts:

Market: We addressed the impact to the housing market under three separate circumstances, and determined that only in a worse case scenario (interest rates increasing significantly during the transition period) would any negative effects likely to occur. In this event, some form of ratcheting (such as extending the effective date of eliminating the subsidy until conditions were more favorable or phasing-out the subsidy over time)

would eliminate this problem. However, based on projected interest rates, we do not currently believe this to be the likely scenario.

AHFC: Either the elimination or phase-out of the interest rate subsidy will provide for a financially stronger Corporation and no negative effects to Corporation bond or loan covenants, or bond ratings from credit agencies. Without the interest rate subsidy for the taxable programs, the Corporation will lose much of its competitive market advantages over the private sector. In the long-term, this could lead to a healthier competitive capital market environment.

Without any future changes to the subsidy, and no further State capital injections, we have projected that the Corporation will have a major decrease in its unrestricted net liquid assets over the next five-year period. Because of the immaterial amount of total unrestricted net liquid assets available as of June 30, 1989 (only \$10 million), any substantial decrease in unrestricted assets will have the following two important negative impacts on the Corporation's short-term borrowing arrangements:

- If minimum unrestricted net liquid asset balances are not maintained, the Corporation may be in a default position on its working capital debt
- If net losses resulting from bond programs continue in the future, the critical short-term Corporation borrowing arrangements necessary for day-to-day operations may be severely jeopardized.

State Appropriations: Because elimination of the subsidy will provide for a more financially solvent AHFC, this may be one of the few ways for the State to ever receive a return on their substantial contributed capital. This is assuming the AHFC has to reach at least break-even operations in order to be able to return a dividend from operations to the State.

The net effect over a five-year period of eliminating the subsidy may range from \$43 million to \$91 million, depending on market conditions. In summary, elimination of the subsidy will reduce costs, either to the State or to the Corporation, by these substantial amounts.

D. POLICY OPTION TO RETURN AHFC TO ORIGINAL LEGISLATIVE INTENT

The original legislative intent was for AHFC to provide housing for low- to moderate-income individuals. Based on this interpretation of intent, we made a determination that the taxable program and the second mortgage program did not meet original legislative intent. Because the magnitude of the second mortgage program is negligible, we then estimated the impact of phasing-out the taxable program on Alaska's housing market and on the financial position of AHFC and the State.

The effect of phasing-out the taxable program on AHFC's financial position is measured by the change in unrestricted net liquid assets. The potential change in these assets arises from two sources:

- First, to the extent that loans under the taxable program are subsidized, terminating this program means that further subsidies are unnecessary and these assets, therefore, should increase
- Second, because bond issues supporting the program are overcollateralized as a credit enhancement measure, terminating this program frees up assets which would otherwise be pledged as collateral.

The additive effect (over and above elimination of the subsidy) of eliminating the taxable program as of June 30, 1990, would be to reduce by \$45 million the level of unrestricted net liquid assets otherwise required over the five-year period of fiscal years 1990 through 1994.

Due to the generally perceived role of AHFC, its long-term institutional relationships with other secondary market purchasers, and the continuing importance of the taxable program to the Corporation's REO sales, any phase-out of the program should proceed carefully and take place over an extended period of time. A careful implementation of the phase-out will avoid market disruption because if any disruption does become evident, mechanisms will then be in place to slow the phase-out and stabilize the situation.

In summary, AHFC programs supported by taxable bonds compete directly with private sector sources of financing. The AHFC, in absence of the subsidy, adds no unique value to these taxable mortgage programs, over and above the private sector. In addition, AHFC is not serving primarily low- to moderate-income persons with its taxable programs. However, it should be clarified that even though AHFC programs supported by taxable bonds appear to be presently expendable, we are not suggesting that this occur. These taxable programs must remain accessible to AHFC, but only on an "as needed" basis.

E. POLICY OPTION TO CHANGE OWNERSHIP OF AHFC

The legislature requested an evaluation of the potential for "privatizing" all or a portion of AHFC. Typically, privatization has been an arrangement in which the private sector supplies goods, facilities, and services that have been traditionally provided by the public sector. However, in the case of the Housing Finance Task Force request, this policy option actually extends to selling all, or a portion, of the Corporation's assets and related liabilities to a third party.

The sale of AHFC assets is probably not feasible for several reasons:

- There is little or no interest in the purchase
- The price paid could be far below State investment in AHFC
- Legal problems may exist with respect to the Alaska constitution and various bond covenants.

However, contracting out of the REO disposition process may be a viable option, and could offer cost-savings to AHFC. The REO functions performed are commercially available, non-governmental in nature, somewhat routine, and easily defined in terms of workload. A private firm(s) could avoid many government restrictions which presently hamper the AHFC REO disposition process, such as civil service requirements, procurement restrictions, and difficulty in authorizing needed additional staff positions. Competitive bidding for providing the services could lower the cost of disposing of REO properties. If AHFC used the private sector, rather than its own employees, to deliver the REO service, it would not have to give up its responsibility to provide the service.

F. CONCEPTUALIZATION OF AN IDEALIZED AHFC

We recommend the Legislature consider a new formal mandate for AHFC in order to redefine its role in the years ahead. We believe that the role of AHFC, as described below, makes good public policy sense and serves to stabilize Alaska's cyclical housing market, both in good times and bad.

The net effects of the proposed legislative mandate would be positive to the State, AHFC, and the Alaska real estate market, and would make AHFC a more effective organization in carrying out public policy. We recommend, therefore, that the Legislature consider the following long-term mandates:

- Focus AHFC'S role on low- and moderate-income housing, but retain AHFC in a "backstop role" to provide taxable mortgage financing, as required. This will help stabilize the Alaska housing market in the long-term
- Restructure AHFC's financing mechanisms to concentrate on tax-exempt revenue bonds. This will be consistent with its focus on low- and moderate-income housing and holds the long-term potential of freeing up part of AHFC's capital base
- Enable AHFC (through elimination of the subsidy and by operations improvements) to operate on a break-even or profitable basis. This will provide funding for the housing backstop role and provide the potential to pay dividends from operations to the State
- Make AHFC more independent of close legislative control. This will promote both efficiency of operations and the ability to respond to market conditions based on long-term legislative policy
- Require AHFC to pay operating dividends to the State. This is a reasonable condition considering the large investment already made by the State
- Protect AHFC's capital base and avoid new capital infusions by the State. This will protect AHFC's financial integrity. Also, because AHFC will be breaking even or making a project, no new capital will be required.

SECTION I

**OBJECTIVES AND SCOPE
OF EVALUATION**

Ernst & Young

I. OBJECTIVES AND SCOPE OF EVALUATION

The State of Alaska Legislature established the Housing Finance Task Force (Task Force) in 1989 to review and recommend changes in publicly-assisted residential finance programs, including those loan programs managed by the Alaska Housing Finance Corporation (AHFC). The Task Force issued a Request for Proposals to assist in the analysis and evaluation of the financial condition of the AHFC as it pertains to the Corporation's loan programs. Ernst & Young's response to the RFP was presented in its proposal dated October 20, 1989. A contract with Ernst & Young to perform the study was approved November 9, 1989.

The remainder of this introductory section is organized under the following headings:

- *Background of State of Alaska Housing Finance Task Force*
- *Objectives of Evaluation*
- *Scope of Evaluation*
- *Study Tasks and Schedule.*

Subsequent sections of the report are organized as follows:

- **Section II Background of Alaska Housing Finance Corporation**
- **Section III Present Financial Position of AHFC**
- **Section IV Present Economics of Alaska Housing Market**
- **Section V Description of Policy Options and Evaluation Methodology**
- **Section VI Policy Option to Change AHFC Subsidy**
- **Section VII Policy Option to Return AHFC to Original Legislative Intent**
- **Section VIII Policy Option to Change Ownership of AHFC**

- **Section IX Conceptualization of an Idealized
 AHFC**

Following Section IX are five appendices:

- **Appendix A Selected AHFC Operational Concerns**
- **Appendix B Projections of AHFC Unrestricted Net
 Liquid Assets**
- **Appendix C Survey of the Alaska Real Estate Market**
- **Appendix D Evaluation of Housing Assistance Fund
 Mortgage Loan Purchase by AHFC**
- **Appendix E Legal Review by Delaney, Wiles, Hayes,
 Reitman, & Brubaker, Inc.**

**A. BACKGROUND OF STATE OF ALASKA
HOUSING FINANCE TASK FORCE**

The Alaska State Legislature has provided for a substantial public financing system to assist homebuyers. Through the Alaska Housing Finance Corporation, the Legislature has provided more than \$1 billion of capital, as well as bonding authority, to initiate and sustain a large variety of residential loan programs.

Concerned over the future of the State's significant investment in AHFC, particularly in light of recent economic hardship in the State, the 1989 Legislature created the Housing Finance Task Force through Legislative Resolution Number 54. The charge of the Task Force was to review and evaluate the financial condition of AHFC's residential loan programs. Specifically, the Legislature requested the Task Force to:

- Summarize the financial condition of AHFC's residential loan programs, guidelines governing the loan programs, and the status and condition of any bonds sold to capitalize these loans
- Evaluate options and implications for restructuring, reducing the size of, privatizing, or phasing out AHFC, and to evaluate the potential return on the capital invested in AHFC by the State
- Review a proposal which would require AHFC to purchase mortgage loans from the Housing Assistance Loan Fund, and determine whether the purchase should be at par value or market value.

The Housing Finance Task Force was comprised of six members of the State Legislature, including three members of the Senate and three members of the House of Representatives. The Task Force had an advisory group composed of the Director of the Rural Development Division of the Department of Community and Regional Affairs, and the Executive Directors of AHFC, the Alaska State Housing Authority, and the Alaska Housing Market Council. The Housing Finance Task Force was to dissolve when the Task Force submitted its report to the Legislature.

B. OBJECTIVES OF EVALUATION

The primary goal of this study was to provide information and assistance to the Task Force, the State administration, and AHFC board and management in their determination of AHFC's future role in providing financing for Alaskan homebuyers. This included addressing the following concerns of the Task Force:

- Availability of a return on the State's \$1 billion investment in AHFC, without impairing AHFC's financial condition.
- The affect on AHFC's financial standing from a change of the subsidy program
- The impact on the State's housing market due to changes in the AHFC subsidy and/or AHFC programs.

In meeting the needs of the Task Force, the following were established as specific goals of the study:

- Determine the status of AHFC programs, including number of participants, target population, current status of loans outstanding, and financial condition
- Determine status of bond programs capitalizing the loan programs
- Assess restrictions on the State's original \$1 billion investment in AHFC
- Evaluate the history and present economics of the State's housing market, and AHFC's role in the housing market
- Evaluate the impact on the State's housing market, AHFC financial position, and State funds from implementation of various options which change existing AHFC programs and ownership
- Determine the feasibility and impact of a proposal to purchase mortgage loans administered by the Housing Assistance Division (HAD) of the Department of Community and Regional Affairs.

C. SCOPE OF EVALUATION

The primary focus of this study was an analysis of three basic policy options regarding the long-term role of AHFC in providing financing for homebuyers, and a determination of the implications of these options on the State's housing market and financial condition of AHFC. The policy options originally were outlined by the Legislature in its formation of the Task Force. Working with the Task Force, Ernst & Young then refined these alternatives to the following three basic policy options:

- Terminating the subsidy now available to Alaska homebuyers, either by a one-time elimination or gradual phase-out
- Returning AHFC to its original charge of primarily providing residential housing financing for low- to moderate-income Alaskans
- Changing the ownership of AHFC, which could involve the selling of some or all Corporation assets.

In addition to addressing the above three basic policy options concerning the future of AHFC, Ernst & Young also spent a considerable amount of effort addressing the legislative question of the present availability of, and amount of, AHFC net unrestricted assets which could be returned to the State.

This study impartially evaluated future policy options for the AHFC. The evaluation primarily considered financial impacts on AHFC and economic impacts to the Alaskan housing market. Minor emphasis was placed on social or welfare considerations as it was assumed that these issues would be debated in the legislative process. The findings in this report are presented independent of AHFC management and Task Force member positions. However, we did obtain considerable input from both AHFC management and Task Force members during the course of the study.

The scope of this study did not focus on review of day-to-day AHFC operations or cash management and financial systems. However, during the course of this policy review areas of concern were noted which are briefly commented on in Chapter II, "Background of AHFC."

The analysis of each policy option required an examination of its impact on the State's housing market, considering the significant role AHFC now plays in residential housing. The analysis also examined the impact of each policy option on AHFC's financial position, specifically the expected change in the Corporation's unrestricted assets over the next five years. Finally, the analysis determined what impact each option would have on the State's General Fund, whether a return on capital originally invested by the State was possible, or if additional State funds would be needed by AHFC as a result of the policy change.

In addition to an economic and financial analysis of each policy option, the study also obtained selected legal advice regarding the implementation of each option. Legal questions addressed included the following:

- What is the legal definition and structure of AHFC?
- What legal steps must be taken to modify the subsidy?
- Can the State legally expropriate funds from AHFC? Is AHFC required to provide a return on the State's capital investment in AHFC?
- Will an expropriation of Corporation funds by the State create an obligation of the State of Alaska for ultimate repayment of AHFC bonded indebtedness?
- Are there any significant legal issues which constrain AHFC from selling any, or a portion of, its assets?
- Are there any legal constraints to establishing a new agency to provide for low- to moderate-income housing as originally intended by the legislature? Can specific bond programs be eliminated?
- Can AHFC issue revenue bonds?

Ernst & Young retained as a subcontractor the Anchorage law firm of Delaney, Wiles, Hayes, Reitman & Brubaker, Inc. to perform this legal review. Their letter report addressing these legal issues is presented as **Appendix E** to this report.

The analysis in this report was based on an internal review of AHFC programs, and an external review of the present housing market in Alaska. Numerous interviews were conducted with AHFC staff, management, and board; Task Force members; Alaska State Government representatives; banks and other financial institutions both within and outside Alaska; selected financial intermediaries (Federal National Mortgage Association, Federal Home Loan Mortgage Corporation, etc.); real estate brokers and developers, title companies, rating agencies and mortgage insurers; Alaska Housing Market Council; and University of Alaska and Alaska House and Senate researchers. The analysis included a detailed review of the financial position of AHFC, including requirements of bond covenants and short-term borrowing agreements.

This study did not involve construction of detailed econometric or financial models to complete the analysis. Rather, the analysis was kept at a macro level, and modelled only significant factors influencing AHFC liquidity and the State's housing market. These factors included general demand for home loans in Alaska, interest rates, and over-collateralization needed for the subsidy and for maintaining AHFC bond credit rating.

D. STUDY TASKS AND SCHEDULE

This project began November 9, 1989 with a kickoff meeting with the Task Force in Anchorage. With the due date for a final report already established by the Legislature, the study had just forty-two (42) working days to complete this report. Therefore, study emphasis was placed on an internal analysis of AHFC liquid assets and an external, macro-economic analysis of the State's housing market. On December 6th, Ernst & Young conducted a status meeting for the Task Force in Anchorage, providing findings to-date regarding AHFC financial position and recent trends of the Alaska housing market.

Other specific tasks which were completed in this study included the following:

- Initiate and Administer Project
- Assess Current Status of AHFC Financing Programs
- Determine Financial Requirements of Bond Covenants
- Evaluate Present Financial Position of AHFC
- Assess Historical and Existing State Housing Market
- Interview Industry Representatives
- Define Policy Options Regarding the Future Role of AHFC in Providing Housing in Alaska
- Develop Evaluation Methodology and Criteria
- Assess Policy Option Impact on AHFC Financial Position
- Assess Policy Option Impact on Housing Market
- Assess Policy Option Impact on State Funds
- Assess Legal Issues Which Impede or Facilitate Each Policy Option
- Evaluate Proposal Requiring AHFC to Purchase Housing Assistance Division (HAD) Mortgage Loans
- Summarize Findings
- Prepare Draft and Final Report
- Present Results of Study to the Housing Finance Task Force.

SECTION II

**BACKGROUND OF ALASKA
HOUSING FINANCE CORPORATION**

Ernst & Young

II. BACKGROUND OF ALASKA HOUSING FINANCE CORPORATION

In this section we provide a historical review of the Alaska Housing Finance Corporation, as well as a description of each housing program now administered by the Corporation. This background information is organized in the following subsections:

- *AHFC Enabling Legislation*
- *Evolution of AHFC*
- *Existing AHFC Financing Activities*
- *Existing AHFC Programs.*

During the course of performing our study of AHFC programs, we noted several issues and possible concerns which we summarize in **Appendix A** to this report.

A. AHFC ENABLING LEGISLATION

The Alaska Housing Finance Corporation was created by the State Legislature in 1971 as a public corporation within the Department of Commerce¹ but having a legal existence independent of and separate from the State. The Legislature determined that the private sector and existing federal government programs were inadequate in meeting the housing needs of low-income individuals. The AHFC was created to provide affordable housing for low-income residents, and was given the authority to issue bonds to carry out its programs.

The newly created AHFC was given a broad range of powers to provide low-income housing, including the following:

- Make or participate in construction loans to sponsors, developers, and builders
- Make or participate in the making of mortgage loans to sponsors, developers, and builders
- Purchase mortgage loans on the secondary market
- Make partial rental or mortgage interest payments
- Make loans from the Housing Development Fund (created by the enabling legislation)
- Issue bonds as a means of financing programs.

The Corporation eventually selected the actual scope of its activities, limiting its initial activities to the purchase of federally-insured² mortgages (secondary market purchases) originated and serviced by private lending institutions. Construction and direct mortgage lending were viewed as being in direct competition with the private sector. In addition, the AHFC decided not to provide rental subsidies because the Alaska State Housing Authority already had a rental subsidy program.

¹ The name of the Department of Commerce was later changed to the Department of Revenue.

² Most loans purchased by the AHFC from 1972 to 1975 were loans insured by the Federal Housing Administration or the Veterans Administration.

The purchase of loans through the secondary market would be financed by the sale of tax-exempt bonds, which provided for a mortgage loan interest rate that was below market rates. The enabling legislation did not appropriate any State funds to AHFC for financing the housing programs.

B. EVOLUTION OF AHFC

Since 1971, there have been several significant changes to AHFC, most of which have generally expanded the market which the Corporation serves, while leaving unchanged its core activities of selling bonds and purchasing mortgage loans. Legislative actions removed income limits, increased loan limits, and created a special interest rate subsidy so many Alaskans could afford to buy their own home. Additional programs allowed for more loans for rural and mobile homeowners, provided additional subsidies to low-income borrowers, and allowed AHFC mortgage holders to refinance their loans in order to lower payments and avoid delinquencies.

In the subsections which follow, we briefly summarize milestones in the evolution of AHFC.

1. Changes From 1972 Through 1979

In May, 1972, prior to the first bond issue in October, 1972, the legislature expanded AHFC's programs to include moderate-income individuals, as well as persons living in remote, underdeveloped, or blighted areas. The criteria qualifying such individuals was left to AHFC, although all individuals still had to have incomes sufficient to qualify for federal government mortgage insurance or guarantees because AHFC was only purchasing federally-insured mortgages.

In 1975, the Legislature created the State Mortgage Insurance Fund which allowed the Corporation to purchase loans which were not federally-insured. This allowed purchase of conventional loans (i.e., not FHA or VA insured), which was the majority of new home loans. While income limits and maximum loan amounts remained unchanged, the number of eligible borrowers in the state increased. Mortgages held by AHFC went from 2,161 at fiscal year end 1974 to 4,965 at FY year end 1977. The insurance fund lessened the risk to bondholders and improved the marketability of the insured mortgage bonds sold to finance purchase of mortgage loans.

During 1978 and 1979 the Legislature created a rural housing program to be administered by AHFC. Although AHFC's insured mortgage program already authorized loan purchases in rural areas, relatively few loans were purchased. The Legislature requested AHFC make a special effort in making mortgage loans in rural areas, and appropriated \$13 million to fund the program. The AHFC operated two rural programs from 1979 until 1982, when the programs were transferred to the State Department of Community and Regional Affairs.³

Beginning in 1979, AHFC developed a mobile home loan program at the request of the Legislature. Mobile homes were less expensive than other housing types, and were viewed as needed during a period of higher population growth and general housing price inflation. However, financial institutions treated mobile homes as personal, not real, property. Loan terms for mobile homes resembled consumer loans, with higher interest rates and shorter terms than real estate loans. This caused problems for low- and moderate-income buyers, a potentially large segment of the population. This new program was initially funded by State appropriations.

2. Changes In 1980

During 1980, State and Federal legislation resulted in significant changes to AHFC programs and operations. The legislation expanded AHFC's housing programs to all owner-occupying purchasers (not just low- to moderate-income individuals) and increased the State costs of these programs. These changes are summarized below:

- *State Legislation*

- Subsidized interest rates were established at ten percent on the first \$90,000 of all loans (nine percent for veterans), regardless of AHFC's cost of funds

³ One rural program provided for State funded mortgage title insurance and mortgage hazard insurance accounts, enabling AHFC to provide financing in those areas where title to the land may still be subject to conveyance under the Native Claims Settlement Act or where commercial hazard insurance is effectively unavailable due to cost. The second rural program provided for financing of rental housing in rural areas, by not requiring owner occupancy of the property.

- Borrower income limits were removed, opening up AHFC programs essentially to all Alaskans
- Loan limits were increased
- The Home Ownership Fund (HOF) was established which reduces the monthly mortgage payment a borrower is required to pay. The loan is written at the current interest rate but the borrower was required to pay a maximum of 25 percent of their annual income, with the AHFC paying the difference⁴. Because of the additional subsidy, AHFC subsequently developed qualifying criteria including the amount of total assets based on family size, and sales price limits
- Refinancing loans for home improvement were allowed
- A program for financing mobile homes in trailer parks was funded, providing for 20 year (or less) loan terms
- A rural housing program was funded
- For the first time, AHFC's operating budget was to be subject to the Executive Budget Act for fiscal years beginning June 30, 1982. This provision required that AHFC's budget be approved by both the Legislature and the Governor, meaning more direct control over the level of AHFC activities.

- *Federal Legislation*

- The Mortgage Subsidy Bond Tax Act of 1980 was enacted, restricting the use of tax-exempt bonds to first-time home buyers and limiting the amount of tax-exempt mortgage revenue bonds which could be sold in the State of Alaska to \$200 million per year. This limited the issuance of AHFC Home Mortgage Bonds, also known as AHFC's first-time home buyer bonds.

In order to implement the new programs, the Legislature appropriated to AHFC more than \$500 million in cash and residential mortgage loans held by the State General Fund. Earnings on the appropriated mortgage loans and a portion of the cash were utilized

⁴ The HOF program has changed since 1980, where the amount of the subsidy is now based on a borrower's income in an amount that would reduce the monthly payment to 28 percent of their monthly income or a six percent interest rate loan, whichever is greater. The amount of the computed monthly payment not paid by the borrower is paid directly by AHFC each month to the seller/servicer.

to subsidize the difference between the legislatively mandated interest rate and the Corporation's cost of funds.

The Corporation also implemented the Pledged Account Mortgage (PAM) program in 1980 as a means of offering a type of graduated payment mortgage plan. With a PAM, the borrower places a portion of the down payment in an interest-bearing savings account which is pledged as additional security. Money is drawn out of the account each month to pay a portion of the mortgage payment in the early years of the loan. Because the borrower is qualifying on a lower first-year payment, borrowers can purchase a larger home in anticipation of their income increasing.

3. Changes From 1981 Through 1985

The AHFC's volume increased sharply in 1981 as a result of changes made through 1980. According to AHFC, by 1981 the Corporation was purchasing eighty-five percent of all mortgage loans made in the State. In FY 1979/80, AHFC held 15,879 mortgages in its portfolio. In FY 1981/82, after all changes were implemented, AHFC held 29,037 mortgage loans.

The original structure of the interest rate subsidy, provided for ten percent loans to the majority of applicants. As a result, AHFC was subsidizing many loans purchased in 1980 and early 1981 at up to six percent below the Corporation's cost of borrowing money. Recognizing this uncapped subsidy, the Legislature in 1981 changed the subsidy program, limiting the subsidy to a maximum of three percent (four percent for veterans) below AHFC's cost of borrowing.

In 1981, AHFC issued taxable bonds (the first public agency to do so) in order to meet the growing demand for AHFC funded home loans. With the federal cap on tax-exempt debt, the AHFC had to develop other sources of financing the increased loan demand. The taxable debt increased the Corporation's overall costs of borrowing. The cost of the taxable State Assisted Mortgage (SAM) Bonds reached 18.8 percent (SAM Series D and E).

Also in 1981, the Legislature required a "due on sale" provision for all loans; in effect, AHFC loans were not assumable. This was established partly so that new buyers would have to pay current interest rates rather than the more heavily subsidized earlier rates. In 1986, loans became assumable.

In 1982, legislation transferred AHFC's rural programs to the Department of Community and Regional Affairs. In addition, two new programs were implemented in fiscal year 1982:

- Second Mortgage Loan Program, which allows a borrower to: (1) obtain a second for home improvement while maintaining their existing interest rate, or (2) assume an older first mortgage to maintain a lower interest rate
- Tax-Exempt Mortgage Loan Program for first-time home buyers, which are those who have not owned a home in the previous three years and who meet federal requirements, including purchase price limits.

In response to increased interest rates, AHFC on June 1, 1982, implemented the Alaska Building Equity (ABE) mortgage. These graduated payment loans are structured to pay off within 16 to 18 years. The AHFC could then issue shorter-term bonds which generally had lower interest rates than longer-term bonds. The ABE structured loans applied to all AHFC programs, with the exception of the Mobile Home Loan program and the Second Mortgage Loan program. Loans purchased under the tax-exempt, veterans, and taxable bond programs from June, 1982 through 1986 have the ABE loan structure.⁵

In fiscal year 1982/83, two new programs were implemented:

- The Veterans Mortgage Program was approved by Alaska voters. This allowed issuance of tax-exempt bonds guaranteed by the state for use in purchasing qualified veterans mortgage loans⁶

⁵ In 1987, AHFC signed an agreement with FHLMC ("Freddie Mac") which, among other provisions, required all loans to be written for 30 years.

⁶ Veterans who cannot qualify for the Veterans Mortgage program still can get the "veterans preference" of one percentage point below the current interest rates from AHFC on the first \$90,000 of AHFC loans. Veterans under any AHFC program also can qualify for VA loan guarantees, allowing them to take out loans with no down payment.

- The Triplex/Four-Plex Program was developed in response to concerns about the shortage of rental units throughout the State.

In FY 1984/85, the Legislature transferred authority for making non-conforming loans in urban areas from the Department of Community and Regional Affairs (DCRA) to AHFC. The program is intended for purchasers of houses that do not meet typical structural or other standards of private mortgage lenders. In remote areas of Alaska there are a number of houses that are not of standard construction, and it is difficult for borrowers to obtain conventional financing. The DCRA administers state financed loans geared towards rural areas.

From fiscal year 1980/81 through fiscal year 1983/84, the Legislature appropriated approximately \$1 billion to AHFC. A large portion of these funds, plus earnings on mortgage loans, was used to subsidize the difference between the interest rates offered to borrowers and the Corporation's cost of borrowing.

Through fiscal year 1984/85, the AHFC issued three types of bonds to finance loan purchases: tax-exempt, tax-exempt veterans, and taxable bonds. In fiscal year 1983/84, AHFC signed an agreement with the Federal National Mortgage Association (FNMA, also referred to as "Fannie Mae"), to swap Alaskan mortgages for Mortgage Backed Securities, achieving "AAA" bond rating on taxable issues for the first time and eliminating the need for mortgage pool and special hazard insurance through FNMA's guarantee of timely payment of mortgages. Also, the State Guaranteed Veterans Mortgage bonds were restructured to extend bond maturities to 30 or 35 years, and to allow AHFC to use loan prepayments to purchase new loans. This ability to "recycle" funds provided AHFC with continued access to a pool of funds at a known tax-exempt rate, hedging against a rise in interest rates or a loss federal tax-exemption on future issues.

In fiscal year 1984/85, the AHFC became an issuer of Government National Mortgage Association ("Ginnie Mae") mortgage certificates as a means of securitizing VA guaranteed loans. Also, AHFC signed another agreement with FNMA allowing the Corporation to swap mortgages financed with tax-exempt funds and extending the "AAA" rating to the tax-exempt Home Mortgage (first-time home buyers) and Veterans Mortgage bonds.

4. Changes from 1986 Through 1989

The price of oil started a dramatic decline in December, 1985, slowing overall economic activity and reducing State revenues. Also, the Tax Reform Act of 1986 changed the way mortgages could be financed. The Act substituted a ceiling on annual issuance of qualified private activity bonds at a level of \$250 million for the remainder of 1986, \$250 million for 1987, and \$150 million per year thereafter. This ceiling encompasses not only qualified mortgage revenue bonds but also student loan bonds and some of the bonds which are issued by other Alaska State agencies. The Governor allocated half of the new ceiling to AHFC and the other half to the Alaska Industrial Development and Export Authority.

Changes made by AHFC and the Legislature in fiscal year 1985/86 were in response to economic and tax reform changes, and included three new programs and two other changes:

- A refinance program was begun in March, 1986, allowing any AHFC borrower to refinance their existing loan, generally to obtain a lower monthly payment. This program also reduced AHFC's cost of the subsidy because older (higher interest rate) bonds could be retired with the refinancing of the older loans
- A rental program was initiated with the sale of two, \$25 million note issues with five year maturities. The program allows a borrower to refinance a property for the purpose of renting. This was popular with borrowers with the means to "move up" but who were unable to sell their current home, as well as with borrowers who have moved out of state but have been unable to sell their homes
- AHFC began purchasing loans secured by properties for which typical financing cannot be obtained. These properties have non-conforming features such as low ceilings or lack of utilities. Single family homes, duplexes, and mobile homes on lots are eligible. In fiscal year 1985/86, AHFC purchased 27 such loans
- Regulations were adopted which made all AHFC loans assumable to qualified borrowers, providing the seller and buyer more flexibility and lower costs

- The ABE graduated loan structure was approved by the Federal Housing Administration (FHA), qualifying AHFC loans for FHA insurance. Moderate income borrowers who cannot meet AHFC down payment requirements may now make an FHA loan instead of a FNMA loan.

In 1988, the Home Owners' Assistance Program (HOAP) was implemented. Under the original program design, borrowers which were experiencing some hardship were allowed to refinance an existing AHFC loan in order to lower the interest rate, eliminate scheduled increases in principal and interest (from the ABE graduated payment loan structure), or provide funds to bring the loan current (if delinquent). In 1989, HOAP II was implemented which was open to any AHFC borrower. In 1990, HOAP III will be added which is different in two respects. The subsidy cannot be greater than two percent below AHFC's cost of borrowing, and the borrower cannot keep their old interest rate but must instead take the interest rate currently offered by AHFC.

Most of AHFC's loan activity in fiscal year 1988/89 involved refinancings. The AHFC purchased 9,081 loans made in fiscal year 1988/89, of which 6,316 were refinancings of existing loans under HOAP. In the prior fiscal year 1987/88, AHFC purchased just 363 HOAP loans. Exhibit II-1, on the following page, provides a summary of AHFC program activity in fiscal year 1989.

In the fall of 1989, AHFC initiated the Condominium Stabilization program which has three components:

- Retail Sales Financing Program will provide low interest rate (7.5 percent) financing for AHFC owned condominiums and planned unit developments. The program, referred to in public advertisements as the "Yes You Can" program, is funded from accumulated prepayments from the tax-exempt insured mortgaged bond program. The AHFC has estimated that this program is not subsidized because of accumulated excess earnings in the insured mortgage program
- Association Loan Program will provide loans to homeowners' associations for common area improvements necessary for the health and safety of the residents (essentially to make the property more marketable)

**AHFC Programs and Level of Activity
Fiscal Year 1988/89**

Program	Loans Purchased in FY 1988/89	
	Number	Dollar Amount (\$ Millions)
<i>New Loans</i>		
Tax-exempt	1,371	\$100.9
Tax-exempt veterans	254	29.8
Taxable	892	78.8
MGIC special financing	161	6.6
Mobile home	18	0.3
Home Ownership Assistance (HOF)	26	1.9
Non-conforming	16	1.2
Pledged account mortgage	<u>2</u>	<u>0.2</u>
Total new loans	2,740	\$219.7
<i>Refinancings and Seconds</i>		
HOAP refinancings	6,316	\$647.5
HOAP seconds	23	1.0
Refinance -- taxable and rental	<u>2</u>	<u>0.2</u>
Total refinancings and seconds	6,187	\$648.7
Total loans purchased	9,081	\$868.4

Source: AHFC 1989 Statistical Abstract

- Exchange Program will allow condo owners in projects with high foreclosures ("donor" project) to exchange their property for a condo of greater value owned by AHFC ("receptor" project). The AHFC then would return the vacated condo development to some other use (such as low-income housing).

In the past two years, AHFC has expanded its staff to handle the disposition of foreclosed properties. The number of delinquencies, foreclosures, and real estate owned (REO) properties increased significantly in the last few years. In 1986, AHFC had 360 REOs. Today, AHFC holds over 4,000 foreclosed properties. The AHFC expanded its activities and staff to handle the increased workload and to manage the disposition of REOs. A REO broker program was instituted which employs private real estate firms across the state to market and sell AHFC foreclosed properties.

In 1989, AHFC established the REO Financing program, providing financing of AHFC REO properties or MGIC (Mortgage Guarantee Insurance Corporation) pool insured properties which do not meet property requirements of other AHFC programs. The properties can be owner-occupied, second home loans, or non-owner occupied. Condominiums and mobile homes are not eligible under this program. The AHFC estimates that there are 300 properties which would fit under this program.

In addition to the mortgage programs, AHFC was requested by the Legislature in fiscal year 1985/86 to purchase \$70 million in mortgage loans from the Alaska Department of Community and Regional Affairs, Housing Assistance Division (HAD). The AHFC used its own funds to purchase the loans in November, 1986. One year later, AHFC combined the \$70 million in HAD loans plus an additional \$9.5 million in other AHFC loans, and used the \$79.5 million loan pool as collateral for a \$62 million bond issue. In effect, bond holders paid for approximately \$62 million of the HAD loans.

In fiscal year 1988/89, the legislature requested that AHFC purchase an additional \$80 million of HAD loans. An evaluation of this second purchase is provided later in Section IX of this report.

C. EXISTING AHFC FINANCING ACTIVITIES

The AHFC does not lend mortgage money directly to home buyers but rather supplies the funds indirectly, purchasing mortgage loans originated by banks and other lending institutions. Both the bank originating the loan and AHFC review and must approve all new loans and refinancings, which includes a review of the borrower's eligibility and the property's appraisal documents. Payments by borrowers are made to the lending institution which then transfers accumulated payments to AHFC. The banks charge a fee for servicing the loan⁷ and also charge an additional fee for originating the loan. Banks reduce their risks by not owning these long-term loans, and free up their own capital for other commercial and personal loans.

1. Source of AHFC Funds

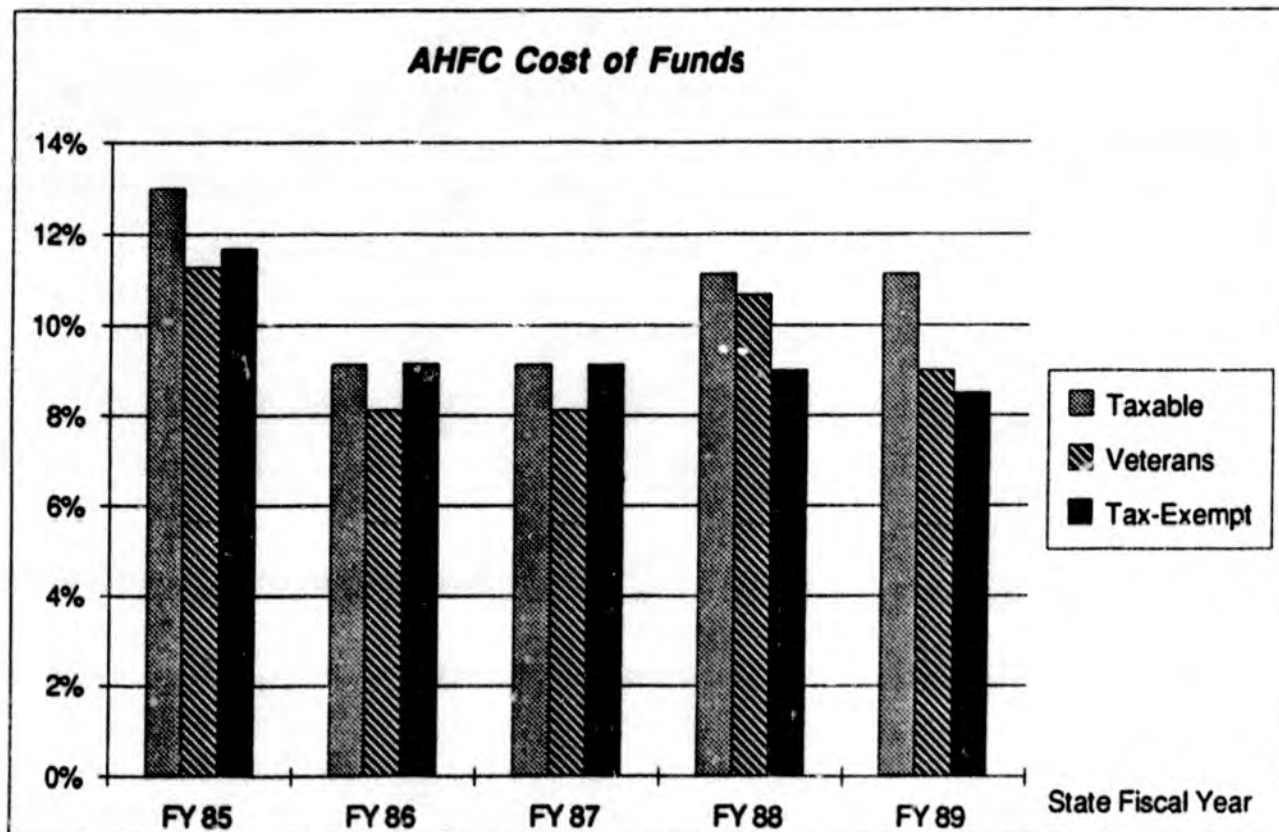
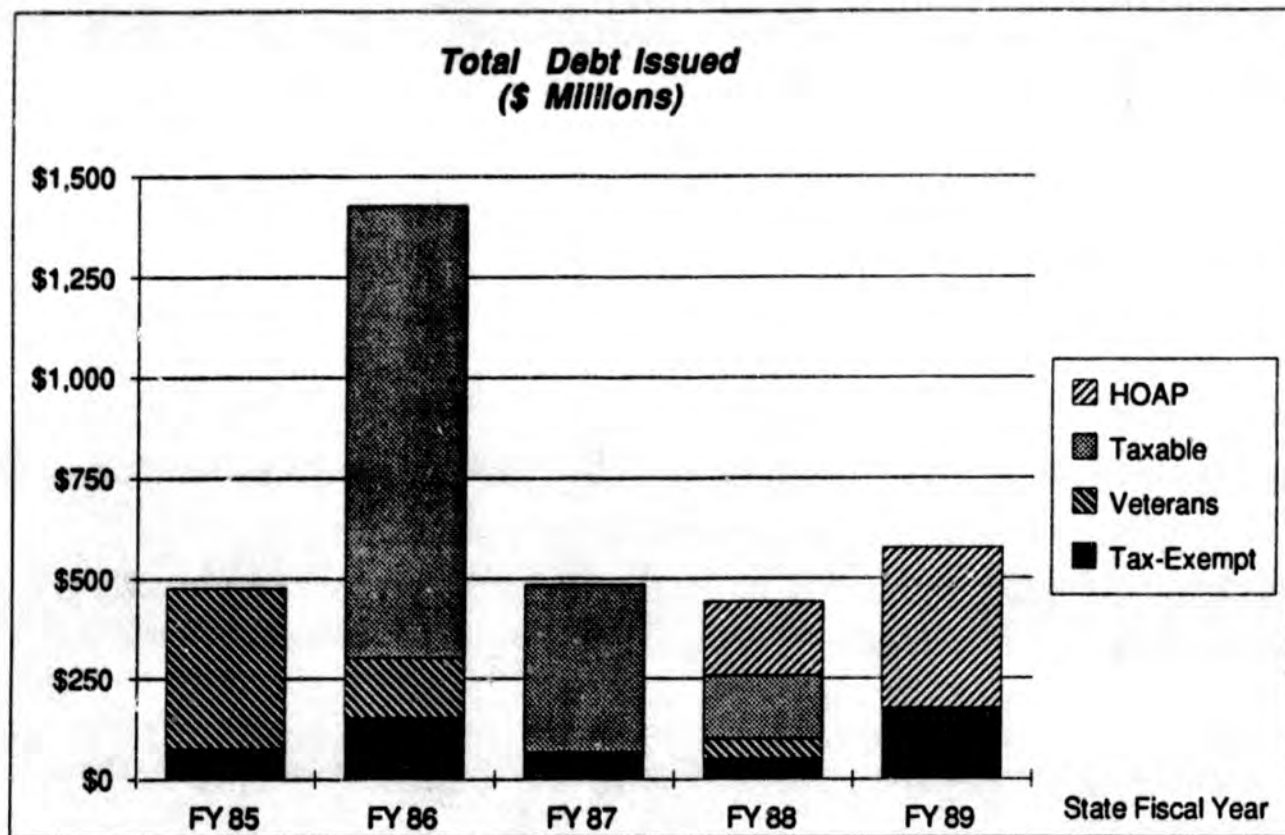
Funds for purchasing the loans come from two sources: State appropriations and bond sales. State appropriations totalled approximately \$1 billion through fiscal year 1983/84, the last year AHFC received State funds. The second source of funds is through the sale of bonds and notes of the Corporation. Through 1989 fiscal year-end, AHFC had cumulatively issued \$6.7 billion in bonds and notes, of which \$3.6 billion remain outstanding.

Exhibit II-2, on the following page, shows total bond issuance by type of debt over the last five years. The type of debt issued includes the following:

- Tax-exempt debt used by first-time homebuyers
- Tax-exempt veterans bonds
- Taxable debt used by borrowers who cannot qualify for tax-exempt funds which are restricted to use by first-time homebuyers and veterans
- Home Owner's Assistance Program (HOAP) debt used by borrowers who want to refinance an existing AHFC loan.

⁷ The monthly charge for servicing the loan is at an annual rate of generally 3/8 of 1 percent of the unpaid principal due on the mortgage loan.

AHFC Debt Issued and Cost of Funds Fiscal Years 1985-1989



2. Security for AHFC Debt

Except for the tax-exempt veterans mortgage bonds which are unconditionally guaranteed by the State of Alaska, all bonds and notes issued by AHFC are general obligations of the Corporation. Security for the bonds and notes issued by AHFC are the revenues generated from a pool of mortgage securities. Mortgage loans purchased by AHFC are combined into loan pools which then are exchanged for a class of mortgage backed securities, depending on the type of loans purchased:

- Federal National Mortgage Association Mortgage Backed Securities (Fannie Mae MBSs) in the case of conventional mortgage loans
- Federal Home Loan Mortgage Corporation (FHLMC) Participation Certificates (Freddie Mac PCs), again for conventional mortgage loans⁸
- Government National Mortgage Association (Ginnie Mae) Certificates for those loans which are insured by the Federal Housing Administration or guaranteed by the Veterans Administration.

Each mortgage backed security (or certificate) represents an undivided interest in the pool of mortgage loans created by AHFC. Timely payment of both principal and interest of the MBS is guaranteed by FNMA, FHLMC, and GNMA, whether or not the mortgage holder makes payment. This loan pooling and swap program was designed to obtain the highest possible rating for AHFC debt issued. Additional security for specific bond issues may be provided by a letter of credit purchased by AHFC.

3. Collateralization of AHFC Debt

Bonds and notes issued by AHFC generally are collateralized by mortgage backed securities of FHLMC, FNMA, or GNMA. Repayment of the bonds is dependent on the cash flow from these securities, which is essentially a pass-through of principal and interest

⁸ In connection with the agreement AHFC signed with Freddie Mac, AHFC in FY 1988 switched to a 30-year, level payment mortgage, dropping the Alaska Building Equity graduated payment structure.

from the underlying mortgages. The structure and number of mortgage backed securities which are pledged to an individual bond issue is designed to accommodate the following:

- Expected lags in the payment of principal and interest (i.e., delinquencies), as well as expected prepayments of the outstanding mortgage loans. Additional loans will be pledged to a bond or note series to obtain the maximum rating possible on the debt
- The interest rate subsidy provided borrowers. If the cost of the debt (including additional AHFC costs of borrowing) is greater than ten percent, there must be a sufficient number of underlying loans purchased at ten percent to generate the cash flow to repay the bonds. In simplest terms, to pay for the subsidy, more loans are needed than the size of the bond issue. The Corporation has estimated that for each one percent subsidy on a \$100 million bond issue, an additional \$7 million in mortgage loans must be pledged to meet the subsidy.

The cost of the subsidy, therefore, is reflected in the original over-collateralization of a bond issue (the aggregate principal balance of the underlying loans exceeds the aggregate principal balance of the bonds). Sufficient AHFC funds, plus mortgage loans pooled and swapped for mortgage backed securities, are pledged to a specific bond issue to generate the cash flow needed to service the debt and pay for the subsidy.

The over-collateralization of mortgage loans is estimated by AHFC to actually range from 105 percent to 120 percent of any particular bond issue. After a bond is fully redeemed (paid off), any remaining investment or loan pledged to the bond is freed-up and becomes available for use by AHFC for pledging to other new bond issues. The overcollateralized bond issues are:

- State Assisted Mortgage bonds (taxable)
- Home Mortgage bonds (tax-exempt)
- Second and Third Series of Insured Mortgage bonds (tax-exempt) issued in 1980 after the subsidy became effective
- Home Owner's Assistance Program (HOAP) bonds
- Collateralized FNMA and medium term notes.

4. AHFC's Cost of Borrowing

The cost to AHFC of the subsidy program is directly related to the Corporation's costs of funds. By statute, the current subsidy on the first \$90,000 of a loan is up to three percent less than AHFC's costs of borrowing (four percent for veterans), if AHFC's costs of funds is greater than ten percent. If AHFC's costs of borrowing is less than ten percent (nine percent for veterans), then loans are made at AHFC's cost of borrowing, and there is no subsidy. The interest rate on the balance of a loan greater than \$90,000 is at the Corporation's cost of funds.

The cost of funds is tied directly to the cost of borrowing money from investors through bond sales, plus additional costs of issuance, credit enhancement, the originating mortgage lender's fees for servicing loans, and AHFC overhead. Because of a general decline in interest rates nationwide, and because of specific financing actions of AHFC, the cost of funds in fiscal years 1985/86 and 1986/87 were lower than the ten percent threshold established for the AHFC subsidy. Essentially, AHFC was lending money at its cost of funds. Since fiscal year 1986/87, AHFC's cost of funds has increased to just over the threshold level of ten percent (nine percent for veterans), so that there was a subsidy of approximately one percent or less. Exhibit II-2 summarizes AHFC cost of funds since fiscal year 1984/1985. Because AHFC's cost of funds were at times lower than ten percent, there were periods when there was no subsidy.

The interest costs of just bond sales since July 1, 1989, are shown in Table 1, on the following page. Assuming other costs of borrowing add 0.8 percent to the actual bond debt costs, we make the following observation regarding the subsidy program:

- **Tax-exempt** No subsidy currently, because the costs of funds are now about 7 percent. This may increase after the short term, floating rate bonds are converted to fixed-rate bonds in 1990. The floating rate changes weekly, and was 6.2 percent in early December
- **Veterans** No subsidy currently. Estimated cost of funds for the \$45 million issue is less than 9 percent

- **Taxable** A subsidy of between 0.5 to 0.8 percent may exist for the most recent \$70 million HOAP bond issue and two, \$75 million taxable issues.

Table 1
AHFC Interest Costs of Bonds Sold Since July 1, 1989

Program	Size (\$ Millions)	Bond Interest Cost
<i>Tax-Exempt</i>		
Home Mortgage Bonds	\$148	Floating
Veterans	45	7.5%
<i>Taxable</i>		
HOAP	70	9.7%
Other:		
CMO Series 1989-2	75	10.0%
CMO Series 1989-4	<u>75</u>	9.7%
Total	\$413	

D. EXISTING AHFC PROGRAMS

A summary of existing AHFC housing programs which had activity in fiscal year 1988/89 is provided in **Exhibit II-3**, following this page. It should be noted that approximately two-thirds of the loans purchased by AHFC under three bond financed programs (tax-exempt, tax-exempt veterans, and taxable), are guaranteed by the Federal Housing Administration (FHA). These FHA loans generally have more lenient down payment and qualifying guidelines. **Exhibit II-4**, following **Exhibit II-3**, summarizes general eligibility requirements, and shows the number of loans purchased in fiscal year 1988/89 for each program.

AHFC Housing Programs

Tax Exempt Program

Intended primarily for first-time homebuyers. Only those who have not owned homes in the previous three years and certain low-income residents qualify

Tax Exempt Veterans Mortgage Loan Program

Open to Alaskans who are military veterans and who meet specific service requirements

Taxable Program

Open to borrowers who do not qualify for the tax-exempt or veterans mortgage program

MGIC Special Financing Program

Provides low down payment financing of condominiums where MGIC previously provided pool insurance, and on certain properties owned by AHFC

Mobile Home Loan Program

Provides for loans on mobile homes in trailer parks with terms up to 20 years at the same rate as the taxable program

Non-Conforming Loan Program

Provides financing of properties which do not meet typical structural or other requirements of private, state, or federal mortgage programs

Home Ownership Assistance (HOF) Program

Provides loans for low- to moderate-income homeowners by subsidizing a portion of the borrower's monthly payment. Restrictions exist on purchase price and total assets.

Home Owner's Assistance Program (HOAP)

Provides for refinancing of any AHFC loan, including restructuring an ABE loan to a 30-year fixed payment loan and advances to bring a loan current

Second Mortgage Program

Provides financing for home improvement or for a second on the purchase of a property with an AHFC first

AHFC Housing Program Terms

Program	Number of Loans Purchased Fiscal Year 1988/89	Average Annual Income of Borrower (a)	Maximum Loan Amount				Down Payment	Income or Asset Ceiling
			Single Family Residence	Duplex	Triplex	Fourplex		
Tax Exempt	1,371	\$42,305	New \$108,180 Exist. \$86,850	\$97,793			10%	Yes
Tax Exempt Veterans	254	\$59,125	\$199,850	\$255,650	\$308,900	\$384,000	10% SFR/Duplex 20% Tri/Fourplex	No
Taxable	892	\$59,948	\$199,850	\$255,650	\$308,900	\$384,000	10% SFR/Duplex 20% Tri/Fourplex	No
MGIC Special Financing	161	\$36,507	\$199,850	\$255,650	\$308,900	\$384,000	5%	No
Mobile Home	18	\$33,018	I \$125,000 II \$75,000				10%	No
Non-Conforming Property	16	\$42,354	\$199,850	\$255,650			10%	No
HOF	26	\$25,431	\$72,000	(b)			10%	Yes
HOAP (refinancing)	6,339	\$56,158	(c)				N/A	No
Second Mortgage	2	\$79,368	\$99,900	\$99,900			N/A	No

(a) Averages for all loans purchased from July 1, 1986 through June 30, 1989.

(b) AHFC sets the maximum purchase price of the home being financed, depending on family size, with a maximum limit of \$100,000.

(c) Maximum loan amount for HOAP is 110% of the outstanding loan balance. Eligible properties include single family residences, duplexes, triplexes, fourplexes, and mobile homes.

SECTION III

**PRESENT FINANCIAL
POSITION OF AHFC**

Ernst & Young

III. PRESENT FINANCIAL POSITION OF AHFC

The purpose of this report section is to provide a discussion of the Corporation's financial position. We first define the term financial position as it is used in this report. Secondly, we present a brief history of the Corporation's financial position. Finally, we present the financial position of AHFC at June 30, 1989, with an emphasis placed on the various restrictions imposed on the Corporation's assets and equity.

This section is organized under the following headings:

- *Definition of Financial Position*
- *History of Financial Position*
- *Analysis of Present Financial Position*
- *Summary of AHFC Financial Position.*

A. DEFINITION OF FINANCIAL POSITION

In our analysis of the present financial position of AHFC, we considered both the concepts of solvency and liquidity in determining the overall ability of the Corporation to continue to operate as a going concern. The concept of solvency includes the Corporation's equity strength and general credit worthiness. The concept of liquidity includes AHFC's ability to meet necessary cash flow payments.

Both criteria are equally important. As can be seen later in this section, it is essential to understand not only what the net liquidity of the Corporation is at any point in time, but also whether or not all debt covenants and minimum balances are being met and that credit ratings are being maintained.

B. HISTORY OF FINANCIAL POSITION

To understand the evolution of the Corporation's financial position at June 30, 1989, we reviewed key historical data and discussed AHFC's history with members of its management and various outside interested parties (including representatives of its credit rating agencies, FNMA, FHLMC, and local financial institutions and real estate businesses). From this extensive review process, we learned the following significant items:

- Prior to June, 1980, the Corporation had issued only tax-exempt bonds with no subsidy of interest rates. These bonds were issued under the Housing Mortgage Bonds (HMB) and Insured Mortgage Bonds (IMB) programs. (Note that the last two issuances of IMB, totalling \$460 million, were sold after June, 1980, and were subject to the subsidy)
- In June of 1980, legislation was passed to allow for the State to subsidize interest rates on mortgage loans purchased by the Corporation. In connection with the legislation, the State contributed monies to the Corporation to provide for the overcollateralization of bonds sold to finance these loans so that qualified residents could obtain interest rates on mortgages below market rates
- During the fiscal years 1981 through 1984, a total of \$808 million was contributed by the State of Alaska to AHFC for the overcollateralization purposes described above. Additionally, another \$225 million was provided by through 1984 for various other specifically identified purposes. **Exhibit III-1**, following this page, summarizes these contributions, by year
- Of these total contributions, \$766 million had been subsequently transferred to the bond-financed programs as of June 30, 1989. **Exhibit III-2**, following **Exhibit III-1**, shows how the remaining \$267 million of contributed capital was allocated as of June 30, 1989.

History of State Appropriations to AHFC

(\$ Millions)

Year	- Revolving Fund -					Total State Funding
	General Purposes	Home Ownership Fund (HOF)	Rural Mortgage Purchase	Mobile Home Purchase	State Mortgage Insurance Fund	
FY 1979 and Prior			\$ 1		\$ 7	\$ 8
FY 1980					3	3
FY 1981	\$474	\$53	12	\$12	7	558
FY 1982	222	43				265
FY 1983	105	45				150
FY 1984	7	42				49
Total	\$808	\$183	\$13	\$12	\$17	\$1,033

AHFC Equity -- Corporation and Combined
June 30, 1989
(\$ Millions)

Program	Retained Earnings	Contributed Capital	Total
<i>Operating/General</i>	\$371	\$148	\$519
<i>Home Ownership Fund (HOF)</i>	(42)	103	61
<i>Insurance Fund</i>	<u>(44)</u>	<u>16</u>	<u>(28)</u>
Corporation Totals	\$285	\$267	\$552
<i>Bond Financed Programs</i>	53	766	819
Combined Totals	\$338	\$1,033	\$1,371

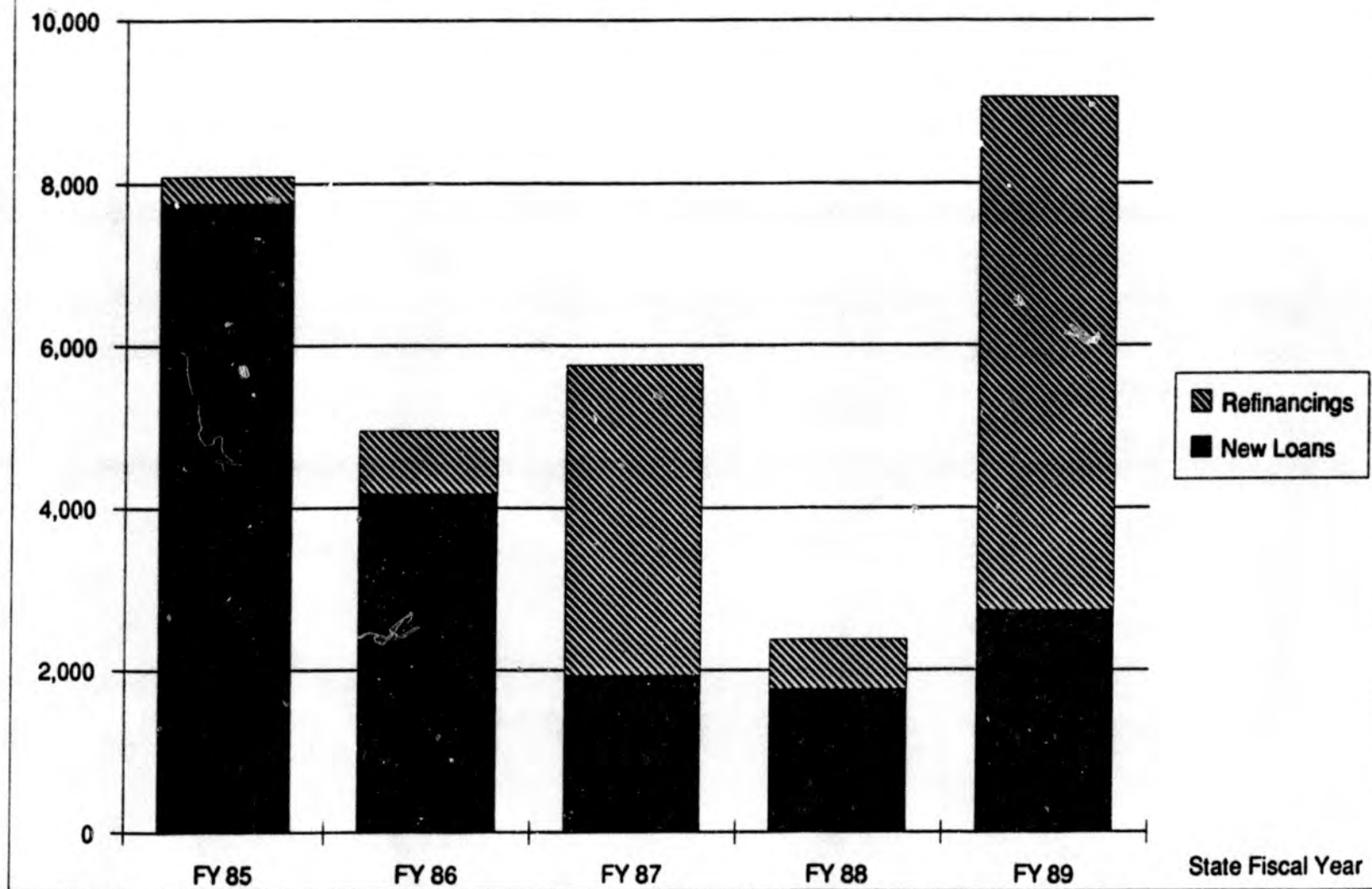
Other significant historical data which we reviewed relate to loan purchase activity, loan delinquency, and loan foreclosure and property disposal. From this review we noted the following significant items:

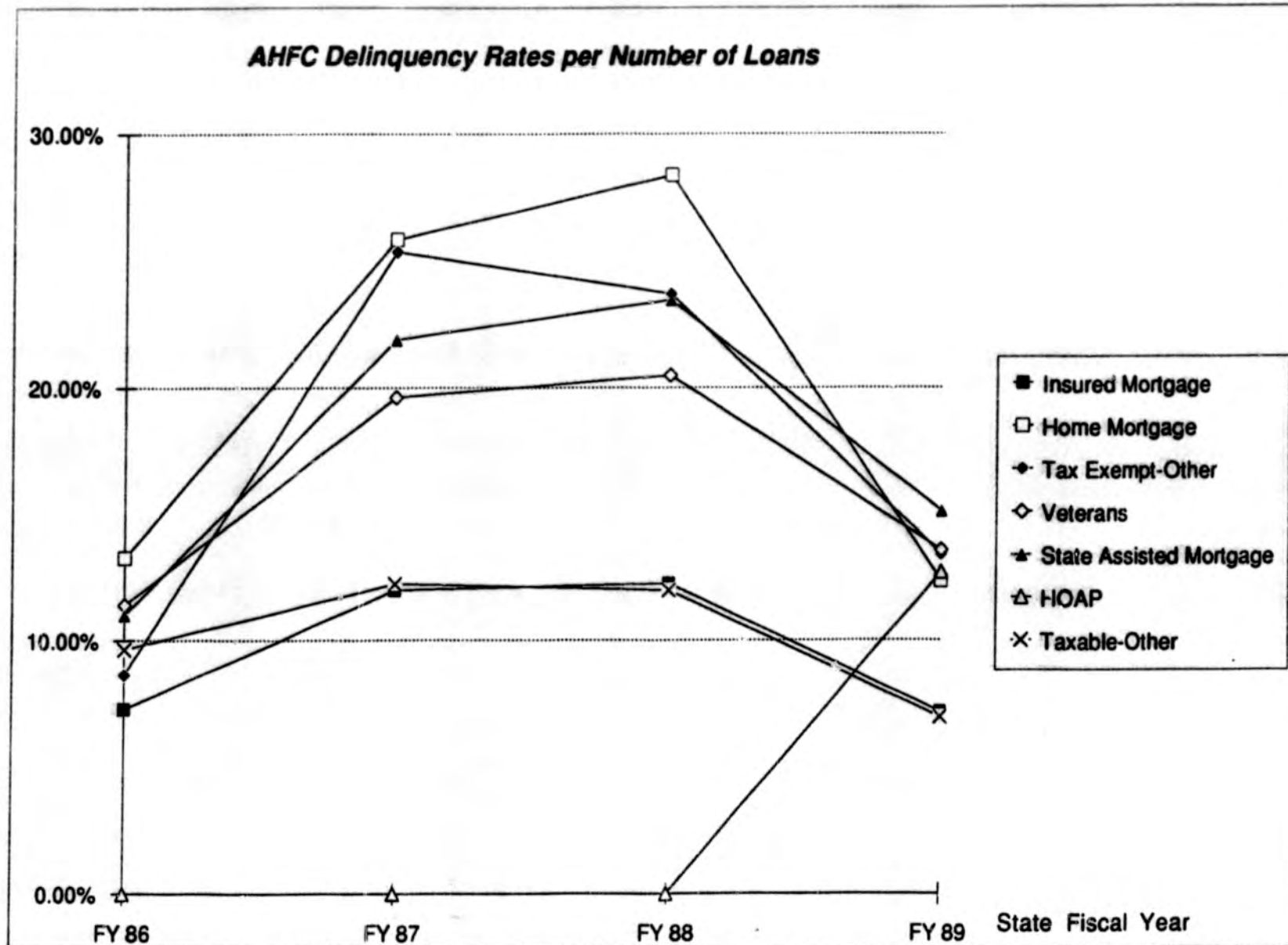
- **Exhibit III-3**, following this page, shows that new loan purchases decreased significantly since 1985. Refinancings, which were principally under the Home Owners' Assistance Program (HOAP), were dominant in fiscal years 1987 and 1989
- **Exhibit III-4**, following Exhibit III-3, illustrates the magnitude of delinquencies in recent years. Even though this rate dropped in fiscal year 1989, the AHFC delinquency rate remains significantly higher than national averages. It should be noted that the calculations of the delinquency rates exclude loans in foreclosure
- **Exhibit III-5**, following Exhibit III-4, shows the severity of loan foreclosure activity since 1985. This foreclosure activity, as well as the delinquency activity noted above, eventually lead to approximately \$170 million of losses reflected on the Corporation's 1989 financial statements.

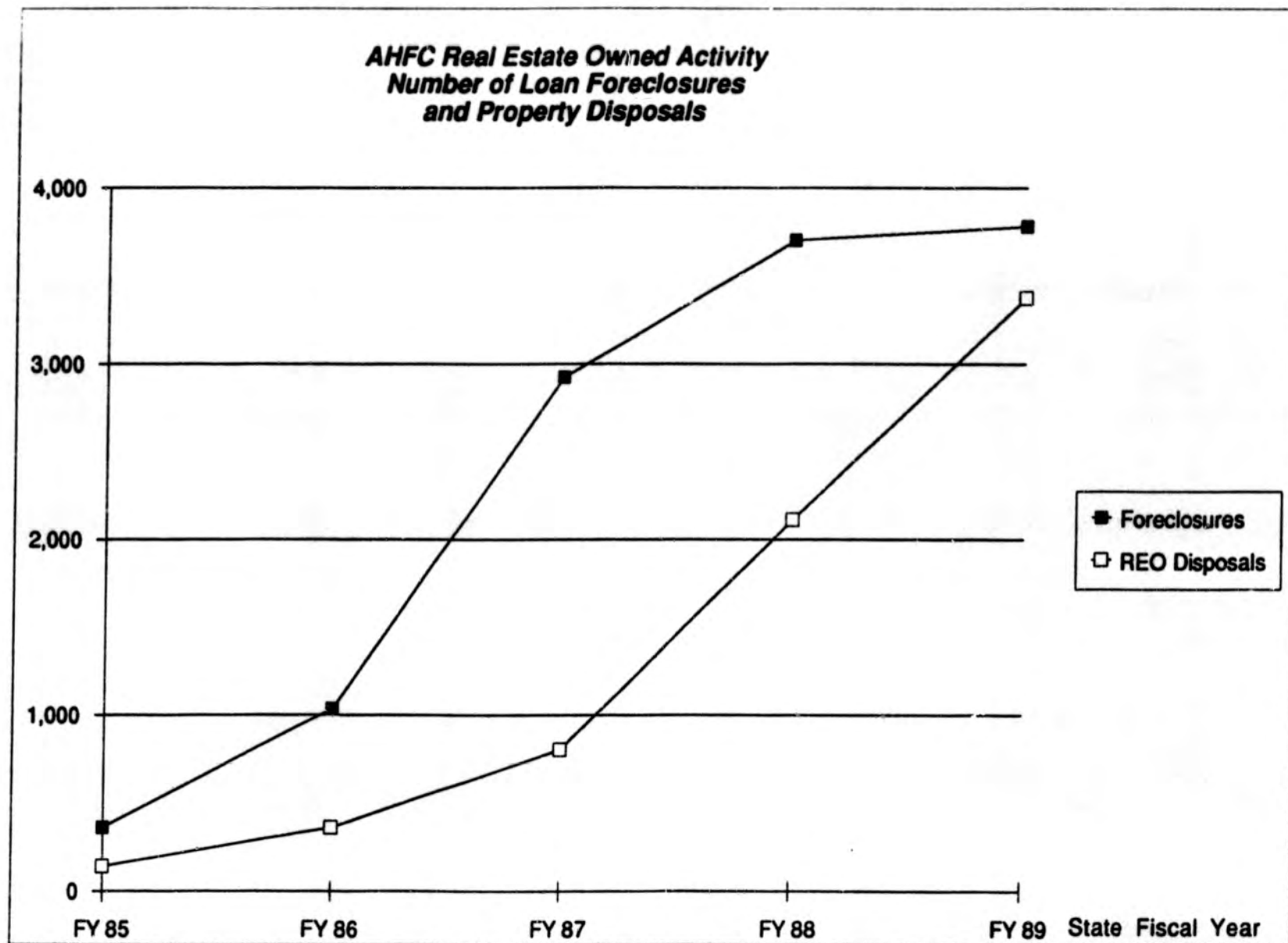
In summary, the Corporation has undergone significant changes over the past several years. The Corporation initially was established to provide only loans to low- and moderate-income persons. However, because of the economic boom in Alaska in the early 1980's, AHFC's role was expanded. During these boom years, the Corporation was financing up to 85 percent of the entire State's housing needs.

AHFC's audited financials reflect retained earnings of over \$300 million as of June 30, 1989. However, it is important to note that these cumulative earnings were principally a result of interest earned on State contributions, and that without prior State contributions the Corporation would reflect a deficit to-date.

Number of Loans Purchased by AHFC







C. ANALYSIS OF PRESENT FINANCIAL POSITION

We segregated the Corporation's programs and financing activities into two overall categories, State-financed activities and bond-financed programs. This division is shown on Exhibit III-2. Within these two broad categories, we further categorized the bond-financed programs as to tax-exempt (IMB and First-Time Homebuyers being separately classified), veterans, and taxable (HOAP and State Assisted Mortgage (SAM) programs being separately classified). These categories were chosen because these general programs were established by the Corporation for different reasons and generally provide for their own distinctly different risk factors.

1. Bond Financed Programs' Equity

As of June 30, 1989, the Corporation had cumulatively issued bonds totalling over \$6 billion to finance the majority of the programs currently in existence. Of this total amount issued, \$3.6 billion remained outstanding as of the end of fiscal 1988/89.

The retained earnings sections of most bond-financed programs currently reflect an accumulated deficit, indicating that these programs would not have been able to continue without State appropriations as support. As can be seen from Exhibit III-6, following this page, the two principal exceptions to this are the IMB and HMB programs which reflect retained earnings to date of approximately \$134 million and \$31 million, respectively. However, to present a more accurate picture of the IMB program, the deficit in the Combined Insurance Fund of \$44 million (see Exhibit III-2), should be considered, because this is the only program which the Corporation self-insures. It is important to note here that these two programs with positive retained earnings contain the only bond issuances dated prior to the change in legislation in 1980, which provided for the subsidy of interest rates.

As previously discussed, \$766 million of State funding remains in the bond-financed programs. Based on our reading of key documents and discussions with Corporation management, this entire balance is available almost exclusively for use by the respective bond programs. These assets were transferred from the revolving (Corporate

Equity of AHFC Bond Financed Programs

June 30, 1989
(\$ Millions)

Program	Retained Earnings	Contributed Capital	Total
<i>Tax-Exempt</i>			
Insured Mortgage Bonds (IMB)	\$134	\$(29)	\$105
First-Time Homebuyers	(38)	142	104
Others (Primipally HMB)	31	7	38
<i>Veterans</i>	(44)	106	62
<i>Taxable</i>			
HOAP	(5)	168	163
State Assisted Mortgage Bonds	(21)	174	153
Other	(4)	198	194
	\$53	\$766	\$819

Operating/General Account) fund based on needs reflected by cash flow projections done at the time of the bonds being sold, and the funds cannot be drawn out of the programs until the bonds are paid in entirety.

Only minor exceptions apply to the exclusivity of each program's equity. Some indentures, within the tax-exempt and veterans programs only, allow for either excess revenues over expenses or prepayments to be used outside the indenture, but only for specifically identified purposes such as making or purchasing loans. In no instances did we note any allowance for withdrawing the funds from the Corporation itself.

We also performed an analysis of specific bond indenture covenant requirements, and found that certain programs and issuances of bonds require minimum balances to be maintained. Based on our review, we noted no significant requirements which were not being complied with, nor did we note this to be a significant factor in our study with regards to additional limitations or restraints on the liquidity of the Corporation's assets or the availability of funds.

Because of the previous transfers of assets and equity into these bond programs, principally at the time of the bonds being issued (based on cash flow projections), these programs should theoretically be self-sufficient. However, the liquidity of these programs is only as good as the related assets' ability to generate revenues to pay debt payments. When the assets turn into non-revenue producers, principally through foreclosure of loans, the ability to make debt payments becomes difficult because of lack of cash flow. In that event, the Corporation would be required to lend monies to the respective bond programs as necessary. As of June 30, 1989, the net amounts owed by the bond programs to the Corporation (Operating and General Account) totalled approximately \$89 million. The repayment of this amount is discussed later in this Section.

As stated above, a big factor affecting each bond program's ability to maintain their present solvency and liquidity position is collectibility of their respective loans and the value received from disposal of their real estate owned (REO) properties. Although significant losses were realized in AHFC's fiscal 1989 audited financials (as a result of write-downs of loans and property values based on Corporation calculations), questions appear to exist as to whether further losses will result.

We understand that the Corporation is undertaking measures currently to alleviate future losses, including an effort to resolve its dispute with its largest insurer, Mortgage Guaranty Insurance Corporation (MGIC), and to most effectively dispose of its REO. As of June 30, 1989, MGIC was the primary insurer for \$402 million of the Corporation's loans. Of this total, \$124 million was under the taxable HOAP program and the majority of the remainder was under the IMB program (\$98 million) and first-time homebuyer's program (\$81 million) -- both tax-exempt programs.

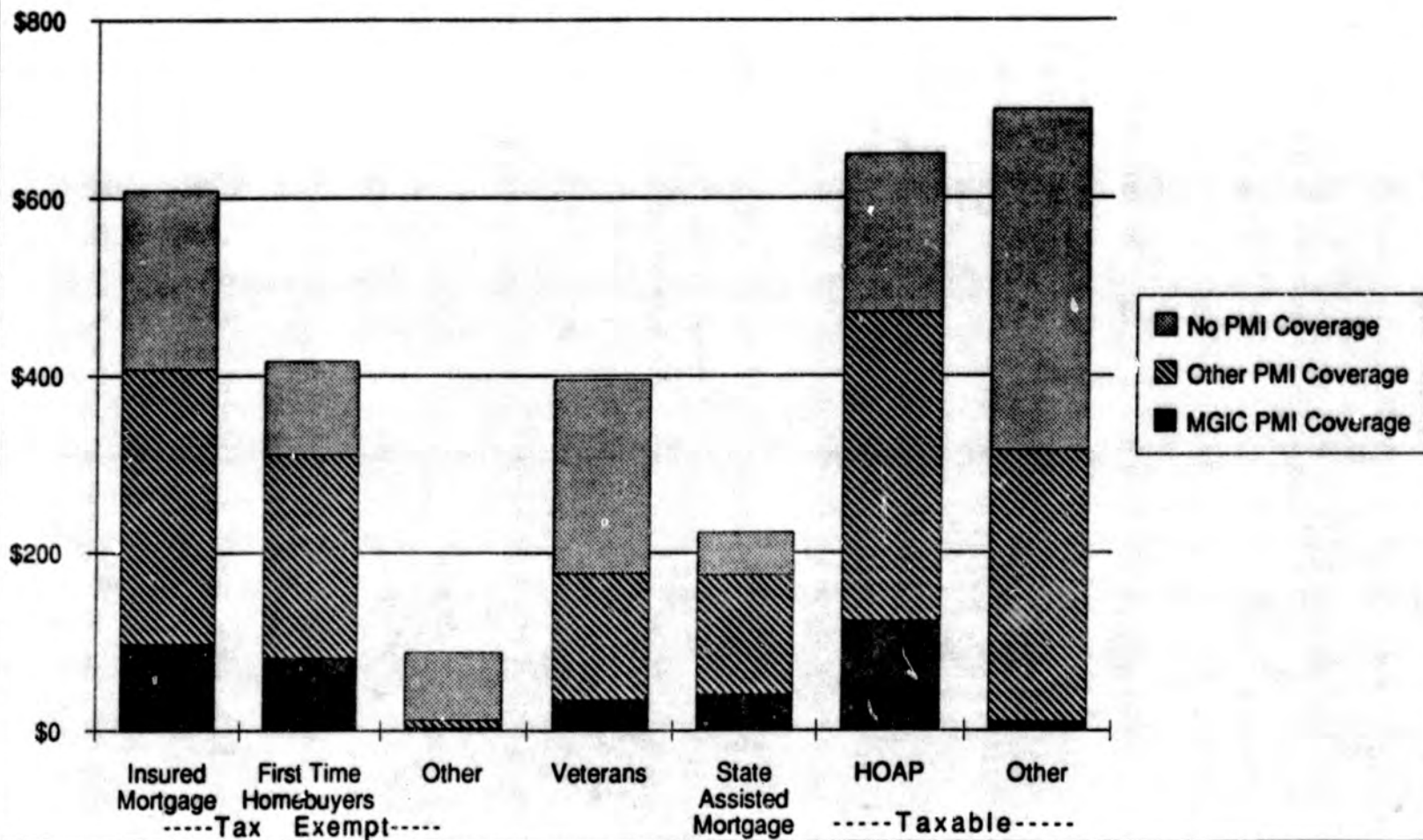
Exhibit III-7, following this page, shows loans outstanding as of June 30, 1989, and the representative portion of loans by program which are insured by a private mortgage insurance (PMI) carrier, and by MGIC specifically. MGIC also is the principal pool coverage carrier, providing this secondary coverage to approximately a third of the Corporation's total loan portfolio. Again, the programs with the most dependency on PMI carriers are the HOAP program and the tax-exempt first-time homebuyers and IMB programs. We have been informed that as of this date no pool coverage is currently available, and that only one PMI carrier is currently providing primary coverage.

To summarize, the Corporation's financial condition has weakened in recent years. Because of the economic factors noted above, net losses resulted in fiscal 1989 totalling approximately \$124 million. Although we have no indication from outside sources that any programs will not be self-sufficient, the unstable economy and its possible effects to the bond programs' equity in the future should provide one more reason for considering total bond equity to be currently restricted.

2. Corporation Equity

AHFC total equity not attached directly to bond-financed programs totalled approximately \$552 million (see Exhibit III-2) at June 30, 1989. Of this total, \$61 million remained in equity in the Home Ownership Fund (out of \$103 million originally appropriated by the State) and the Combined Insurance Fund showed a negative equity balance of \$28 million. Net of these two funds, the equity balance of \$519 million represents net Corporate assets not pledged as collateral for specific bond indentures.

**Total AHFC Loans Outstanding by
Primary Mortgage Insurance Coverage
as of June 30, 1989
(\$ Millions)**



As is the case with the bond-financed programs, this \$519 million equity balance is only as strong as the Corporation's assets. Total assets of the Corporate Operating and General accounts, assuming the netting of all due to/due from balances, was \$710 million as of June 30, 1989. Of this total, almost \$400 million was comprised of loans or mortgage-backed securities. These loans, which have not yet been attached to a bond financial program, had a delinquency rate of over 13 percent as of the end of fiscal 1989. Additionally, a portion of this balance (approximately seven percent) represented uninsured loans with a loan-to-balance ratio of greater than or equal to 80 percent. The loans also had minimal pool or secondary coverage (less than 30 percent of the loan portfolio). The total asset amount also included \$27 million of REO potentially subject to valuation problems. Based on our knowledge of these asset types, it appears that, as of June 30, 1989, a fairly significant portion may not be liquid, if collectible or realizable at all. The Corporation estimated that this non-liquid portion was approximately \$146 million. We noted no reason to believe this amount was overstated.

As previously discussed, included in the total assets shown above is a net receivable from all programs in the amount of approximately \$89 million. AHFC management estimates that 30 percent of this balance will not be reimbursed by the bond programs.

Another important factor to consider in the discussion of the Corporation's assets is what they are used for. Under the current financing structure, a significant portion of the mortgage loans maintained in the Corporate Operating and General accounts are continuously in the process of being pooled and replaced (by selling the loans to FNMA, FHLMC, GNMA) by MBS's for greater security. At June 30, 1989, approximately 19 percent and 40 percent of the revolving fund's loans, respectively, were either already pooled or scheduled for pooling. Although these receivable balances represent valid and collectible assets, the principal intent is to place these balances into a bond issue.

In addition to the above potential restrictions on the availability of the Corporation's assets and equity, consideration must be given to restrictions imposed by debt covenants. The Corporation's major source of financing its working capital needs is through Euro-commercial paper. In accordance with the Euro-dollar Revolving Facility Agreement, which supplements the commercial paper and provides for \$150 million of additional credit (unused at June 30, 1989), certain equity balances must be maintained in the Corporation's

General Account. As of June 30, 1989, this minimum balance requirement of \$336 million was met.

Therefore, under the Corporation's current borrowing arrangement, Exhibit III-8, following this page, represents the total net unrestricted funds available at June 30, 1989. It should be noted that this analysis, which arrives at a \$10 million unrestricted net liquid asset balance, is not intended to place any ultimate restrictions on Corporate assets or equity, but is simply a measurement of net liquidity and a reflection of the availability of funds as of an historical point in time. Looking ahead, certain of the restrictions referred to could change (such as debt covenant requirements if a different borrowing arrangement were used). As previously stated, a significant assumption we are making in our analysis above is that the Corporation will continue to operate as it has in the past. Appendix B to this report provides projections of AHFC unrestricted net liquid assets under future scenarios.

AHFC Unrestricted Net Assets
June 30, 1989
(\$ Millions)

Total Unrestricted Net Assets		\$519
Less:		
• Non Liquid Assets		
- Mortgage Loans	119	
- REO	<u>27</u>	
		(146)
• Net Due From Other Programs (\$89 x .30)		<u>(27)</u>
Unrestricted Net Liquid Assets (Before Debt Covenant Requirements)		\$346
Less:		
• Restrictions on Assets and Equity (from Debt Covenant Requirements)		<u>(336)</u>
Total Unrestricted Net Liquid Assets		\$ 10

D. SUMMARY OF AHFC FINANCIAL POSITION**1. Credit Rating Agencies**

In addition to bond and loan covenant requirements, to continue effective operations the Corporation must maintain a certain financial status as determined by credit rating agencies. Both Moody's and Standard & Poor's (S&P) constantly evaluate the Corporation's financial reserves, bond performance, expected losses and balance sheet.

Generally, the nature of the Corporation's debt evaluated by the credit rating agencies are either mortgage-backed securities, collateralized mortgage obligations, or tax-exempt issues. Under each of these, the debt is rated in a worst-case scenario considering both foreclosure frequency and dollar amount (or percentage) of loss expected per foreclosure.

The principal concerns of the rating agencies presently remain the ability of AHFC to work through its disputes with the pool insurance carriers (principally MGIC), so that the pool policies do not run through, and the potential vulnerability of the Corporation's equity to appropriations by the State of Alaska.

We understand that neither of these two rating agencies are pleased with the general economic conditions affecting AHFC. However, even in light of the significant write-downs of loans and REO activity in fiscal 1989, we are unaware of any drop in bond ratings to date or alarm being sounded on Wall Street. This is principally due to the overcollateralization of assets provided to bond issuances which allows for the pooling of loans into MBS's and the resultant transfer of risk (to FNMA, FHLMC, GNMA, etc.). Of course, the principal reason for the availability of internal funds necessary to enable the overcollateralization is the equity contributed by the State of Alaska. Primarily because of this, and the fact that all bonds are either general obligation bonds of the Corporation or of the State (State Guaranteed Bonds veterans program only), the bonds are able to obtain their high ratings.

It appears highly likely under the current scenario of doing business that, if funds were appropriated from the Corporation, a precedent would be set and the bond programs may appear to be less solvent and credit worthy. Additionally, if funds were withdrawn

presently, the State could conceivably run the risk of being held responsible for any resultant future losses in the bond programs.

The Corporation's ability to operate as a going concern depends on both its liquidity and solvency. Currently, the Corporation is experiencing liquidity problems as reflected in the most recent year's net loss of income. The financial community generally views the Corporation's stability as being due to the solvency of its balance sheet. Any further extraction of Corporation assets in any form presently may have a serious impact on the Corporate financial health.

2. Conclusion of Financial Position of AHFC

To summarize, even though the Corporation's combined balance sheet reflects equity at June 30, 1989 of approximately \$1.4 billion, \$819 million of this total was directly supporting the operations of bond-financed programs. Although portions of this \$819 million may free up in subsequent years, it was inaccessible as of the Corporation's fiscal 1989 year end.

The remaining \$552 million consists principally of the Corporation's working assets which allow AHFC the capability to carry on its business. At June 30, 1989, under its current borrowing arrangements and financing policies, virtually all of this equity also was restricted.

SECTION IV

**PRESENT ECONOMICS OF
ALASKA HOUSING MARKET**

Ernst & Young

IV. PRESENT ECONOMICS OF ALASKA HOUSING MARKET

AHFC plays a major role in the Alaska housing market. It is the chief secondary mortgage purchaser in the State, and its policies largely determine the availability and cost of residential mortgage funds in Alaska.

This section reviews the background of Alaska's housing market, analyzes its existing condition, and discusses the current and potential AHFC role in the market. It is organized as follows:

- *Alaska's Population, Employment, and Construction Industry*
- *Review of Regional Housing Markets*
- *Summary of Housing Markets in Alaska*
- *General Comments on Alaska's Housing Market*
- *Structure of the Secondary Market*
- *Conceptual View of AHFC's Activities in the Housing Market.*

In compiling this report, it was necessary to investigate various regional markets in Alaska to determine their recent history and current conditions. The detailed regional reviews are contained in **Appendix C**, at the end of this report. Because this section contains summaries only, interested readers are referred to Appendix C for more detailed information on each regional market.

**A. ALASKA'S POPULATION, EMPLOYMENT,
AND CONSTRUCTION INDUSTRY****1. Population**

Alaska's population showed a very high rate of growth in 1982 and 1983. The growth rate then declined through 1986, and was negative in 1987 and 1988. Some recovery is evident in 1989.

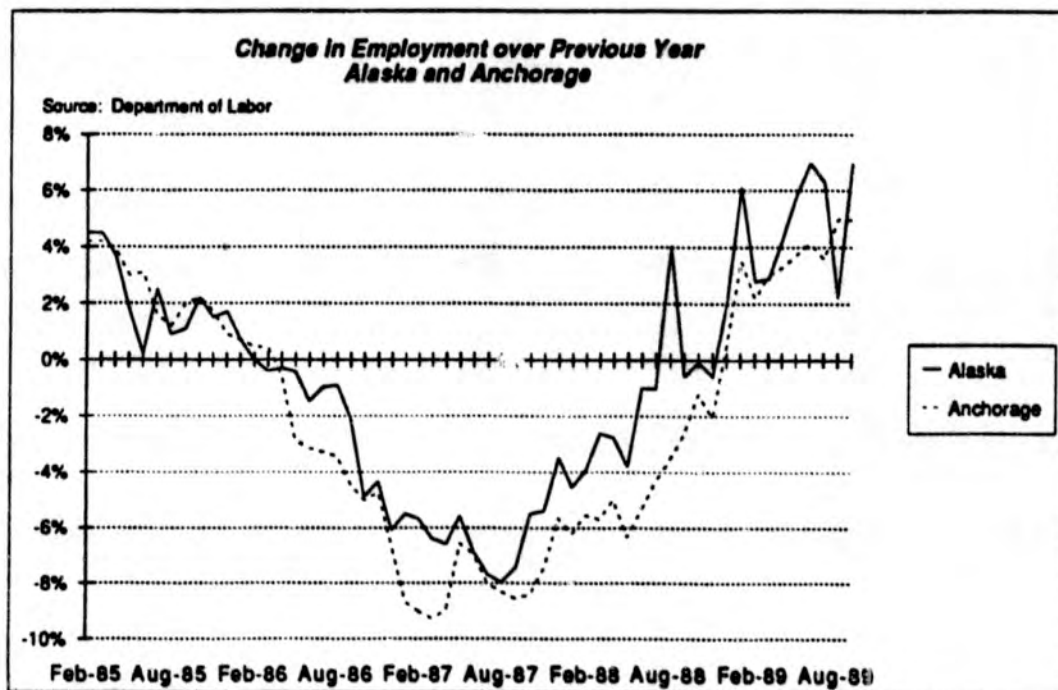
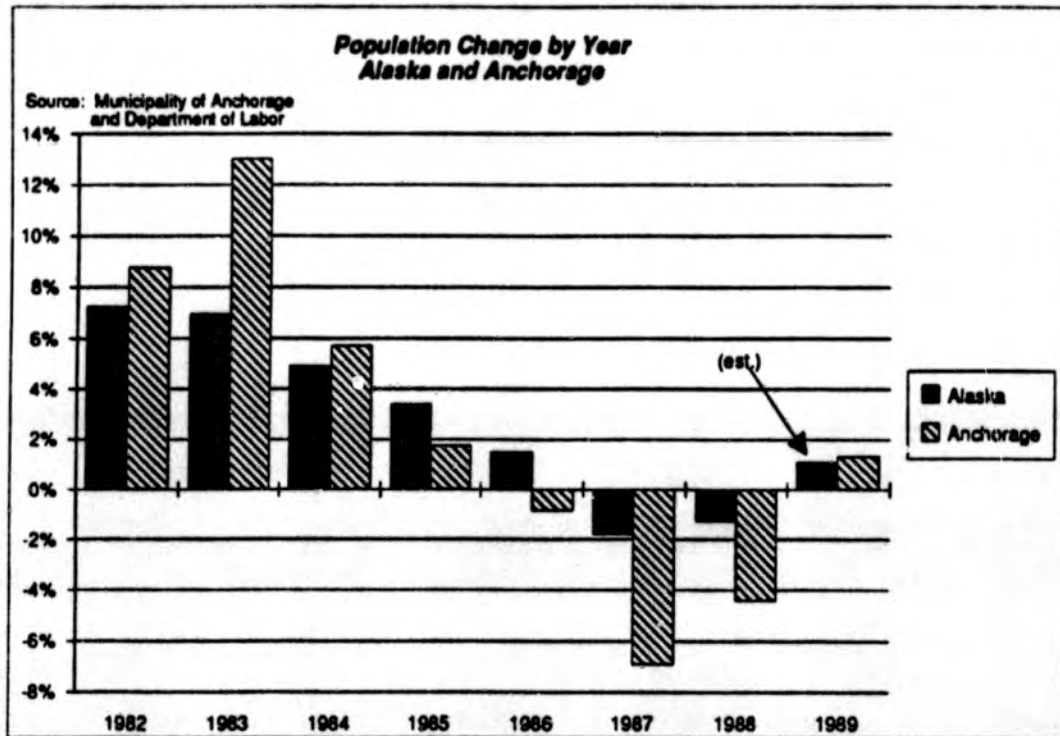
Anchorage, which contains about half of Alaska's population, showed a similar but even more pronounced swing. A graphical summary of changes in population is shown in Exhibit IV-1, following this page.

The dramatic loss of population in Alaska (and especially in Anchorage) in 1987 and 1988 had a major role in contributing to the crisis in Alaska's housing market. This loss in population, combined with overbuilding in the period 1983 to 1985, resulted in a substantial housing surplus and resulting high vacancies. It is important to realize that it was primarily demographics, not financing, that brought about the steep decline in housing prices experienced in 1987 through 1989.

In total, Anchorage lost just over 29,000 people between 1985 and 1988, representing 11.8 percent of its peak population. Assuming an average family unit size of 2.7 (Anchorage average for 1987 and 1988), this meant that demand for 10,740 housing units evaporated. Thus, about two-thirds of Anchorage's 1988 vacant stock of 15,287 housing units were vacant due to population loss.

Anchorage aside, the rest of Alaska did not lose population. Outside of Anchorage, Alaska realized small but real population gains in the period 1985 to 1988. This helps explain why the Anchorage market was hit so much harder than some other markets, particularly those in Southeast.

Alaska Population and Employment Change



Recent data indicate that both Anchorage and Alaska as a whole experienced population gains in 1989. These gains, while small, are a welcome sign, especially for Anchorage. Alaska gained about 2,900 new residents in 1989, for a net population gain of about 1.1 percent, while Anchorage population grew by just over 5,800 in 1989, a gain of 1.3 percent. Caution should be exercised when reviewing these numbers, since they are not based on census data but are derived from a variety of indirect indicators.

2. Employment

Total employment followed the same pattern. Exhibit IV-1, preceding this page, also shows change in monthly employment compared with monthly employment for the previous year, for both Alaska and Anchorage.

Interpreting Exhibit IV-1, employment increases dropped to zero at about the end of the first quarter of 1986. Net employment loss then occurred, with the highest rate of employment loss occurring through the year 1987. Jobs continued to be lost through 1988, but at a decreasing rate. Net job gains began at about the beginning of 1989, and the economy has continued to add jobs through the third quarter of 1989.

State and Municipality economists agree that the job gains in 1989 are partly oil spill-related, but they cannot measure the exact impact of the spill. The general opinion seems to be that about half of the job gain is due to spill-related activity and is thus non-sustainable. Even taking the spill into account, it appears that the bottom of the Alaska depression has been reached and that a gradual recovery may be beginning.

The recovery is more apparent in the Southeast than in the Kenai Peninsula, Anchorage, or points north. Strength in mining, fisheries, and timber sectors are providing relief to communities such as Juneau, Sitka, and Ketchikan.

Most observers agree, however, that job gains in Anchorage foreshadow a gradual recovery of markets in Northern areas. Even if part of the 1989 job gains are oil spill-

related, the residual increase is a welcome event after continuing job losses from 1986 through 1988.

3. Construction Industry

The history of housing construction in Alaska follows population changes. New housing units contracted each year are shown in **Exhibit IV-2**, following this page. As can be seen, a small increase is shown for 1989, probably based largely in the Southeast (Anchorage and Fairbanks show little increase in 1989).

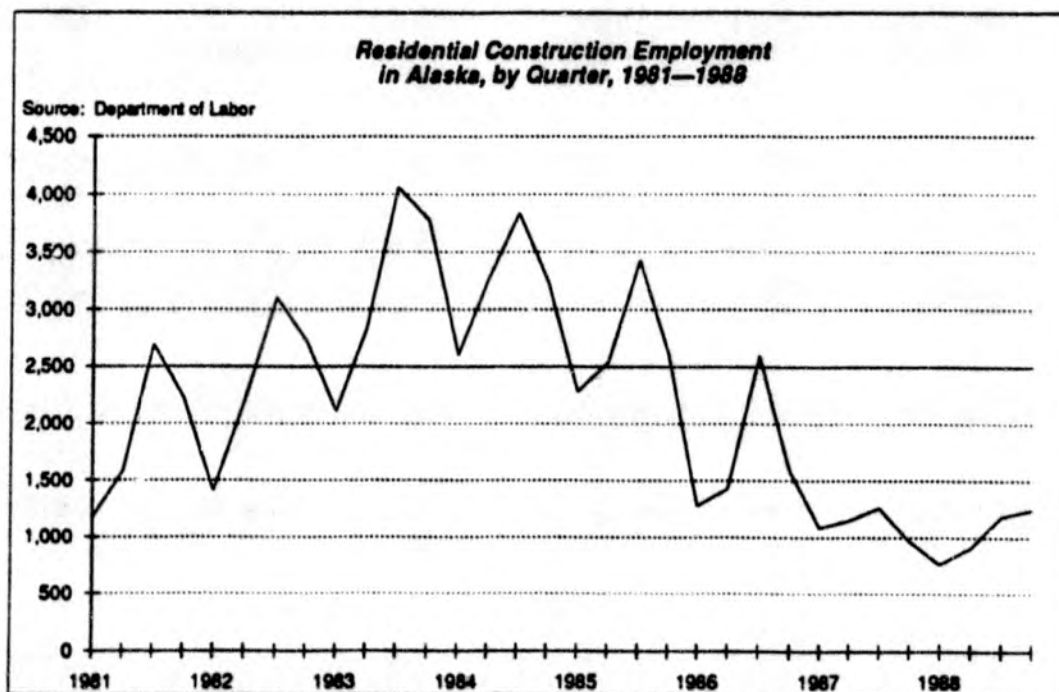
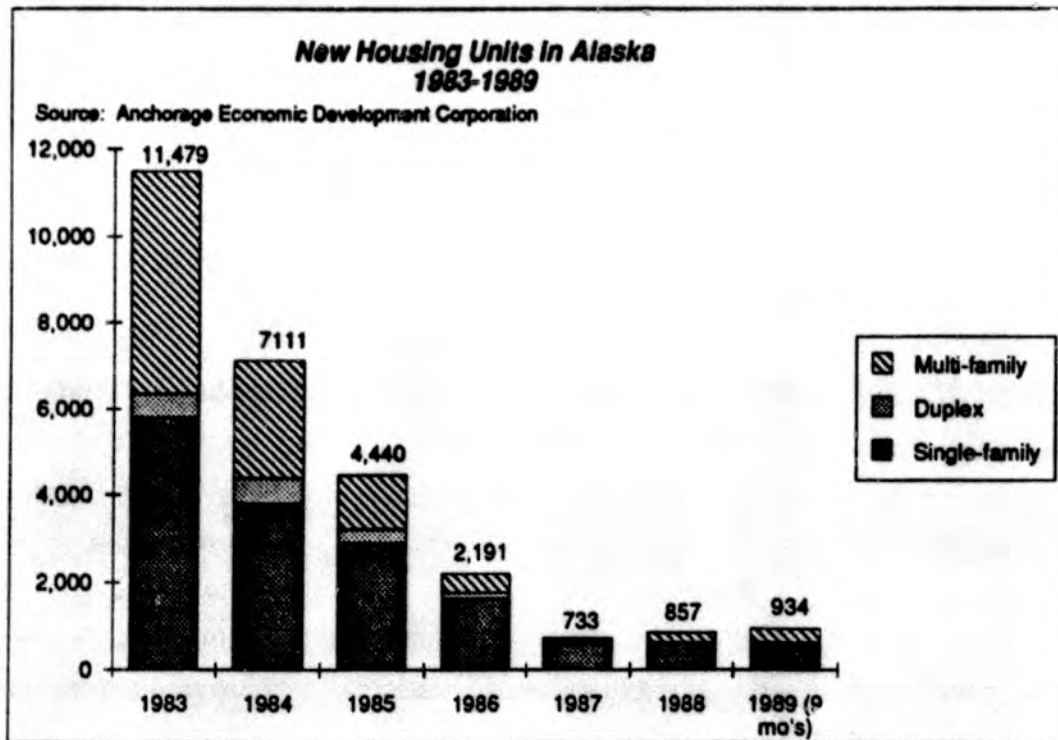
Exhibit IV-2 also shows total employment in the industry by quarter since 1981. Seasonal peak employment hit about 4,000 in 1983 and has been generally falling since. Current employment is less seasonal, reflecting a high percentage of plumbing, electrical, and remodelling work rather than new unit construction. Total employment now ranges between 700 and 1,200 people.

Average monthly payroll per employee for reporting companies predominantly active in residential construction has declined since 1983, dropping from a seasonal range of about \$2,300 to \$2,650 per month to a more recent range of about \$1,900 to \$2,300 per month. The total number of employers in this industry, which peaked at about 1,000 in mid-1984, has now dropped back to about the 1981 level of about 400.

In summary, the residential construction industry is much smaller and less prosperous than in the boom years of 1983 to 1985 and is less seasonal as well. Due to the lack of new unit construction, it is more heavily oriented to maintenance and remodelling and is less vulnerable to damage from real estate market slowdowns than it was five years ago.

We note without comment that many industry sources consider the construction boom of 1983 to 1985 to be a contributing factor to Alaska's subsequent real estate depression. These sources believe that the construction industry overheated the economy in two ways, both of which contributed to the "overshoot" and vacancies which followed the market collapse:

Alaska New Housing Units and Residential Construction Employment



- Construction workers during the peak years were considered stable members of the population, and demographic projections included them in the base population. This population was expected to continue growing and to generate demand for new housing units, many of which were built "on speculation" in anticipation of this demand. Of course, many construction workers left the state when construction slowed down and units were left empty
- Residential construction in particular is said to have a very high "multiplier" effect. If we assume that one dollar of construction cost generates two additional dollars of furniture, appliance, finishing, auto, school, road, etc. expenditures, then a contraction in the construction industry will have a similar multiplier effect.

To the extent that (as some say), "Construction is the engine of Alaska's economy," these two ideas should be carefully considered in setting State economic policy during any future economic expansionary periods.

B. REVIEW OF REGIONAL HOUSING MARKETS**1. General**

Our investigations of regional markets concentrated on the following areas, accounting for about 96 percent of AHFC's current portfolio:

- Anchorage
- Fairbanks
- Matanuska-Susitna Valley
- Juneau
- Kenai Peninsula
- Ketchikan
- Sitka.

In general, housing markets remain quite depressed in Anchorage, Fairbanks, the Mat-Su Valley, and the Kenai peninsula. The Juneau market is improving, and Ketchikan and Sitka are both showing strong price gains. Unfortunately, the areas where AHFC has the highest exposure continue to be the worst-hit locations in Alaska, and only the tentative beginnings of a gradual recovery are evident.

The following material contains brief summaries of the housing market conditions in each of the above areas. More complete and detailed market analyses are contained in Appendix C of this report.

2. Anchorage

Anchorage accounts for about 58 percent of AHFC's total portfolio. It has experienced above-average delinquency and foreclosure rates. It remains Alaska's most active housing market, accounting for over half of Alaska's total annual transactions.

Anchorage suffers from acute overbuilding. New unit construction peaked at over 9,000 units in 1983—it dropped to about 200 units in 1987 and has remained stable at that

depressed level ever since. Given absorption at current rates (which may be inflated by oil spill activity), the market still has about ten years vacant stock to absorb.

Prices for single-family homes have dropped from the 1986 peak of \$137,450 to as low as \$96,890 (2nd quarter, 1989). Condominium prices have dropped from \$102,900 to \$36,942 (1st quarter, 1989). Prices for single-family residences appear to be stabilizing or increasing slightly, but condominium prices remain flat even though sales of these units are increasing.

There is increasing strength in the rental market, especially in high-end units. Vacancies in larger projects dropped dramatically in the twelve months ended June 1, 1989, but this appears to have put little pressure on sales prices. Housing starts are confined almost exclusively to very high-end single family homes, reflecting some demand in this area which is said to arise from incoming transfers of senior oil company personnel.

3. Fairbanks

Fairbanks accounts for about 13 percent of AHFC's portfolio. It has experienced very high delinquencies (higher than Anchorage's), but lower than average foreclosures.

To a certain extent the recent history of Fairbanks' housing market parallels that of Anchorage. A period of overbuilding has been followed by oversupply and falling housing prices. Single family housing prices fell from \$102,587 in 1986 to \$76,201 in 1989. Condominium prices fell from \$79,729 to \$36,732 over the same period.

The market has a smaller percentage of condominiums than Anchorage, which should help in its ultimate recovery. Only one-sixth of 1989 sales were of condominium units. In Anchorage, over half of sales were of condominium units during the second half of 1989.

4. Matenуска-Susitna Valley

The Mat-Su Valley, which accounts for about eight percent of AHFC's portfolio, was very hard hit by the housing downturn. It has experienced the highest delinquency and foreclosure rates of all geographic areas tracked by AHFC.

It is notable that this degree of damage was experienced in a market with very little multi-family housing. In Anchorage, the greatest damage was felt in condominium units while single family residences did comparatively better. But in the valley, single-family residences fell more in value than in Anchorage. Industry sources estimate that a "typical" 3-bedroom Valley home which would have sold for \$110,000 in 1985 was worth only \$55,000 to \$60,000 by 1988, a drop of 45-50 percent. In Anchorage, single-family homes dropped only about 30 percent.

Industry sources feel some recovery is evident in 1989, but a month-by-month analysis of Valley multiple listing data shows no trend of increasing prices through the year. Market activity has increased slightly during the year, but announcement of a trend would be premature.

5. Juneau

Juneau accounts for about seven percent of AHFC's portfolio. It has experienced delinquencies and foreclosures at well below the AHFC average rates. Again, the Juneau market has shown a cycle of overbuilding followed by vacancies and price drops. But the market overshoot appears to have been less extreme than in the areas previously discussed. Transaction volumes are declining as available stock is shrinking, and prices appear to be firming.

Industry sources estimate that prices for single family detached housing are now at or near 1985 levels. Zero lot lines are still down about 15 percent from 1985 levels, while condominium prices are still down about 34 percent. But prices are improving in all cases.

In general, the Juneau market (like the Ketchikan and Sitka markets, below) is small and self-contained. It is affected strongly by events which may have no implications for other Alaska locations, and relatively small movements in population or jobs may have a disproportionate effect on the market.

6. Kenai Peninsula

The Kenai Peninsula market accounts for about six percent of AHFC's portfolio. It has experienced below average delinquency and foreclosure rates. Even though this market consists primarily of single family detached housing, it suffered steep price drops after 1985. Average home prices of \$105,000 in 1985 had decreased to \$70,556 by 1988, a drop of about 33 percent. Prices show no signs of recovery based on a month-by-month analysis through November, 1989.

Activity levels, which increased slightly in 1988, declined in 1989. Days on market continued to increase, indicating a very slow market.

7. Ketchikan

Ketchikan accounts for only about two percent of AHFC's portfolio, with a below-average delinquency rate and AHFC's lowest foreclosure rate. Ketchikan largely escaped the overbuilding-oversupply cycle which hit much of the rest of Alaska. To a large extent, Ketchikan was bypassed by builders who were put off by Ketchikan's small market and difficult terrain. As a result, there was only a small decline in prices following 1985, and prices are already above 1985 levels. Lot sales are increasing, perhaps indicating that new construction will pick up next year.

8. Sitka

Sitka accounts for less than two percent of AHFC's portfolio. It has AHFC's lowest delinquency rate, and the second-lowest foreclosure rate. Like Ketchikan, Sitka maintained a reasonably stable housing market after 1985. Prices are increasing, available stock is low, and increasing lot sales may presage new construction in the near future.

C. SUMMARY OF HOUSING MARKETS IN ALASKA

Table 1, below, presents a summary of activity levels, price levels, and stratification of housing markets in those geographic concentrations in Alaska which make up about 96 percent of AHFC's total portfolio. Table data, however, apply to the entire market areas, not just to AHFC activity within the markets.

Table 1
Summary of Housing Markets in Alaska

Location	% of AHFC Portfolio	Annual Volume	Prices (% of 1985)	% below \$86,850	% below \$135,000	% above \$235,000	Price Trend
Anchorage	57.99%	4,500	60%	63%	85%	3%	Flat
Fairbanks	13.15	875	71	59	92	1	Flat/down
Mat-Su Valley	7.68	870	57	89	98	0	Flat
Juneau	7.11	500	90	65	80	0	Up
Kenai Peninsula	5.91	350	67	78	97	0	Flat
Ketchikan	2.36	250	105	45	90	0	Up
Sitka	1.57	40	106	10	65	1	Up
Totals or averages	95.77%	7,385	66%	64%	87%	2%	

Sources of the data in this summary table are as follows:

- **Percent of AHFC portfolio:** Percent by dollar value of total AHFC portfolio per AHFC records, as of October 31, 1989. This column is presented only to indicate AHFC activity levels and exposure in each market area.
- **Annual volume:** Transactions per year are from local multiple listing services in most cases, adjusted for an estimated 80 percent of sales involving MLS listings. Figures for some locations are industry estimates. All estimates are for calendar year 1989.

- **Prices (percent of 1985):** In some cases, price changes are based on average selling prices in 1989 per the local MLS. In other cases, where MLS histories are unavailable or incomplete, industry estimates are used.
- **Percent below \$86,850:** Per MLS stratifications of actual closings in most cases. In others, industry estimates. All relate to market transactions during 1989.
- **Percent below \$135,000:** Same.
- **Percent above \$235,000:** Same.
- **Price trend:** Consultant's judgment based on recent price movements and on views of industry sources.

Percentage figures listed in the "Total or average" row are averages of the individual figures for each location, weighted by participation in AHFC's overall portfolio.

D. GENERAL COMMENTS ON ALASKA'S HOUSING MARKET

Several comments are in order concerning Alaska's housing markets and residential financing vehicles. These comments do not all relate directly to the material following, but provide some background on specific issues which affect the markets.

The first set of comments relates to four issues which make the market very unusual in nature: (1) the varying natures of Alaska markets by location, (2) the new class of housing buyers currently in the market, (3) the high percentage of housing transactions occurring below the tax-exempt limit, and (4) the potential problems for mortgage buyers posed by Chapter 13 bankruptcies.

- Varying natures of the markets—Although the major concentrations in Alaska's housing market (Anchorage, Mat-Su Valley, and Fairbanks) suffer similar problems, some regions of the State have different situations which should be considered carefully when proposing actions with State-wide scope. Southeast, in particular, appears to have fewer problems, stronger markets, and more positive market trends
- New classes of housing buyers—Depressed housing prices in much of Alaska have had the salutary effect of making owner-occupied housing available to segments of the population which have previously only been able to rent. Many realtors report that most of their sales are to customers in entry-level jobs who would be unable to buy in a more normal market. As housing prices increase, a potential downside is that there may be fewer qualified buyers as housing becomes less affordable
- Housing below tax-exempt limit—The same depressed prices mean that much of Alaska's housing now falls below the tax-exempt limit. As prices increase, some homes will move above the tax-exempt limit, reducing housing stock available under tax-exempt programs. Currently, over 60 percent of housing sales take place below the tax-exempt limit (see Table 1, above)
- Chapter 13 bankruptcies—Prevailing negative home equities may lead to an increase in mortgageholder losses under a recent court ruling concerning Chapter 13 bankruptcies. According to this ruling, an individual seeking protection from creditors under Chapter 13 rules could have the secured portion of his residential mortgage written down to current market value; the remainder would be considered unsecured,

and subject to discharge after three years of good-faith payments. The net effect would be a pro-rata reduction in PMI and pool mortgage protection, leaving the holder of the mortgage with a significant loss upon discharge of the unsecured portion of the debt.

The second set of comments relate to industry views on the likely effects of reducing or eliminating the AHFC subsidy and of reducing the scope of AHFC's activities to original legislative intent. These comments are distilled from a large number of interviews with mortgage brokers, real estate brokers, residential mortgage lenders, and other industry representatives both in Anchorage and elsewhere in the State.

We emphasize that the following comments are industry views and do not necessarily reflect the conclusions reached in this report.

- Effect of reducing or eliminating the subsidy—Industry opinion is split. Most representatives interviewed felt that eliminating the subsidy would make little difference now, but that elimination might retard market recovery if interest rates were to rise significantly. A few felt that elimination now could cause a shock wave in the market and damage market confidence, and should be avoided at all costs. Most representatives agreed, however, that the subsidy is ultimately economically damaging and distorts normal market workings.
- Effect of reducing the scope of AHFC to original legislative intent—Many industry representatives believed that abruptly removing AHFC as a secondary market purchaser of standard mortgages would severely limit new mortgage originations and make housing purchases more difficult. They believed that there is no near-term alternative to AHFC as a secondary market for mortgages, and that an immediate rollback would reduce market volumes and depress housing prices. Contrary views, however, were presented. Most contrary views came from the Southeast.

A few more words are in order concerning these views. Several industry representatives interviewed believe that AHFC is the mortgage purchaser of choice in many cases for reasons of preference, not necessity, and that viable alternatives to AHFC currently exist in the secondary mortgage market. Three reasons for industry preference for AHFC over these secondary market alternatives were given:

- AHFC interest rates remain fixed for long periods of time, corresponding to individual bond issues, while commercial rates may vary between loan approval and closing, which often complicates transactions for realtors
- AHFC policies and procedures are well-known through long experience, and processing requirements are predictable
- Finally, of course, the subsidy (when one is present) makes AHFC an attractive alternative to other financing sources. Even a 1/2 percent difference in rates saves a buyer \$30 each month in mortgage payments (\$90,000 home, 10 percent down, 10 percent rate versus 10.5 percent rate).

In considering these views, the economic interests of industry representatives also should be considered. For players in the real estate market, higher volumes and prices are both inherently "good" because they increase the income of these players. But in economic terms, over-availability of financing, lack of strictness in qualifying buyers, and failure to consider longer-term potentials of the market may ultimately be very damaging.

E. STRUCTURE OF THE SECONDARY MARKET**1. What the Secondary Market Does**

Most originators of residential mortgage loans do not retain the mortgages, but sell them to the secondary market. The secondary market includes AHFC as well as national quasi-public players such as FNMA, FHLMC, and GNMA, and purely private institutions such as Goldome and Fleet. The originator typically retains the right and obligation to service the loan, and receives a fee for doing this. The fee is usually about 3/8 of one percent of the outstanding balance of the loan annually.

This is definitely the pattern in Alaska. Alaska has few or no private portfolio buyers. We were unable to identify any banks, credit unions, saving and loan associations, or mortgage companies with a policy of retaining mortgages for their own accounts, except sometimes for their own REO. In other words, if an Alaska mortgage is not salable, it will likely not be made by a private institution.

We note here that mortgage lending does not appear to be a priority with most banks, even on the basis described. Alaska lenders indicated little interest in originating and servicing loans without the ability to later sell these mortgage loans to the secondary market. Mortgage companies seem to be somewhat more aggressive than banks in this respect.

We also note that there is a degree of nervousness among some industry representatives concerning the continued presence in Alaska of certain secondary market buyers. But in our discussions with officials of FNMA and FHLMC we were unable to discern any movement towards withdrawing from the Alaska market. Both institutions remain active in Alaska, either disposing of REO or financing new mortgage purchases.

In summary, the importance of the secondary market is that without it, lending institutions would not generally make residential mortgage loans in Alaska. There are exceptions to this statement, of course, but the limited capital available to Alaska lending institutions makes a secondary market absolutely essential to meaningful levels of mortgage lending.

2. AHFC's Role in the Secondary Market

AHFC is certainly the largest single purchaser of mortgages in the Alaska market. Industry estimates of AHFC secondary market share vary from 50 percent to over 70 percent. Although reliable statistics are lacking, AHFC management indicates that it believes that it currently purchases 60 to 65 percent of newly originated residential mortgage loans in Alaska. Most residential brokers interviewed also stated that AHFC was the largest purchasers of loans originated from their real estate sales.

We estimate that about 7,700 homes were sold in Alaska in 1989. In many cases these purchases involved assumptions of existing loans or direct contracts between buyer and seller, and thus do not result in new first mortgages. The number of purchases whose financing falls into these categories is unknown, although most industry sources feel it is quite large, possibly as large as 40 percent of all sales. Accordingly, AHFC's contention that its current purchase level of 2,723 (fiscal year 1989) mortgages represents the majority of new mortgage purchases seems reasonable.

AHFC total market share, including refinancings and seconds, is much larger. In fiscal year 1989 HOAP refinancings through AHFC were over twice total new mortgage purchases (\$643 million versus \$225 million). Although the HOAP programs are refinancing vehicles and do not directly impact housing sales, they actually stimulate the housing market in three ways:

- By helping homeowners with ABE (Alaska Building Equity) graduated payment structures to avoid foreclosure, they limit the REO stock which would otherwise depress market prices further
- By allowing assumptions of loans, they expand the pool of potential buyers and help homeowners avoid the necessity of paying off any negative equity at closing. This allows homeowners to more easily sell their homes and purchase new homes

- By allowing properties to be used as rentals (that is, by removing the requirement for owner occupancy), they allow homeowners to vacate their homes while earning an income stream to pay the existing mortgage. This avoids the necessity of a sale and payoff of any negative equity, allowing more homeowners to purchase new homes.

AHFC also has an important role as a pooling agency. Many of the loans purchased under its taxable program (892 loans in fiscal year 1989) are pooled and sold to other secondary market buyers in exchange for mortgage backed securities. FHLMC is the current buyer, although FNMA has purchased pools in the past. In this role AHFC can be seen as a facilitator rather than an ultimate purchaser of mortgage loans.

**F. CONCEPTUAL VIEW OF AHFC'S ACTIVITIES
IN THE HOUSING MARKET**

Conceptually, AHFC's activities can be divided into four activities:

- Purchases of mortgages under tax-exempt bond financed programs (15 percent of AHFC's activity by dollar volume in fiscal year 1989)
- Purchases of mortgages under "special" programs (one percent of AHFC's activity in fiscal year 1989)
- Purchases of mortgages under the Taxable Program (nine percent of AHFC's activity in fiscal year 1989)
- HOAP and other refinancings of existing mortgages (75 percent of AHFC's activity in fiscal year 1989)

Of these activities, the first and the second may generally be considered to fall under the umbrella of "original legislative intent". The fourth is a special purpose program to limit damage to the housing market (and to AHFC and its partners such as FNMA, FHLMC, and MGIC) from the severe market downturn. Only the third, the Taxable Program, represents an area that would clearly be rolled back if AHFC were to be returned to its original legislative intent. The Taxable Program represented 31 percent of all new mortgage loans purchased by AHFC in fiscal year 1989.

To gain further perspective on this issue, an analysis is presented in Table 2, on the following page, of the Taxable program's relationship to AHFC activity in fiscal year 1989 excluding tax-exempt programs and refinancings/seconds. This remaining activity represents all of AHFC's new first mortgage purchases except those under tax-exempt programs.

Table 2
Analysis of AHFC Non Tax-Exempt Mortgage Purchases

Program	Number Purchased	Amount (\$ Millions)	Percent of Total
Taxable	892	\$78.8	88.5%
MGIC Special Financing	161	6.6	7.4
Mobile Home	18	0.3	0.3
HOF	26	1.9	2.1
Non-conforming	16	1.2	1.5
Pledged account mortgage	2	0.2	0.2
Total	1,115	\$89.0	100.0%

As can be seen from this table, purchases under the taxable program represent almost 90 percent of all non tax-exempt mortgage purchases by AHFC in the current market. Most of the remaining programs are very small in scope and serve a minimal number of Alaska residents. A brief description of the remaining programs follows:

- The *MGIC Special Financing Program* allowed MGIC to borrow money from AHFC at low rates to finance the sale of AHFC REO. This program is being replaced by the "Yes You Can" Program which should have somewhat wider scope
- The *Mobile Home Program* is designed to allow purchasers of mobile homes access to financing on more generous terms than those offered by commercial lenders on their own accounts. Most lenders treat mobile homes as personal property, while this program offers terms more in conformance with real property loans. Interest in mobile homes is limited now because of the prevalence of inexpensive condominium units
- The *Home Ownership Assistance (HOF) Program* offers subsidized payment terms to low income borrowers. Access to this program is limited because loan originators find that loans made under this program are difficult and expensive to service. The recent steep decrease in housing prices also limits interest in the program

- The *Non-conforming Loan Program* offers loans on homes which do not meet standard underwriting criteria. AHFC management states that few applications under this program meet the "safe, sound, and sanitary" criteria specified in the enabling legislation.
- The *Pledged Account Mortgage Program* allows otherwise unqualified buyers to pledge liquid assets against mortgage payments as a form of insurance. Few Alaskans seem interested in this approach to home financing.

In summary, the taxable program represents the large majority of all new mortgage purchases currently made by AHFC outside of the tax-exempt programs. The remaining programs are either REO-related or serve small numbers of Alaskans with special needs.

Since the tax-exempt programs (except the Veteran's Mortgage Bond Program) are included in AHFC's "original legislative intent", and because HOAP and other refinancings are temporary expedients to prevent foreclosures and help make the market more liquid, only the taxable program need be considered when assessing the effects of a return of AHFC to its original legislative intent.

A further analysis of the taxable program and the importance of this program to Alaska's housing market is contained in Section VII of this report, where the effects of returning AHFC to original legislative intent are considered.

SECTION V

DESCRIPTION OF POLICY OPTIONS AND EVALUATION METHODOLOGY

Ernst & Young

V. DESCRIPTION OF POLICY OPTIONS AND EVALUATION METHODOLOGY

The State Legislature identified a number of options defining AHFC's role in providing housing, and requested an analysis of the implications of these options. In this section, we describe the various policy options, and present a description of how we evaluated the implications of each option. We also present the major assumptions made by our team in evaluating each option.

This section of the report is organized as follows:

- *Policy Options*
- *Evaluation Methodology*
- *Analysis Assumptions.*

A. POLICY OPTIONS

Three options were evaluated during the course of this study:

- Phase-out or eliminate the interest rate subsidy
- Return AHFC to original legislative intent of providing for low- and moderate-income housing
- Change the ownership of AHFC.

Each of these is described in the subsections which follow.

1. Change AHFC Subsidy

The first option evaluated was a change in the current interest rate subsidy now provided by AHFC. This change could range from a gradual phasing out of the subsidy to its one-time elimination. Phasing out of the subsidy would allow adjustment by the housing sector, including mortgage financing sources, in the removal of AHFC as a below market price source of mortgage funds. On the other hand, a one-time elimination of the subsidy, rather than a gradual phasing-out, would make sense if market conditions were such that AHFC was no longer providing lower than market rate financing.

Phasing out of the subsidy can be done by either of the following two methods:

- Reducing the spread between AHFC's cost of funds and the rate provided to a borrower (e.g., from three percent to zero percent over time)
- Reducing the loan amount on which the subsidy is applied (e.g., from the first \$90,000 to some lower figure over time, eventually to no subsidy).

There may not be any effective difference between the above two alternatives if AHFC cost of funds are low enough that there is no subsidy being provided. It was pointed out in Section II of this report that there was no subsidy on most new loans purchased in fiscal year 1986 and 1987, and only with an increase in the costs of bonds issued in 1988 and 1989 has the subsidy actually reappeared for some AHFC programs. Depending on where

interest rates may head in the future, and AHFC's resulting cost of funds, there may be no significant subsidy provided by AHFC currently, and in the very near future.

By State statute, AHFC currently provides a subsidy of residential mortgage rates. For most loans purchased by AHFC, the interest rate on the first \$90,000 is three percent less than the cost of funds used to purchase the loan, except that: (1) if the cost of funds is less than ten percent, the interest rate is equal to the cost of funds, and (2) if the cost of funds is greater than ten percent, the interest rate may not be less than ten percent. A qualifying veteran is provided an additional one percent subsidy on the first \$90,000 of a loan. The interest rate on the remaining balance of a loan is at AHFC's cost of funds.

The only exceptions to how the interest rate on a loan is determined under the subsidy statutes are as follows:

- MGIC special financing of selected properties with previous MGIC pool insurance. The interest rate is to be selected by MGIC or by AHFC, depending on the property being financed. The weighted average interest rate on all 161 loans purchased in fiscal year 1989 was 9.1 percent, about one-half of one percent higher than the tax-exempt rate for fiscal year 1989.
- Non-Conforming property loans, which carry an interest rate which is one-quarter of one percent higher than the taxable rate for the same loan amount. The reason for the interest rate adjustment is because the risk is greater to AHFC, and because the loan cannot be sold to FNMA and must be held by AHFC.

2. Return AHFC to Original Legislative Intent

The second policy option examined involved restructuring AHFC housing programs to include just those which provide affordable housing for persons and families of low and moderate income, as well as for persons living in remote, underdeveloped, or blighted areas. Determining which existing programs actually meet the original legislative mandates can be accomplished in two ways:

- Identify programs whose eligibility requirements include income or asset ceilings, or provide an incentive (or remove a barrier) to financing properties in remote areas

The AHFC has income or asset limits on just two programs: tax-exempt bond financed program and the Home Ownership Assistance (HOF) program. None of the other programs have limits placed on a borrower's income or assets, and there are no programs specifically designed for persons in remote, underdeveloped, or blighted areas. A rural program is provided by the Department of Community and Regional affairs which makes loans at one percent less than AHFC, although this program is not limited specifically to underdeveloped or blighted areas

- Identify programs actually used by persons and families of low and moderate income, or who purchase housing in remote, underdeveloped, or blighted areas

Determining who uses the programs can be accomplished by reviewing the demographic data maintained by AHFC on each borrower and on the entire loan portfolio

The determination of what is low- or moderate-income has been made by AHFC for the tax-exempt program, following federal regulations. The borrower's annual family income cannot exceed 115 percent of the median income of the area. The maximum annual incomes which AHFC has established for nine geographic areas of the State range from \$53,130 (all "other" areas of the State) to \$71,530 (Juneau). The average income of the borrowers in each of the following programs is well below the lowest AHFC limit of \$53,130 as shown in Table 1, on the following page.¹

¹ AHFC also has established for the tax-exempt program the maximum purchase price of the home, based again on federal regulations. Federal regulations limit the purchase price to 90 percent of the area's average sale price.

Table 1
Average Annual Income of AHFC Borrowers

AHFC Program	Borrower Average Annual Income ²
• Home Ownership Assistance (HOF)	\$25,431
• Mobile Homes	\$33,018
• MGIC Special Financing	\$36,507
• Tax Exempt	\$42,305
• Non Conforming Property	\$42,354

The alternatives we examined included a gradual phase out of the two programs which are not specifically designed to provide for low- or moderate-income housing and which have not historically been used primarily by individuals of low or moderate income. These two other programs are taxable and second mortgage.

The veterans program was assumed maintained as an active AHFC housing program for financing of new loans. In addition, we assumed that AHFC would continue the Home Owners' Assistance Program (HOAP), although this program is not actually a low- to moderate-income program. This refinancing program is needed to assist AHFC borrowers in lowering their monthly payments, and to help mitigate the potential impact on AHFC's financial position from loans which may otherwise become delinquent or go into foreclosure.

Finally, although the mobile home loan program has resulted in significant losses to the AHFC, the program provides housing for that sector of Alaskans who may not otherwise be able to purchase a home. We have assumed that the mobile home program would be continued. We understand that AHFC is planning changes to the mobile home

² The programs listed are ranked by the average annual income of all borrowers obtaining financing in the program over the last three fiscal years (July 1, 1986 through June 30, 1989).

loan program which would increase the down payment required and reduce the loan terms to be more in line with industry underwriting practices for mobile home loans.

3. Change Ownership of AHFC

This third option was the most difficult to define of the three options examined. This option generally involves selling a portion or all of the Corporation to a third party. This could possibly include the following alternatives:

- Selling all AHFC assets
- Selling a selected portion of AHFC assets
 - Real estate owned (foreclosed) properties
 - Loans of a selected type or bond program
- Creating a joint venture of financial institutions and the State Permanent Fund
- Creating and selling stock in the Corporation and paying a dividend to stockholders
- Contracting with a private firm(s) to manage the disposition of real estate owned properties.

During the course of this study, we did not identify a single potential buyer of any AHFC assets. It should be pointed out that most of the financial institutions participating in AHFC programs do not maintain residential real estate loans but rather sell these to either AHFC or other secondary mortgage purchasers. We found little support or basis for assuming that these same institutions would buy back the loans or foreclosed properties, unless for a very deep discount on the assets.

B. EVALUATION METHODOLOGY

We determined the implications of each feasible policy option on the following:

- Alaska State housing market. We considered the potential impact on the present demand for home loans. Given an oversupply of housing in most geographic areas of the State, we focused on resales rather than new construction.
- AHFC financial position. Specifically, we projected the change in AHFC net unrestricted (or "liquid") assets through fiscal year 1993/94.
- State Funds. We estimated whether an additional injection of state funds would be needed to support AHFC programs, or if AHFC had sufficient financial resources to provide a return to the State on its current investment in the Corporation.

1. Methodology to Evaluate Impact of Policy Options on Alaska State Housing Market

We estimated the total number of new loans originated statewide and AHFC's approximate share of that market. This included an estimate of the type of loans purchased, that is, whether the loans were FHA or VA insured, or were conventional loans which have private mortgage insurance or at most an 80 percent loan-to-value ratio. For each option we determined the number of new loans which may or may not be purchased by AHFC and whether there would be a secondary market for loans AHFC was no longer purchasing. A discussion is presented of the likely impact that AHFC's withdrawal from a market segment would have on the ability of home buyers to obtain financing at a reasonable cost.

2. Methodology to Evaluate Impact of Policy Options on AHFC Financial Position

Our measure of the financial position of AHFC was unrestricted net liquid assets available to the Corporation. As noted earlier in Section III of this report, unrestricted assets include cash, investments which mature over the five-year projection period, and mortgage loans available for pledging to bond issues. These assets are net of short-term

obligations of the Corporation. Also included are loans and investments which are currently pledged to a bond issue but which will be released when a specific bond issue is paid off during the five year projection period.

Under baseline conditions, that is, assuming continuation of existing AHFC volume of purchases under each major loan program, we projected what the change in unrestricted net liquid assets would be over the next five years (fiscal year 1989/90 through fiscal year 1993/94). For each policy option, we then estimated the change (i.e., increase or decrease) in net unrestricted assets over the next five years, due either to a change in the subsidy provided, a change in the number of loans purchased under a program, or both.

3. Methodology to Evaluate Impact of Policy Options on State Funds

Based upon the estimated change in net unrestricted assets over the next five years, we determined whether additional State funds would need to be appropriated to AHFC, or whether funds were available to return to the State. This estimate was judgmental because there is no legal requirement nor definition of appropriating funds from AHFC.

C. ANALYSIS ASSUMPTIONS

Because of the complexity of AHFC operations and of the Alaska housing market, it is difficult to measure precisely the impact of a specific change in policy. There are many other factors influencing AHFC's financial position and the housing market which will change over time and which AHFC and the legislature cannot control. Examples include changes in population, personal income, construction costs, and financial markets. These other factors influence the housing market regardless of AHFC's presence in that market.

In order to prepare our analysis, we made a number of assumptions regarding housing and financial markets. These assumptions were designed to simplify the analysis so that it is understandable and to focus on the more significant factors influencing the housing markets and AHFC's financial position. Our basic assumptions were as follows:

- AHFC's volume of loan activity over the next five years was assumed to be approximately the same level as the previous five fiscal years
- Under the new HOAP III program, \$90 million in loans was assumed refinanced, with half being refinanced in fiscal year 1989/90 and half in fiscal year 1990/91
- Changes in AHFC subsidy were assumed not to have an impact on the total demand for loans statewide. Also, reductions in AHFC purchases of loans under the taxable program was assumed to be offset by increases in purchases by non-AHFC secondary market participants
- No subsidy was assumed for the tax-exempt or tax-exempt veterans bond programs because the cost of funds for these two programs was assumed to be below the threshold of the subsidy
- A subsidy of approximately 0.75 percent was assumed provided on loans financed with taxable bonds over the next five years under our baseline scenario. An alternative assumption was made for analysis purposes that interest rates would rise in fiscal year 1990/91, and that AHFC provided a two percent interest rate subsidy on loans purchased under the taxable program through fiscal year 1993/94

- A two percent subsidy was assumed provided under the HOAP III program, which is the maximum available under that program
- Bonds sold by AHFC were assumed overcollateralized by two percent in order to improve the bond's credit rating
- Interest earnings and expenses on Corporate Operating and General accounts were assumed to be equal to eighty percent of the average earnings and expenses over the last five years
- AHFC general and administrative expenses were assumed to be \$10 million annually, approximately the annual budget for fiscal year 1989/90.

SECTION VI

**POLICY OPTION TO CHANGE
AHFC SUBSIDY**

Ernst & Young

VI. POLICY OPTION TO CHANGE AHFC SUBSIDY

This section of the report reviews the policy option to change the AHFC subsidization of interest rates. It is organized under the following headings:

- *Overview of Subsidy*
- *Description of Alternatives to Change Subsidy*
- *Analysis of Elimination of Subsidy*
- *Analysis of Phase-Out of Subsidy*
- *Impacts of Changing the Subsidy*
- *Conclusions Concerning the Subsidy.*

A. OVERVIEW OF SUBSIDY

This section is intended to review the impact of changing AHFC's practice of subsidizing residential mortgage rates, either through immediate elimination of the subsidy or through some form of phase-out. For purposes of this section, we are referring to the term "subsidy" as the Corporation's practice of providing interest rates to mortgage holders at a rate below the Corporation's cost of funds. This subsidy is essentially financed through overcollateralizing bond issues (through the influx of Corporate capital).

The section is intended to only address bond-financed programs and not the various programs offered by the Corporation which are financed directly and/or entirely by State appropriated monies. Additionally, elimination or reduction of the subsidy as discussed in this section pertains only to the "buy-down" of interest and is not related to those interest rates necessary to ensure the tax-exempt status of applicable bonds.

The Corporation's (and State's) subsidization of interest rates first came about as a result of legislation passed in 1980 which stipulated the following¹:

- The interest rate may not exceed nine percent for the first \$90,000 of the loan if the loan is made to an eligible veteran
- The interest rate may not exceed 10 percent for the first \$90,000 if the loan is made to a person other than an eligible veteran
- The interest rate for the amount of the loan which exceeds \$90,000 shall equal the mortgage program costs to the Corporation attributable to that part of the loan.

Subsequently, in an effort to reduce the Corporation's exposure in times of escalating interest costs, a ratcheting measure was introduced to establish a cap on the subsidy. This was done in 1981, through changes in legislation. The principal effect of this change was to cap the Corporation's exposure to a three percent subsidy on the first \$90,000 of a loan.

The Corporation's practice of subsidizing interest rates for almost ten years has accounted for an exhaustion of significant resources appropriated to AHFC by the State of Alaska. Eventually, depending on the scenario predicted for the future in regards to interest

¹ Excerpt from Alaska State law Chapter 106, Sec. 18.56.098 (1) (2) (3).

rates and loan demand, these State appropriations will be totally depleted if this practice is continued. Accordingly, without additional State appropriations sometime in the future, the Corporation's capital base will gradually be weakened and its ability to provide any assistance (even to first-time homebuyers) may some day no longer exist.

B. DESCRIPTION OF ALTERNATIVES TO CHANGE SUBSIDY

In this section we address alternatives for changing the historic and current practice of subsidizing interest rates. Although many possible alternatives exist, we believe the following three are the most meritorious, and we will therefore limit our discussion to these:

- Complete elimination of the subsidy as of a pre-determined future date (for purposes of this Section we chose June 30, 1990 for reasons shown below)
- Complete elimination of the subsidy as of a pre-determined future date, but only if conditions (principally interest rates) are favorable at that time
- A phase-out of the subsidy over a future period of time (such as would result from a draft bill dated October 5, 1989, proposed by Mr. Robert Mintz, Chairman of the Board, AHFC).

These alternatives, and their possible impacts on the market, the Corporation, and State appropriated monies, are discussed below.

C. ANALYSIS OF ELIMINATION OF SUBSIDY

Although the subsidy of interest rates provided valuable benefits to Alaskan homeowners at a time when the State had a need to attract buyers of residential property and also had the available resources to fund such an effort, today, circumstances have significantly changed. Specific negative attributes which are directly associated with the present subsidy are as follows:

- The subsidy may have historically contributed to artificially increased housing prices
- The subsidy may have acted as a factor in driving out of the market competitive sources of mortgage capital
- The subsidy is not a sound economic or financial practice for AHFC, and funds already appropriated will run out at some future date
- The subsidy today may be construed to be an indiscriminate use of increasingly scarce State resources.

Because of the above probable detrimental effects of the subsidy and the dramatic changes in the economy since the early-to-mid 1980's, the sooner the practice of subsidizing interest rates is terminated (as long as it is done properly), the better. Although we tried to consider all possible ramifications of subsidy elimination, our analysis of a termination of the subsidy was strongly motivated by the need to restore financial soundness to the AHFC.

Because we firmly believe that some change in the subsidy is inevitable, we determined under what conditions cessation of the subsidy would be most favorable. We believe the conditions when the least negative impact would be felt from elimination of subsidy would be at a time when:

- The Corporation's cost of funds pertaining to bond issuances are below threshold rates
- The demand for new mortgage loan applications is minimal
- Housing prices are at, or near, a low point in comparison with the recent past and expected (at least in the short-term) future
- Market interest rates, projected over at least the short-term, are expected to remain constant or decline.

We reviewed the current situation regarding the supply of unused bond proceeds at AHFC. Exhibit VI-1, following this page, lists all of the Corporation's currently active bond-financed programs and illustrates the proceeds (or overcommitted amounts) remaining for financing loans as of December 31, 1989. The exhibit includes proceeds from bonds issued through this date.

For purpose of Exhibit VI-1, the availability of proceeds (funds) includes not only investor pools already purchased, but investor pools ready to be purchased, mortgages ready to be pooled, and outstanding commitments to mortgage loans. Therefore, the "uncommitted funds" (or overcommitted amounts in some cases) reflect a minimum level of total availability of bond proceeds. We have included overcommitments on this exhibit merely to illustrate the demand level for certain of the programs. Along with this information, we have included the Corporation's cost of funds pertaining to the associated bond issuances. All information shown was made available from AHFC internal records.

Our observations of Exhibit VI-1, as well as our other analyses, is presented below. We have segregated this discussion into three principal program categories, as follows:

- Tax-exempt and Veterans bond programs
- Refinancing bond programs (HOAP)
- Taxable bond programs (other than HOAP).

Tax-exempt and Veterans' Bond Programs: An opportunity appears to currently exist for the complete elimination of the subsidy pertaining to these programs for the following reasons:

- The cost of the Corporation's funds are sufficiently below the threshold rates (10 percent and 9 percent, respectively)
- According to AHFC management, and recent history of loan applications, there currently exists sufficient available proceeds to meet demand over at least the next year.

**AHFC Schedule of Available Funds
As of December 31, 1989
(\$ Millions)**

Bond-Financed Program	Uncommitted (Over Committed) Funds	Cost of Funds
First-Time Homebuyers:		
1987 A	\$ (2)	8.92%
1988 A-1	(1)	8.57%
1988 A-2	(5)	8.43%
1988 A-3	25	8.65%
1989 Series A(a)	-	-
1989 Series B(b)	<u>148</u>	Floating
	<u>\$165</u>	
Veterans:		
1988 First	\$ (5)	8.81%
1989 First	<u>45</u>	8.25%
	<u>\$ 40</u>	
Taxable:		
CMO 1989-2	(1)	10.78%
CMO 1989-4	<u>12</u>	10.42%
	<u>\$ 11</u>	
HOAP:		
1988-1(c)	\$ (7)	
1988-2(c)	(7)	
CMO 1989-1	(20)	12.23%
CMO 1989-3(d)	<u>-</u>	-
	<u>\$(34)</u>	

- (a) Original issuance was for \$90 million. This was subsequently refunded from proceeds of 1989 Series B.
- (b) Issuance closed near the end of November 1989. Initial interest at 6.19 percent; cost of funds is currently below 10 percent.
- (c) Cost of funds were unavailable, however rates were estimated at substantially above 10 percent.
- (d) A \$70 million issuance was sold late in 1989. All proceeds were committed at December 31, 1989.

Also, with regards to these two programs, a "subsidy" would still remain (only in a different form) because tax-exempt financings (by the very nature of these bond structures) should continue to provide qualified applicants with below market interest rates.

HOAP Bond Programs: We have segregated the HOAP programs from other taxable programs because of the importance of the Corporation's attempt to provide a vehicle to restructure (in the form of refinancings) certain of the earlier programs sponsored by the AHFC. Therefore, even though there is currently a definite subsidy involved with loans issued under the HOAP programs, we would not necessarily suggest that this particular subsidy be universally ceased.

We understand from AHFC management that demand for these loans has recently slowed and that total future bond proceeds expected to be necessary as of December 31, 1989, to fund the expected loans necessary to complete the HOAP programs, is estimated at \$90 million. This will be accomplished through the issuances of bonds under the HOAP III program. Although the loan funding period is expected to continue throughout the Corporation's 1990 and 1991 fiscal years, two alternatives exist under the scenario of eliminating the subsidy in the HOAP programs as of June 30, 1990, as follows:

- The Corporation could issue all bond(s) necessary to fund the entire HOAP III program prior to the change in legislation as of June 30, 1990. We suggest this method be given top priority as it is the most financially sound alternative and because it treats all programs equitably with regards to removal of the subsidy
- If the first alternative is not feasible, we suggest a change in legislation as of June 30, 1990, with the intent of eliminating the subsidy, but specifically segregating refinancings with elimination of the subsidy under the HOAP programs as of June 30, 1991, if not before. However, from a legal perspective, this may result in due process concerns. Finally, if the second alternative is chosen, we would support a formal cost-benefit analysis be performed showing that the subsidy cost to AHFC for the HOAP III refinancings is offset by future savings in REO or other costs.

Taxable Bond Programs: As can be seen from Exhibit VI-1, the taxable programs present a potential downside to the proposal of eliminating the subsidy,

as recent bonds issued have a cost of funds at a rate slightly higher than the ten percent threshold rate. Also, even though some uncommitted funds exist, demand over the next few months will most likely exceed the amount of these available funds.

However, we believe that a window of opportunity still exists currently to eliminate the subsidy for taxable programs because of the following rationale:

- Interest rates, according to numerous industry sources (including the National Association of Realtors, economists polled by Wall Street, and representatives from the Federal Reserve Board) are expected to remain stable or decrease slightly in 1990²
- Demand for new home loans is at a low point as compared to the past couple of years
- The price of housing, according to local Anchorage real estate and financial institution representatives, appears to be at or near the bottom
- Additional taxable bonds could be issued, based on expected demand, to provide for a cushion of available funds, if necessary. This issuance of additional taxable bonds could provide for a smoother transition prior to the date set for elimination of the subsidy. However, this action should be taken only if interest rates are advantageous and it makes general economic sense considering all relevant factors.

In summary, because of the above considerations, it appears that a very unique window of opportunity currently exists to allow for the complete elimination of the subsidy. However, we wish to emphasize that an elimination as of a set date (June 30, 1990) is only appropriate under the conditions noted above. A significant time delay in implementing the change could result in changed market and economic circumstances. Therefore, as a possible backstop, a ratchet mechanism may be wise to consider. That is, eliminate the subsidy through revised legislation as of a set date (again June 30, 1990 seems to be appropriate), but provide for the ability to extend this date if conditions are not actually favorable at that time.

² On January 8, 1990, major U.S. banks cut their prime lending rates a half point to ten percent in a move that should translate into lower borrowing costs for consumers and businesses. First National Bank of Chicago took the first step and was followed by Citicorp, Bank of America, Wells Fargo, and First Interstate Bank of California. Reports indicate that long-term mortgage rates will also decline slightly.

D. ANALYSIS OF PHASE-OUT OF SUBSIDY

As an alternative to eliminating the subsidy as of a set date, it could be phased out over a period of time. A phase-out could be accomplished by either of two principal means. Either the maximum interest rate differential (between the threshold rate, and the Corporation's cost of funds) could be scaled back over time, or the dollar amount of the loan subsidized (currently \$90,000) could be reduced pro-rata over a period of time. We understand that the latter method is currently being proposed in a draft bill by Mr. Robert Mintz, Chairman of the Board of AHFC.

Although either of the above two methods would eventually result in the same effect as the entire elimination of subsidy as of a set date, we believe that the more timely elimination is preferable. This is principally because of the unique window of opportunity which we feel currently exists in the near-term and which may not exist over the longer term. Also, earlier elimination of the subsidy will have less negative financial impacts to the AHFC and the State.

E. IMPACTS OF CHANGING THE SUBSIDY

We addressed the impact of changing the subsidy as to its effect on the housing market, AHFC, and the State (appropriated funds). Below is a summary of what we determined to be the impacts:

Market: We addressed the impact to the housing market under three separate circumstances, as follows:

- If no subsidy exists and is not expected to exist in at least the short-term future, there would theoretically be no effect on the housing market. This is currently the case with the tax-exempt and Veterans' programs
- If a minor subsidy is in effect, such as is the case with the taxable programs, the impact may be minor but it should not be significant because of the potential ability to create a cushion of available funds for financing loans during the transition period. Also, the premise that housing prices appear to be at or near the bottom should help to minimize any effect to the housing market
- If a minor subsidy exists, but interest rates increase significantly before the transition period, a more serious downside effect would occur. If this "worst-case scenario" were to take place, some form of ratcheting (such as extending the effective date of eliminating the subsidy until conditions were more favorable or phasing-out the subsidy over time) would obviously be necessary. However, based on projected interest rates, we do not currently believe this to be the likely scenario.

AHFC: Either the elimination or phase-out of subsidization of interest rates will definitely provide for a financially stronger Corporation. Other impacts to AHFC will be as follows:

- Generally, the eventual elimination of the subsidy will provide no negative effect to Corporation bond or loan covenants
- Because of the stronger financial condition which will result, there should be no negative effect to the Corporation's bond ratings from credit rating agencies. However, the cessation of interest rate subsidization must remain (in appearance as well as in fact) independent of any possible appropriations

by the State as it is important not to promote any form of an extraction of Corporate assets or equity

- Without the subsidization of interest rates for the taxable programs, the Corporation will appear to lose much of its competitive market advantages over the private sector. This may ultimately, in the long-term, lead to a healthier competitive capital market environment.

Perhaps even more important than the above considerations, without any future changes to the subsidy, and no further State capital injections, we have projected that the Corporation will have a major decrease in its unrestricted net liquid assets over the next five year period. Because of the immaterial amount of total unrestricted net liquid assets available as of June 30, 1989 (only \$10 million), any substantial decrease in unrestricted assets will have the following two important negative impacts on the Corporation's short-term borrowing arrangements:

- If minimum unrestricted net liquid asset balances are not maintained, the Corporation may be in a default position on its working capital debt
- If net losses resulting from bond programs continue in the future, the critical short-term Corporation borrowing arrangements necessary for day-to-day operations may be severely jeopardized.

State Appropriations: Because elimination of the subsidy will provide for a more financially solvent AHFC, this may be one of the few ways for the State to ever receive a return on their substantial contributed capital. This is assuming the AHFC has to reach at least break-even operations in order to be able to return a dividend from operations to the State.

We have analyzed the effect to the Corporation's Operating and General accounts (measured by net liquid assets) over the next five-year period (ending June 30, 1994) under the assumption of eliminating the subsidy as of June 30, 1990. We followed the methodology as in our baseline projections, discussed in Section V.

As can be seen in Appendix B, at the end of this report, the net effect of this subsidy elimination is estimated to increase unrestricted net liquid assets of the Corporation by \$43 million to \$91 million over our projection of an "as-is" scenario

SECTION VI **POLICY OPTION TO CHANGE THE SUBSIDY**

for the same future period. Therefore, the net effect over a five year period of eliminating the subsidy may range from \$43 million to \$91 million, depending on market conditions. In summary, elimination of the subsidy will reduce costs, either to the State or to the Corporation, by substantial amounts.

F. CONCLUSIONS CONCERNING THE SUBSIDY

Because the subsidization of interest rates, by definition, causes a major drain of the Corporation's equity, it must either be terminated at some future date or AHFC will eventually require additional State contributions. The cessation of the subsidy will not only make possible some long-term future return on prior State appropriations, it also will provide a great stride towards long-term fiscal responsibility for the Corporation.

We believe that the elimination of the subsidy as defined in this section, is currently feasible and desirable because of the unique window(s) of opportunity previously discussed. However, because this elimination only makes economic sense under these very favorable conditions, both urgency and caution must be followed in implementing the necessary changes.

SECTION VII

POLICY OPTION TO RETURN AHFC TO ORIGINAL LEGISLATIVE INTENT

Ernst & Young

VII. POLICY OPTION TO RETURN AHFC TO ORIGINAL LEGISLATIVE INTENT

Among the options defined by the State Legislature concerning future policies for AHFC was a return of AHFC to its original legislative intent. Since this policy option was not further defined, we investigated the original enabling legislation of AHFC and early subsequent amendments in order to determine original legislative intent.

Based on this interpretation of intent, we made a determination of which AHFC programs would be affected, and to what degree, and estimated the impact of these program changes on Alaska's housing market and on the financial position of AHFC and the State.

The effects of terminating the subsidy have been discussed previously in Section VI of this report. In discussing the effects of changes analyzed in this section (*i.e.*, termination of the Taxable Program) we assumed that the subsidy has already been terminated unless otherwise noted.

This section of the report is organized as follows:

- *Original Legislative Intent*
- *Effect on AHFC Programs of Return to Original Intent*
- *Implementation of Terminating the Taxable Program*
- *Potential Effects of Terminating the Taxable Program*
- *Summary and Conclusions Concerning Return to Original Intent.*

A. ORIGINAL LEGISLATIVE INTENT

AHFC was created by HB 167 in 1971, which amended AS 18.56. Enabling language clearly emphasized that AHFC was to assist in providing housing for lower income persons. Section 18.56.010, "Findings and Purpose," is quoted here in full:

- "(a) There exists within the State a serious shortage of decent, safe and sanitary residential housing available at low prices or rentals to persons of lower income. This shortage is inimical to the safety, health, welfare and prosperity of the residents of the State and to the sound growth of urban and rural communities.
- "(b) The legislature finds and declares that private enterprise has not been able to provide, without assistance, an adequate supply of safe and sanitary homes at prices or rents which persons of lower income can afford, or to achieve rehabilitation of much of the present housing for persons of lower income, and that existing federal programs are inadequate to meet housing needs of persons of lower income. It is imperative that the supply of housing for persons of lower income be increased and that coordination and cooperation among private enterprise, state and local government be encouraged to sponsor, build and rehabilitate residential housing for these persons.
- "(c) The legislature finds and declares further that, in accomplishing this purpose, the creation of the Alaska Housing Finance Corporation is essential to assist in the acquisition and development of land and the construction, rehabilitation, financing, management, maintenance, sale and rental of dwelling units for persons of lower income and that these activities serve a public purpose in benefiting the people of the State. The Alaska Housing Finance Corporation is empowered to act on behalf of the State and its people in serving this public purpose for the benefit of the general public."

To accomplish this purpose, AHFC was given a broad range of powers including making construction or mortgage loans, purchasing mortgage loans, subsidizing rental or mortgage interest payments, dealing in real property, selling mortgages to FNMA, and borrowing money. AHFC was specifically empowered to sell either revenue or general obligation bonds.

One year later, in 1972, CSHB 547 amended the language given above to specifically include housing for:

- Persons of moderate income
- Persons in "remote, underdeveloped or blighted areas."

If we include this 1972 amendment in the definition, then the words "original legislative intent" are taken to mean that AHFC's primary role is to facilitate decent, safe and sanitary housing for persons of low or moderate income, and for persons in remote, underdeveloped, or blighted areas.

AHFC's programs for persons in "remote, underdeveloped or blighted areas" have never been strong or active. Even programs for non-conforming housing, which are not very active currently, have been as much oriented to urban areas as rural ones. We understand that there are at least two reasons for this:

- Most rural non-conforming loans are handled by DCRA, and AHFC activity in this area would be duplicative
- AHFC, unlike DCRA, is not organizationally set up to qualify large numbers of borrowers or service loans in rural areas.

Therefore, in the discussion which follows, we do not assume any changes in AHFC activities relating to "rural, underdeveloped, or blighted areas."

**B. EFFECT ON AHFC PROGRAMS OF
RETURN TO ORIGINAL INTENT**

Active AHFC programs serving low- and moderate-income Alaskans, as defined by the average income of borrowers in fiscal year 1989 (see Exhibit II-4 on page II-22), include:

- Tax-exempt (1,371 loans, average borrower income of \$42,305)
- MGIC Special Financing (161 loans, average borrower income of \$36,507)
- Mobile Home (18 loans, average borrower income of \$33,018)
- Non-conforming (16 loans, average borrower income of \$42,354)
- HOF (26 loans, average borrower income of \$25,431).

Only the first of these programs is bond-financed, the others being financed by State-appropriated monies.

It would probably be advisable to retain special REO programs so long as the disposal of real estate owned is a significant problem to AHFC, regardless of borrower income. Of the programs shown above, the MGIC Special Financing Program is specifically designed to help AHFC dispose of its REO. We understand that this program will soon be replaced by the "Yes You Can" Program.

Two other programs deserve special mention because, even though they do not strictly meet the definition of original legislative intent, this section does not assume their elimination:

- The tax-exempt Veterans Program (254 loans in fiscal year 1989, average borrower income of \$59,125) is assumed to continue for two reasons: First, it serves public policy in helping veterans obtain housing at preferential rates; and second, it enables qualified Alaska residents to take advantage of federal programs providing tax-exempt funding at no net cost to the State

- The HOAP Program (6,316 loans in fiscal year 1989, average borrower income of \$56,158) is not a new mortgage purchase program, but allows mortgage holders with existing AHFC loans to refinance their mortgages. This provides a variety of benefits both to homeowners and to AHFC. Also, this program will phase out as its purpose is served.

Therefore, only two active AHFC programs remain which do not meet the definition of original legislative intent:

- Taxable Program (892 loans in fiscal year 1989, average borrower income of \$59,948)
- Second Mortgage Program (two loans in fiscal year 1989, average borrower income of \$79,368).

Thus, with the provisos above, the concept of returning AHFC to its original legislative intent involves eliminating these two programs. Since the magnitude of the Second Mortgage Program is negligible, all discussion following relates to eliminating the Taxable Program only. The discussion also applies to any future programs which might meet the same criteria as the Taxable Program, that is, they serve Alaskans by purchasing standard mortgages without specific policies with respect to housing type, income, or special need.

**C. IMPLEMENTATION OF TERMINATING
THE TAXABLE PROGRAM**

Discussion of elimination of the Taxable Program following assumes that program termination, or the beginning of a phased termination, occurs on June 30, 1990. This date is chosen to be consistent with the analysis of termination of the subsidy in Section VI. A review of AHFC management's planned bond issuances indicates that the program should have several million dollars in uncommitted funds as of June 30, 1990.

1. Possible Elimination Mechanisms

There are two basic scenarios for Taxable Program elimination: Sudden or phased. The definition of a sudden termination is simple—after a certain date no new bonds would be issued to purchase loans under this program, and no new mortgages would be purchased after existing funds have been committed.

For the following reasons, a sudden termination would be unwise and should be avoided:

- It gives the State no way to test the secondary market. If the slack created by program termination cannot be filled by alternative sources (FNMA, FHLMC, etc.) then mortgage capital available will be less than demand and real estate transaction volumes and prices may suffer
- Because AHFC uses its Taxable Program to finance a significant portion of REO sales, abrupt termination might harm REO disposition efforts
- Even though the uncommitted funds as of the termination date should provide some "cushion" for a transition period, there is always a possibility that the cost of these funds will be below prevailing market rates even with the subsidy eliminated. This could potentially cause a "run" on remaining funds. Based on industry forecasts of interest rates, however, this scenario appears unlikely
- Since much of the real estate community perceives this program as important to the market, sudden termination may create a market shock beyond any otherwise foreseeable economic effects.

Therefore, a gradual process of phasing out the program is preferred. The phasing out could be accomplished either by limiting supply or limiting demand.

Limiting supply could be accomplished through smaller bond issues, or issues more widely spaced, until at some point no more bonds were issued. Advantages would include those generally applicable to gradual program termination (*e.g.*, "testing the waters" of the secondary market), and there would be no need to modify down payment or qualifying criteria or other loan characteristics. A major disadvantage to this approach, however, might be a "run" on AHFC mortgage funds if the Corporation's cost of funds were below prevailing market rates at some point during the phase-out. This could cause housing market fluctuations and damage market stability.

A sounder approach would be to limit demand for AHFC funds. This might be done by gradually increasing down payment requirements, other loan requirements, or interest rates. Advantages to this approach include:

- Housing market fluctuations would be avoided as demand for AHFC funds tapered off gradually
- Loan originators would increasingly seek alternative lending sources, such as FNMA or FHLMC, thus testing the availability of the secondary market in a gradual way
- In the case of higher interest rates, AHFC net income should increase. This income could either partially be returned to the State or used to fund necessary AHFC reserves.

2. Preferred Phase-out Mechanism

Each of the above gradual phase-out mechanisms could be applicable at different times and under different market conditions. Any one mechanism used by itself would probably be unpopular or unfair to specific groups of borrowers. Of all the mechanisms, sudden termination potentially could cause the most problems and should definitely be avoided.

A combination of several approaches, cautiously applied and tuned to the housing market as it changes, would be the best approach. We therefore recommend that a phase-out program include the following:

- AHFC management is given a formal legislative mandate to phase out the Taxable Program over the long term (*e.g.*, over a five-year period) while maintaining flexibility to act as a long-term "backstop" for the Alaska housing market (this concept is further discussed in Section IX of this report)
- Management prepares a plan to reduce Taxable Program demand using a combination of demand-reduction measures
- Management estimates the potential reduction in demand from this plan and scales down planned bond issues accordingly (thus limiting supply without significant market disruption)
- Management implements its plan and tracks actual demand reduction against its expectations, as well as the increases in direct market share of other secondary mortgage purchasers, in order to ensure that the phase-out does not adversely affect the Alaska housing market
- Management reviews results of the plan against its expectations, makes revisions as required, and continues with the phase-out program.

This phase-out program serves four purposes:

- It gives AHFC management control over the phase-out. Hands-on management control is essential if market disruption is to be avoided, since adjustments to the program may have to be made frequently and judiciously
- It allows AHFC to "pace" the phase-out to the rate at which other secondary market purchasers are filling any vacuum left by its departure
- It allows retention of the Taxable Program for a period of time so that the program can continue to serve as one of AHFC's vehicles for financing REO sales
- It scales down future bond issues based on decreased demand for borrowing, rather than trying to limit borrowing by rationing funds.

D. POTENTIAL EFFECTS OF TERMINATING THE TAXABLE PROGRAM

1. Effects on the Real Estate Market

The key to the effect of a phase-out of AHFC's Taxable Program on Alaska's housing markets is the availability of alternative funds for the residential mortgages purchased under the program. As discussed in Section IV of this report, many industry sources believe that availability of alternative funds is limited.

a. Magnitude of the Taxable Program Compared with the Housing and Mortgage Markets

Prior to addressing this issue directly, it is useful to review the magnitude of the Taxable Program in relation to statewide housing sales, new mortgage generation, and AHFC mortgage purchase activities, as shown in Table 1, below:

Table 1
Alaska Home Sales and Mortgage Statistics
Fiscal Year 1989

Category	Number	Percent
Total home sales	7,700	100% (1)
Total new mortgages	4,600	60 (2)
AHFC New Mortgage Purchases	2,740	36 (3)
AHFC Taxable Program purchases	892	12 (3)

Notes: (1) Estimated based on market survey, Appendix C
 (2) Estimated based on AHFC management's stated 60 percent share of the current new mortgage market
 (3) AHFC statistics.

As can be seen from this table, purchases of mortgages under the Taxable Program currently support about 12 percent of total statewide home sales, or 19 percent of new mortgage generations in the State. While these percentages presently appear small, programs supported by taxable bond issuances have historically served an important

segment of AHFC's financing activities. The Taxable Program is also important to AHFC's financing of REO dispositions. Finally, the percentages shown above would probably be higher in a "normal" year in Alaska, for the following reasons:

- Most current transaction activity (64 percent in 1989) is below the tax-exempt limit because of the general fall in housing prices. This shifts demand for AHFC mortgage purchases into the tax-exempt programs. In a normal market the general price levels would be higher and the Taxable Program might play a larger role
- Further demand for tax-exempt program financing is caused by the wide availability and aggressive marketing of REO, which tends to be lower-end property. In more normal times, REO would represent a much smaller portion of the market
- The prevalence of negative home equities in the market has led to an evident high percentage of home sales made on the basis of mortgage assumptions or direct buyer-seller contracts. In a more normal market this situation would not exist. There would be a higher demand for new mortgages overall, and demand for AHFC's Taxable Program would be correspondingly larger.

The situation is further complicated by the differential in demand between AHFC Taxable Program funds (available at 10 percent as of this writing) and alternative funds (generally about 10 percent to 10.5 percent). To the extent that demand for AHFC funds is price-sensitive, then demand for Taxable Program funds is probably higher than it would be if alternative funds were relatively less expensive.

b. Marketability of Loans Purchased Under the Taxable Program

Availability of an alternative secondary market for loans which AHFC purchases under the Taxable Program will be largely determined by the types and quality of these loans. The following discussion addresses these issues.

Loans purchased under the Taxable Program are of the same type purchased by other secondary market purchasers. They are either FHA-insured, VA-insured, or conventional loans. All conventional loans have either a 20 percent down payment or 10 percent down with private mortgage insurance (PMI). **Table 2**, following this page, shows the relative percentages of loans purchased that fall into the three categories:

Table 2
AHFC Taxable Program Mortgage Purchases

Year	Percentage FHA-insured	Percentage VA-insured	Percentage Conventional
FY 1989	55%	10%	35%
FY 1990 (6 mos.)	59%	8%	33%

Source: AHFC management

The increasingly high percentage of FHA-insured loans is probably due to the fact that PMI is difficult to obtain. We understand that there is only one company currently providing this coverage in Alaska, and that it is applying very strict underwriting criteria to its new policies. Thus, the FHA program is the only method available to many borrowers to avoid a 20 percent down payment requirement.

Since AHFC's underwriting criteria are in accordance with those of FNMA and FHLMC and other secondary market purchasers, the loans appear to be fully acceptable to the secondary market in general. If an alternative market is available, these loans should be readily marketable.

In fact, while AHFC appears to be the secondary market purchaser of these loans, they are routinely sold through to other secondary market purchasers, with AHFC acting as a facilitator. The ultimate secondary market for the Taxable Program loans is currently AHFC's pool purchaser, FHLMC, which is in effect lending money to support Alaska mortgages under the program. We also found that FNMA is active in the Alaska market, and we understand that they have purchased more Alaska loans independently of AHFC during FHLMC's current commitment period than has FHLMC under its pool purchase commitment with AHFC.

c. Summary of Effects on the Housing Market

The following findings summarize the analysis above:

- AHFC's Taxable Program currently serves only a minor portion of Alaska's housing market. In more normal times the program would play a relatively larger role, but the size

of this role would be affected by the subsidy available and the cost of funds from other sources

- AHFC loans under the Taxable Program are of types which are readily marketable and are, in fact, currently being marketed to FHLMC. In effect, FHLMC is the ultimate secondary market and is using AHFC as a vehicle to buy Alaska mortgages under the program
- The role of the Taxable Program is therefore facilitating in nature, and may not be critical to the housing market in the long term.

Due to the generally perceived role of AHFC, however, its long-term institutional relationships with other secondary market purchasers, and the continuing importance of the Taxable Program to the Corporation's REO sales, any phase-out of the program should proceed carefully and take place over an extended period of time as described previously in this section. A careful implementation of the phase-out will avoid market disruption because if any disruption does become evident, mechanisms will then be in place to slow the phase-out and stabilize the situation.

In summary, AHFC programs supported by taxable bonds presently compete directly with private sector sources of financing. The AHFC, in absence of the subsidy, adds no unique value to these taxable mortgage programs, over and above the private sector. In addition, the AHFC is generally not serving low- to moderate-income persons with its taxable programs. However, it should be clarified that even though the AHFC programs supported by taxable bonds may appear to be presently expendable, we are not suggesting that this occur entirely. These taxable programs must remain accessible to AHFC, but only on an "as needed" basis. Until the present Alaska real estate market improves, we believe that the taxable program still cannot be arbitrarily terminated.

2. Effects on AHFC

The effect of terminating the Taxable Program on AHFC's financial position is measured by the change in unrestricted net liquid assets, that is, those AHFC liquid assets which are not used to directly collateralize any AHFC obligations. The potential change in these assets arises from two sources:

- First, to the extent that loans under the Taxable Program are subsidized, terminating this program means that further subsidies are unnecessary and these assets, therefore, should increase
- Second, since bond issues supporting the program are overcollateralized as a credit enhancement measure, terminating this program frees up assets which would otherwise be pledged as collateral.

Since this section presupposes elimination of the subsidy, only increases arising from the second source need be considered.

As can be seen in Appendix B of this report, the additive effect (over and above elimination of the subsidy) of eliminating the Taxable Program as of June 30, 1990, would be to increase unrestricted net liquid assets of the Corporation by \$45 million through June 30, 1994. Assuming the program is phased out rather than terminated abruptly, the potential increase in unrestricted net liquid assets might be half that amount, or \$22.5 million.¹ It should be noted that these figures represent dollars that are "tied up" but not necessarily lost.

The assets freed up on a per-mortgage basis can be calculated from these amounts. Capital tied up on a long-term basis is approximately \$8,000 per \$100,000 mortgage, net of subsidy costs.² The composition of this \$8,000 is:

- Overcollateralization for credit enhancement (about \$2,000), from AHFC assets. These assets are encumbered for the life of the bonds, as are interest earnings from the funds. They are not available for any other purpose prior to issue retirement
- Other reserve funds (about \$5,000), from AHFC internal funds. These funds are also encumbered for the life of the bonds

¹ Savings from eliminating the subsidy on the Taxable Program only, which are not included in these amounts, might vary from \$31 to \$73 million over the same period assuming abrupt termination, or \$16 to \$37 million under a gradual phase-out, depending on future interest rates. These amounts are based on the assumptions stated in Appendix C under scenarios A and B, and represent about three-quarters of AHFC's total expected subsidy costs over the period.

² Subsidy costs per \$100,000 mortgage might range from \$5,000 to \$12,000, depending on prevailing interest rates in the future. These are true costs, since monies pledged to the bonds for interest rate subsidies are intended to pay debt service and are not returned to the Corporation.

- Bond issuance costs (about \$1,000), funded from bond proceeds and repaid with interest over the life of the bonds.

Thus, of this \$8,000, about \$7,000 should ultimately become available to AHFC after bond retirement. However, even this amount is at risk during the life of the bonds. The remaining \$1,000 is a true cost and would never be recovered.

3. Effects on State-Appropriated Monies

While the expected increase in AHFC's unrestricted net liquid assets from Taxable Program termination may seem to make the Corporation's assets more appropriable to the State, in practice the opportunities for such appropriation are limited. Because most AHFC bonds are general obligation bonds, and thus secured by the "full faith and credit" of AHFC, any move toward appropriation of AHFC assets will be seen by existing and potential bondholders as an attack on AHFC's financial integrity. This could have the effect of lowering ratings on AHFC bonds, thus reducing the market value of existing bonds and making future bond sales more difficult and expensive.

Over the long term, there appear to be two principal ways that AHFC assets will become more readily appropriable by the State:

- Modify AHFC programs so that the Corporation can operate on a break-even basis or make a small profit, and implement a program of returning some of this profit to the State as a dividend from operations
- Shift AHFC's financing emphasis over the long term to revenue bond issues, which is consistent with low- to moderate-income housing financing entities in other states. Since the security of revenue bonds is limited to mortgage payments and other specific funds set up as reserves, much of the remainder of AHFC's capital base would ultimately become less relevant to bondholders and potentially could be appropriated to the State.

These mechanisms are consistent with Section IX of this report, which discusses the conceptualization of an idealized AHFC.

**E. SUMMARY AND CONCLUSIONS CONCERNING
RETURN TO ORIGINAL INTENT**

Our conclusions relating to this section of the report are presented below:

- Under the concept of "original legislative intent," only the Taxable Program of AHFC should be considered for elimination. Certain other programs lie outside the scope of original intent, but they are largely oriented to REO sales and refinancings and serve important near-term needs in the current distressed market. However, need for these programs should diminish over time
- The Taxable Program currently serves only a minority of Alaska's housing market, although it supports an important segment of the market. Relative program size would probably be higher in a more normal housing market
- Loans originated under the Taxable Program should be readily marketable to other secondary market purchasers. In effect, the secondary market for these loans already exists in FHLMC though its current commitment with the Corporation
- Reduction of the Taxable Program should be very carefully conceived and controlled, and should be phased in over a period of years
- Net increase in AHFC's unrestricted net liquid assets from abruptly eliminating the Taxable Program are estimated at \$45 million through June 30, 1994. Under a gradual reduction of the Taxable Program, as recommended, the increase should be about half that amount
- These additional unrestricted net liquid assets will not be readily available to the State. The legislature may wish to consider a long-term program for AHFC based on the concepts in Section IX of this report, which may ultimately provide dividends or return of capital to the State
- Even though the Corporation's unrestricted net liquid assets would be decreased the least over the next five years the sooner the taxable program was eliminated, the negative effect this policy option change would have on the housing market is overriding.

SECTION VIII

**POLICY OPTION TO CHANGE
OWNERSHIP OF AHFC**

Ernst & Young

VIII. POLICY OPTION TO CHANGE OWNERSHIP OF AHFC

The legislature requested an evaluation of the potential for "privatizing" all or a portion of AHFC. This section presents a discussion of this option and draws conclusions regarding the feasibility and likelihood that such an action could occur. We have organized this section as follows:

- *Ownership Alternatives*
- *Feasibility of Changing Ownership*
- *Conclusions Concerning Change of Ownership of AHFC.*

A. OWNERSHIP ALTERNATIVES

Faced with fiscal pressures to find alternative sources of funds, and perhaps hearing calls to streamline AHFC operations, the legislature desired to evaluate the concept of privatizing AHFC. Typically, privatization has been an arrangement in which the private sector provides goods, facilities, and services that have been traditionally provided by the public sector. Contracting out has been the most common alternative service delivery method used by governments. The contract services can be provided directly to the consumer, or improve the operations of the government entity.

However, in the case of the Housing Finance Task Force request, this policy option actually extends to selling all, or a portion, of the Corporation's assets and related liabilities to a third party. This policy option could possibly include the following alternatives:

- Selling all AHFC assets
- Selling a selected portion of AHFC assets
 - Real estate owned (foreclosed) properties
 - Loans of a selected type or bond program
- Creating a joint venture of financial institutions and the State Permanent Fund
- Creating and selling stock in the Corporation and paying a dividend to stockholders
- Contracting with a private firm(s) to manage the disposition of AHFC real estate owned properties.

The buyer(s) theoretically might be financial institutions (banks, mortgage companies, and credit unions) or private individuals (if stock were sold).

B. FEASIBILITY OF CHANGING OWNERSHIP**1. Sale of All or a Portion of AHFC Assets**

Proposals have been suggested for the sale of AHFC to a consortium of Alaska and/or "Lower 48" financial institutions. Should such a sale be feasible, the purchase price would probably be far below the State investment in AHFC, and the transaction would raise serious questions of public policy for that reason. Furthermore, the legality of such a sale could be challenged under the State constitution's prohibition on transferring public property, and because of the strictures of various bond covenants. Appendix E to this report provides a legal opinion regarding the sale of all or a portion of AHFC assets.

Also, affordable housing for low- and moderate-income individuals is a legislative objective of AHFC. There is a question of whether this public purpose of AHFC would continue to be served if AHFC were privately owned. Relief and support of the poor has been recognized by the courts as an obligation and a public purpose of government. It would be difficult to obligate a private entity to maintain such a public purpose unless terms and conditions of a transfer were imposed which required the private owner to continue the public purpose objectives of AHFC. Such terms and conditions would probably significantly impact the value of AHFC to any private purchaser.

The transfer of assets to the private sector may in fact be subject to constitutional challenge on the basis that it violates the Alaska constitutional prohibition against transferring public property. As pointed out in Appendix E to this report, the State's constitution prohibits transferring public property except for a public purpose. Under present conditions, there is arguably a public purpose served in selling some AHFC's assets which are causing a negative cash flow to AHFC which create a financial burden on the Corporation. However, if the REO properties were sold and the subsidy changed, and AHFC operated profitably, then a sale of AHFC's assets to the private sector could be considered in violation of the State's constitution because no public purpose is served in selling a profitable asset.

We did not identify a single potential buyer of AHFC assets. With respect to REO, no financial institution we interviewed was interested for obvious reasons. With respect to loans, it is the policy of most mortgage financial institutions not to hold residential real

estate loans but rather to sell these to secondary mortgage purchasers (like AHFC). We found little support or basis for assuming that these same institutions would buy back the loans or foreclosed properties, unless for a very deep discount on the assets. In fact, we have not even identified any formal inquiries regarding the purchase of all or any portion of AHFC assets.

2. Sale of REO to Investors

In much of Alaska the REO market is still a buyer's market, and REO prices are correspondingly depressed. Both local financial institutions and secondary market mortgage purchasers, such as AHFC, have substantial REO portfolios.

AHFC and others are vigorously marketing their REO holdings to both homeowners and investors. At this point there are some signs of market recovery, and REO is being sold more quickly than it is being generated through foreclosures. But any potential buyer of an REO portfolio as large as AHFC's (currently over 4,000 properties), should such a buyer exist, would probably seek extremely low prices to offset market risk and high holding costs.

We do not believe there is currently a buyer or buyers for AHFC's REO portfolio at a fair market price. Were one to appear, the buyer would probably offer a price which, in the long-term, would be below the realization AHFC can reasonably expect from its portfolio in an improving market.

3. Sale of Loans to Investors

If a private entity were to purchase AHFC loans, presumably these would be those loans owned by the Corporation and not pledged to the various bond programs. The loans purchased could be discounted if delinquencies are considered high, and if the underlying property securing the loan were worth less than the unpaid principal balance of the loan. As a result, AHFC could record a loss on sales of those loans not previously sufficiently written down by the Corporation.

The potential loss incurred on the sale of loans held by AHFC may or may not be any more than the loss which will ultimately occur or which AHFC already projects for the loans. The loan loss reserves maintained by AHFC may already have sufficiently considered the potential loss; in this case, the sale would be a simple transfer of assets, and there would be no economic benefit from the sale or transfer of the loans.

4. Contracting Out REO Disposition

One function which could be privatized is the property disposition function. The Corporation formed the Alaskan Home Properties Division to manage the pricing, marketing, and financing of REO properties. The functions performed are commercially available, non-governmental in nature, somewhat routine, and easily defined in terms of workload. A private firm(s) could avoid government restrictions which presently hamper the AHFC REO process, such as civil service requirements, procurement restrictions, and difficulty in authorizing needed additional staff positions. Control and supervision of the contract could be maintained by AHFC; this control is a key factor in assuring that the contract process is feasible and implemented according to the needs of the Alaska housing market.

Contracting out REO disposition will require AHFC to prepare a statement of performance requirements, specifying the technical requirements for the contract and the standards that will be used to determine if the requirements have been met. AHFC would also need to perform a cost-benefit analysis of continuing the REO functions in-house versus contracting out to determine if the private sector can actually perform the functions more efficiently.

**C. CONCLUSIONS CONCERNING CHANGE
OF OWNERSHIP OF AHFC**

The following conclusions are apparent from the preceding discussion:

First, the sale of AHFC as an entity is probably not feasible for several reasons:

- There is little or no interest in the purchase
- The price paid could be far below State investment in AHFC
- Legal problems may exist with respect to the Alaska constitution and various bond covenants.

Second, sale of AHFC assets, specifically loans or REO properties, to local financial institutions does not appear feasible because these institutions have no interest in such assets. Third, sale of AHFC's REO to other investors, were such a sale possible, would likely be of less economic benefit to AHFC than its current marketing policies, because the offering price would probably be too low.

Fourth, sale of AHFC's loans to other investors, were such a sale possible, does not appear to offer any significant economic benefit to the State. Sale of assets pledged to bond issues may be prohibited because of bond covenants, and the transfer of ownership would involve complex issues. Furthermore, transfer of restricted or unrestricted assets from AHFC to the private sector may violate the Alaska Constitution if no public purpose is served. A public purpose might be served by such a transfer, if it would reduce the financial burden on AHFC from the assets transferred. However, it does not appear that the transfer would reduce losses associated with the assets, but would only cause the loss to be realized earlier.

Finally, contracting out of the REO disposition process may be a viable option, and could offer cost savings to AHFC. Competitive bidding for providing the services could lower the cost of disposing of REO properties, and use of the private sector might avoid civil service restrictions and State procurement requirements. If AHFC does use the private sector rather than its own employees to deliver the REO service, it does not give up its responsibility to provide the service.

SECTION IX

**CONCEPTUALIZATION OF
AN IDEALIZED AHFC**

Ernst & Young

IX. CONCEPTUALIZATION OF AN IDEALIZED AHFC

The discussions in previous sections analyze the potential effects of implementing certain policy options with respect to AHFC. From time to time we have noted in text certain other measures that should be considered by the legislature in order to make AHFC more effective and to better define its role in Alaska's housing market.

In this section, we bring these comments together to present a blueprint for AHFC that should help define its role in the years ahead. We have attempted to ensure that the role of AHFC, as described in this section, makes good public policy sense and serves to stabilize Alaska's cyclical housing market in both good times and bad.

This section is organized as follows:

- *Introduction*
- *Define and Limit AHFC's Role in the Housing Market*
- *Structure AHFC to Operate on a Break-even or Profitable Basis*
- *Require AHFC to Adopt a Dividend Policy*
- *Protect AHFC's Capital Base and Avoid New Capital Infusions*
- *Restructure AHFC's Financing Mechanisms*
- *Make AHFC More Independent of Direct Legislative Control*
- *Summary of the Future of AHFC.*

A. INTRODUCTION

We understand from discussions with legislators and others that consideration of a reduction of AHFC's scope to its original legislative intent derives from the following:

- Belief that AHFC's current scope of activities, while possibly appropriate for good times, may contribute to a mis-allocation of scarce State resources in lean years
- Belief that AHFC's extensive involvement in the housing market may cause market distortions, and could possibly prevent the return of private capital to the market
- Belief that, were AHFC's scope to be more limited, its capitalization could be reduced and some contributed State capital might be returned to the State
- Finally, belief that State involvement in the housing market to the extent represented by AHFC's current role is questionable public policy in more general philosophic terms.

While these beliefs may not be universally held, our observations during the course of this study generally support them. Accordingly, we attempt in this section of the report to pursue the question of "return to original legislative intent" to its logical conclusion. In our view, return to original legislative intent should consist of more than just trimming programs. It requires a comprehensive, overall view of what AHFC should be and what role it should play. It also requires, ultimately, a clear legislative mandate with respect to AHFC defining its long-term direction.

Original legislative intent was to facilitate decent, safe, and sanitary housing for persons of low- or moderate-income, and for persons in remote, underdeveloped, or blighted areas. AHFC currently serves this intent through most of its programs, although the "remote, underdeveloped, or blighted areas" are perhaps more directly served by DCRA programs—AHFC's Non-conforming Loan Program is not currently very active. Reduction of the Taxable Program, as discussed in Section VII, would focus AHFC even more on its original intent.

Beyond original intent, however, we note that three additional issues have arisen which are of concern to the legislature:

- First, the State is expecting increasingly severe fiscal pressures from a likely diminution of oil revenues. It is asking whether it should perhaps expect some return on its investment in AHFC to help supplement other revenues in balancing future budgets
- Second, the State is asking whether or not the capital contributed to AHFC is totally committed, or whether under some future circumstances some of that capital might be returned to the State
- Third, there is the issue of AHFC's effectiveness both in operational terms and in terms of its freedom to act in accord with market versus political conditions.

The first and second questions have been briefly addressed in Section VII of this report, and will be further discussed below. The third question, we believe, can be dealt with only by removing AHFC a further step from day-to-day oversight and control by the legislature. We believe that, in order to address all three questions in an effective manner, a clear and formal legislative mandate is required to define policy for AHFC on a long-term basis. The elements of a proposed mandate are discussed below.

**B. DEFINE AND LIMIT AHFC'S ROLE
IN THE HOUSING MARKET**

The first part of the proposed formal legislative mandate is that AHFC should generally serve homebuyers in lower income levels. This concept is evident in the enabling legislation. The basic premise is that scarce State resources should be allocated where they best serve public policy, that is, in providing decent housing for those otherwise unable to obtain it.

At the same time, it is important that AHFC retain a role as "backstop" for the more general housing market, should one ever be required. Alaska's residential mortgage market is capital-poor and depends almost entirely on outside capital to function. At the same time the State is largely dependent on commodity markets for its economic health, and commodity prices tend to fluctuate frequently and widely. Thus, residential mortgage demand and housing prices will continue in the future to be affected both positively and negatively by swings in the overall economy.

This combination of a capital-poor mortgage market and an unstable housing market dictates that the State maintain an ultimate housing backstop mechanism to add stability to the market. AHFC is the ideal mechanism because it is already established, it has existing institutional relationships with outside capital sources, it has an existing substantial equity base, and it has both experience and expertise in funding the residential market.

But the backstop role brings with it certain responsibilities and the necessity for discipline:

- First, this is a "reserve role." That is, the backstop function should only be brought into play in economically hard times. It should not be used as a social benefit in good times, as has been the case in the recent past
- Second, to fulfill this role, AHFC should be allowed to bank good years against bad. Since the backstop role is not compatible with AHFC's long-term goal of break-even or profitable operations, AHFC should be allowed to retain sufficient earnings in good years to subsidize the market as necessary in bad years.

Public policy, in other words, must avoid the temptation to use AHFC as a channel for public benefits at precisely those times when such benefits can best be afforded. It must instead allow AHFC to earn some profits in good years, bank some of those profits, and use the resulting reserves to support the market in bad years.

**C. STRUCTURE AHFC TO OPERATE ON
A BREAK-EVEN OR PROFITABLE BASIS**

The second part of the proposed formal legislative mandate is to structure AHFC programs to operate on an overall break-even basis, or to earn some profit. This supports two policy goals:

- First, it generates funds in good years which AHFC can retain to perform its backstop role
- Second, it generates earnings from operations for dividends which can be paid to the State.

There are several mechanisms to increase profitability:

- Terminate the subsidy. The subsidy of mortgages below AHFC's cost of funds will cause AHFC to incur continuing losses, diminish State-contributed equity, and ultimately require further State funding
- Reduce the taxable program. Under current financing mechanisms, the requirement for overcollateralization of bond issues ties up significant amounts of cash, even without a subsidy
- Consider termination of programs with minimal demand. Several AHFC programs served fewer than thirty Alaskans in fiscal year 1989. The cost of retaining and administering such programs likely far outweighs any benefits received
- Consider termination of programs which are uneconomic by nature. Whenever AHFC programs fund housing types that other market sources avoid, or on terms substantially better than other market sources, the potential for ultimate loss exists and may well be realized.

D. REQUIRE AHFC TO ADOPT A DIVIDEND POLICY

The third part of the proposed formal legislative mandate is to require a prudent dividend policy of AHFC. To the extent that AHFC has positive earnings, and those earnings are not required to fund reserves for AHFC's backstop or other market critical stabilization roles, the State should expect that these earnings from operations will be returned to the State.

Although it is not evident from original intent that such a return was expected, it is also clear that AHFC's subsequent massive funding was not anticipated at that time. Taking the opportunity cost of funds into account, the State (viewed as an investor) is incurring substantial conceptual losses on its investment in AHFC. A prudent dividend policy, combined with a more profitable AHFC, should help remedy this situation.

Again, discipline will be needed. The temptation may be to seek dividends at precisely those times when Alaska's economy (and most likely the housing market as well) is undergoing difficulties. Since these will probably be the times when AHFC is fulfilling its backstop role, no dividends are likely to be available. In other words, dividends should be most available at the times when they are least needed.

**E. PROTECT AHFC'S CAPITAL BASE
AND AVOID NEW CAPITAL INFUSIONS**

The fourth part of the proposed formal legislative mandate is two-fold:

- Rule out any appropriation of AHFC's capital base to the State, either directly or indirectly. An example of an indirect appropriation is the proposed Senate Bill 245 requiring AHFC to purchase mortgage loans from the Housing Assistance Division. We evaluated this proposal and report our findings in Appendix D to this report
- Clearly state a policy of not further subsidizing AHFC through capital infusions.

The first part of this mandate is to protect AHFC's financial integrity. So long as AHFC must access capital markets for funds on a general obligation basis, and so long as substantial general obligations of AHFC's capital base exist, any threat of capital appropriation may impact AHFC's borrowing ability. Financial markets see even the threat of appropriation as reducing the security of their loans. Furthermore, AHFC may need substantial reserves in the near future to deal with continuing REO losses and contingent losses from insurance disputes. Ultimately AHFC may not need such a substantial capital base if funding mechanisms are changed (see below), but for the time being it is important that its capital not be threatened.

The second part of the mandate offsets the first. If AHFC is to be put on a break-even or profitable basis, and if its capital is not to be threatened, then it is reasonable that AHFC and its capital markets expect that the State not supply further funding. Proper maintenance of reserves to support AHFC's backstop role will mean that, even in bad years when AHFC may be required to subsidize the market, no further capital will be required.

F. RESTRUCTURE AHFC'S FINANCING MECHANISMS

The fifth part of the proposed formal legislative mandate is that AHFC implement a long-term program to restructure its financing mechanisms. Because its focus is to support low- and moderate-income housing, it is reasonable that it consider tax-exempt revenue bonds as a primary funding source, as do other states with housing finance agencies operating in a similar role.

While original legislation clearly allowed issuance of general obligation bonds, the effect of those issuances has been to use all contributed State capital as collateral for money borrowed by AHFC. Revenue bonds, unlike general obligation bonds, are not guaranteed by the "full faith and credit" of the Corporation. Their security is far more limited.

As the situation currently stands, any appropriation of money from AHFC to the State is likely to be viewed as weakening AHFC's financial position, thus threatening the security of holders of AHFC bonds, regardless of specific collateral requirements of the bond indentures. Revenue bonds, since they are secured only by mortgage income streams plus whatever specific reserve funds are required for additional security, would not have this effect.

**G. MAKE AHFC MORE INDEPENDENT
OF DIRECT LEGISLATIVE CONTROL**

The final part of the proposed formal legislative mandate would be to redefine AHFC's organizational positioning to allow more independence from legislative pressures, and limit the legislative role to providing long-term policy direction and assessment of management's success in fulfilling policy objectives. Particular steps to be considered include:

- Increase the size of AHFC's Board of Directors and allow a higher percentage of private sector representation on the Board. It is essential that the Board be composed of knowledgeable and active members, and that the private sector members adequately represent the range of industry interests in the housing markets
- Free AHFC from the legislative appropriation process so far as possible, and judge organizational effectiveness based on results obtained.
- Allow AHFC within reason to set its own personnel policies, including hiring, termination, promotion, and compensation levels
- Allow AHFC to obtain in-house counsel of a strength commensurate with the magnitude and complexity of its activities.

H. SUMMARY OF THE FUTURE OF AHFC

The net effects of the proposed legislative mandate would be positive, and would make AHFC a more effective organization in carrying out public policy:

- Focusing AHFC's role on low- and moderate-income housing would reduce AHFC losses. Retaining the backstop role would help stabilize the housing market in the longer term
- Restructuring AHFC to operate on a break-even or profitable basis would mean no need for new State capital, funding for a backstop role, and the potential of dividends for the State
- Requiring operating dividends to the State is a reasonable step considering the potential profitability of AHFC's operations and the investment made
- Protecting AHFC's capital base and avoiding new capital infusions are both desirable. One protects AHFC's financial integrity and minimizes its cost of doing business; the other follows from the fact that, since AHFC will be breaking even or making a profit, no new capital should be needed
- Restructuring AHFC's financing mechanisms to concentrate on tax-exempt revenue bonds is consistent with its newly redefined focus and holds the long-term potential of freeing up part of AHFC's capital base
- Making AHFC more independent of close legislative control promotes both operating efficiency and the ability to respond to market conditions based on long-term legislative policy.

These steps toward an "idealized AFHC" should allow AHFC to serve the residential mortgage market in Alaska more effectively, both in good times and in bad. Although implementation is likely to be a long and arduous process in some instances, we believe the proposed mandate is worthy of consideration by the legislature.

APPENDIX A

**SELECTED AHFC
OPERATIONAL CONCERNS**

Ernst & Young

APPENDIX A

SELECTED AHFC OPERATIONAL CONCERNS

This appendix presents selected comments regarding AHFC's organization and operations. Although we did not perform a specific analysis per se of AHFC operations, our analysis of policy options did require that we interview a number of AHFC personnel, use the management information systems at AHFC, and obtain performance data on some AHFC operations (e.g., Property Disposition (REO) unit). As a result, we note areas where we had concern or where it appeared the operation of AHFC might be improved. In this appendix we present specific recommendations regarding the organization, management, and operation of AHFC.

Organization of this section is as follows:

- *Management and Personnel Recommendations*
- *Internal Improvement Recommendations*
- *Programmatic Recommendations*
- *Legislative Recommendation.*

A. MANAGEMENT AND PERSONNEL RECOMMENDATIONS**1. Evaluate the Size and Composition of the AHFC Board of Directors**

A five member Board of Directors governs AHFC. The Board consists of three members of Alaska State Government and two public members. The Governor appoints all five members of the Board.

We found just one member of the Board, a private citizen involved in the real estate industry, to actually take an active part in our study. The assistance was invaluable to our entire study effort because of the insight and experience obtained on AHFC operations, housing markets, and the capital markets. Assistance from other Board members could have provided additional advice on our evaluation of policy options.

More importantly, the Board should be assisting the CEO and other AHFC management in guiding the direction of AHFC, providing input on organizational improvements, and establishing various committees for governing the manner in which AHFC conducts its business. This requires active participation of Board members, particularly in light of the significant changes in the housing market which AHFC serves.

We recommend that the Legislature evaluate the effectiveness of the current Board composition, and determine whether the Board composition and size should be changed. This includes an analysis of the advantages and disadvantages of having a majority of the Board be public members rather than State Government representatives. An alternative Board arrangement could be nine members, either with five members government representatives or public members.

2. Conduct a Staffing and Organizational Effectiveness Review

The Corporation has almost doubled in staff over the last three years, primarily because of increased workload related to REO dispositions. We noted a significant turnover in certain areas of the Corporation, particularly in key financial staff positions which were assisting us during this study. The rapid growth of AHFC and apparent staff

turnover problems could create a shortage of trained and experienced financial management and staff.

We recommend that AHFC conduct a study of current and future personnel requirements to facilitate an orderly development of qualified staff. This study should include an evaluation of management and staff compensation compared with those available in private industry. This study then should be followed by a program to recruit and retain qualified personnel to meet future needs.

Other areas should be addressed in the study as well:

- Sufficiency of staffing levels in various parts of the organization
- Depth and breadth of the management structure
- Effectiveness of AHFC in fulfilling the various components of its legislative mandate.

3. Obtain Authorization and Fill Legal Counsel Position at AHFC

The Corporation does not have an internal legal counsel, but rather obtains the services of a staff attorney from the Attorney General's Office. The Attorney General recently assigned to AHFC its third different staff attorney in 1989. This high turnover in staff at the Attorney General's office causes considerable expense for AHFC and inhibits the AG's responsiveness to AHFC. In addition, the Attorney General's attorney currently assigned has not had sufficient experience in business and corporate law, nor the background in bond financing, to effectively address and respond to the diverse and complex legal issues which arise at AHFC.

AHFC should substantiate and request authorization for a position for a Corporate attorney reporting directly to the Chief Executive Officer. This will require developing an appropriate job description, estimating the salary and benefits for a full-time attorney, and preparing a written justification for the new position. After the position is authorized, AHFC should fill the position, following appropriate procedures for State civil service (if not an exempt position).

4. Obtain Authorization and Fill Internal Auditor Position at AHFC

The Corporation does not have an internal auditor. The use of an internal auditor (or internal audit staff) would be an effective means of providing AHFC with the following benefits:

- Strengthening AHFC's internal financial and operating controls over assets and increasing the reliability of accounting records
- Reducing the amount of time spent on developing internal procedures
- Increasing assurance that AHFC policies are being adhered to and that internal procedures and controls are being reviewed objectively
- Providing a training ground for future management positions at AHFC.

This position (or audit staff) would report directly to AHFC's Executive Director.

We recommend that AHFC develop the job description and justification for an internal auditor position and submit a budget request for this new position. Upon authorization, the position should be filled.

B. INTERNAL IMPROVEMENT RECOMMENDATIONS**1. Establish a Formal Financial Forecasting System**

Improved forecasting techniques are needed at AHFC to more accurately determine working capital needs, short-term financing needs, and longer-term results of specific loan programs. They also would assist in responding to requests from management, the Board, and the Legislature regarding the financial condition of the Corporation and assist in the identifying funds available for investment. These techniques, which should ultimately be expressed as formalized forecasting systems, should be able to forecast financial results by bond and loan program.

We found only informal techniques being used by AHFC for forecasting the financial condition of AHFC. It should be noted that AHFC does have very detailed and formal models for structuring a specific bond issue. There were no formalized systems for projecting cash flow, changes in unrestricted assets, or projected performance of individual bond and loan programs.

We recommend that AHFC design, develop, and test a formalized financial forecasting system. The new system would allow analysis of changes in loan demand, interest rates, loan programs, and debt structures, and how various changes impact the financial condition of AHFC and its loan programs.

2. Evaluate Adequacy of Existing Management Information System

We often had to rely on information regarding AHFC housing programs which is maintained by Data Processing (DP) systems. The report we primarily relied upon was the "Statistical Abstract," a 300-page document generated by DP containing information about loans, bond issues, markets served, and seller/servicer listings. We cannot comment on the accuracy of the information although we frequently had to get help from AHFC staff to interpret the report, to tie numbers reported in different sections of the report, and, in some cases, to correct the data reported. Due in part to the age of the system, we were told that our special requests for ad-hoc reports would be very difficult and time consuming to complete, and that there was not available staff time to complete special requests.

The role of DP should be to develop and maintain information systems throughout AHFC to meet the needs of management and staff. The recent growth of AHFC's property disposition activities, and the start-up of new loan programs, has put significant pressure on DP to keep up with user requests for new reports, while maintaining existing systems. Also new programs internal to AHFC may not be getting the priority or attention of DP. An example is the critical need for management information regarding claims filed with MGIC.

We recommend a review be conducted of the effectiveness of the existing management information systems, and that an upgrading of DP systems and procedures be considered. This includes a determination of the significant information needs of management, and identification of program areas needing automated management information support.

3. Improve Cash Management Function

We noted during our discussions with AHFC staff that many of the cash management functions of the Corporation were being performed by staff with no substantial experience in treasury or cash management functions. There are many potential areas where improvement can be made in cash management activities which might result in direct and significant cash savings (and income enhancement) to AHFC.

We recommend that AHFC evaluate the entire cash management function and implement changes to improve this function. This includes evaluation of cash management techniques, cash reporting system, and investment strategies and goals.

4. Define Formal Investment Criteria

We noted that AHFC does not currently have formalized investment criteria to control investment of liquid assets. Wherever a significant portfolio of investments must be maintained, such criteria should be in place to assure responsible diversification of investments by industry sector, investment type, and investment grade. Specific risk and

return criteria should be spelled out . We recommend that AHFC management prepare such criteria, and implement a more formal investment management system based on the criteria.

C. PROGRAMMATIC RECOMMENDATIONS**1. Re-evaluate Loan Loss Reserves and Exposure to Insurance Losses**

Because several months have passed since the last evaluation of AHFC's loan loss reserves, and because delinquencies and defaults are a continuing problem in most of AHFC's marketplace, it would be advisable to track loan loss reserves on a basis more frequent than yearly. Combined with this interim review should be a thorough review of MGIC's problems and AHFC's potential exposure arising therefrom.

We recommend that AHFC management arrange an interim loan loss reserve review, and re-evaluate its potential exposure to MGIC's situation.

2. Review REO Pricing and Disposition Policies

The Corporation maintains a very large inventory of REO. Since REO pricing and disposition policies have direct and potentially conflicting impacts on AHFC's financial position and on the housing markets, AHFC policies in this area have always been controversial. The picture is further complicated by the presence in the REO disposition market of other significant sellers (FNMA, FDIC, HUD, etc.)

The Corporation's REO policies can generally be divided into the segments of pricing, marketing, and financing. All three of these areas should be reviewed to ensure that a balance is being maintained among AHFC's financial integrity, the need to support the housing market, price levels versus holding costs, and AHFC's competitive position with respect to other REO sellers. We recommend that management undertake such a review.

3. Evaluate Costs of Maintaining Bond Ratings

The Corporation maintains excellent bond credit ratings largely through overcollateralization of bond issues. The cost of overcollateralization, to the extent that it commits substantial sums of money for extended periods of time, may be high if compared with the lowered interest cost obtained.

There is a need to formally evaluate the costs of "buying" good bond ratings versus the benefits derived (i.e., lower interest costs) from these ratings. We recommend that AHFC management undertake such a study to determine if current policies in this area are cost-effective.

4. Implement a Mortgage Insurance Program

AHFC is authorized to provide its own insurance on loans purchased by the Corporation, but the program has not been implemented. This is particularly relevant because private mortgage insurance is difficult to obtain in Alaska, pushing a higher percentage of buyers into FHA financing. Conventional mortgages are difficult to obtain unless the buyer has at least 20 percent of the purchase price in cash as a down payment.

We recommend that AHFC complete an evaluation of a self-insured mortgage program, and implement the program if appropriate. Such evaluation would include the effect of AHFC mortgage insurance availability on the housing market and, ultimately, on AHFC's own financial position. Implementation would involve: (1) developing goals and objectives for the program, (2) obtaining original capitalization, (3) developing procedures, manuals, and forms (e.g., for underwriting and claims processing), and (4) staffing, accounting, and developing investment strategies (for premiums collected).

D. LEGISLATIVE RECOMMENDATION**1. Exempt AHFC from the Executive Budget Act**

The Corporation operated for its first ten years without direct legislative oversight or approval of its annual operating budget. It was only beginning in fiscal year 1981/82 that the legislature required that AHFC's operating budget be subject to the Executive Budget Act, and, therefore, be subject to review and approval by the legislature and the Governor. This was the same period when the subsidy was introduced, and AHFC's loan programs were opened up to all Alaskans.

The AHFC has operated and continues to operate in an industry that has seen significant and rapid changes. The economic changes in the State are amplified in the housing industry, and AHFC must respond rapidly to these changes. However, civil service requirements and procurement restrictions can prevent AHFC from responding. Recent insurance losses related to MGIC insured bond programs are an example where AHFC could not respond quickly enough. Requests for increased staff to handle the increased workload and complex requirements of claims filed with MGIC were reduced by the Division of Audit and Management. As a result of a shortage in staff, AHFC may have paid costs attributable to the insurer and lost several million dollars of valid claims.

We recommend that the Legislature consider the appropriateness of exempting AHFC from the Executive Budget Act. An exemption would allow AHFC to respond more quickly to its staffing needs, and operate more effectively as a result. More efficient operations would allow for break-even operations or the possibility of returning an operations dividend to the State.

APPENDIX B

**PROJECTIONS OF AHFC
UNRESTRICTED NET
LIQUID ASSETS**

Ernst & Young

APPENDIX B

PROJECTIONS OF AHFC UNRESTRICTED NET LIQUID ASSETS

In this Appendix we present projections of the change in unrestricted net liquid assets of the Corporation over a five-year period ending June 30, 1994. We begin the Appendix with an overview of the projection model and assumptions, and then provide results of projections under alternative assumptions. These projections are presented in the following subsections:

- *Projection Methodology*
- *Projection Assumptions*
- *Projection Results.*

A. PROJECTION METHODOLOGY

The projection period was for the five fiscal years 1989/90 through 1993/94. We prepared projections of changes to the Corporation's balance sheets; specifically changes to the Corporate Operating and General accounts' unrestricted net assets. Unrestricted assets represent assets of the Corporation which are not pledged as collateral for specific bond indentures. We did not prepare projections of the individual bond programs, except to estimate assets which will be released from bond programs and could subsequently be used by the AHFC without restrictions.

Included in AHFC's unrestricted liquid assets, net of short-term obligations of AHFC (e.g., Euro commercial paper), were the following:

- Cash and short-term investments
- Mortgage loans available for pledging to bond issues
- Claims receivable and pledged receipts
- Net payments due from various bond programs
- Long-term investments which mature within the five-year projection period
- Investments, mortgage loans, and mortgage-backed securities which currently are pledged to a specific bond issue but which will be released because the bond issue is paid off in entirety or otherwise retired.

We excluded from liquid assets of AHFC those loans identified by the Corporation as having potential problems, and REO assets. Therefore, we do not project any future losses for these loans and REO properties already held by AHFC. However, our analysis does consider potential losses from loans to be purchased in the future, and additional REO acquired through foreclosure.

The financial operations of AHFC are quite complex, and the transactions affecting the Corporation's financial position are considerable and diverse. Because there was no formal forecasting system already developed for internal use at AHFC, we prepared a simplified model to project the change in unrestricted net liquid assets. With the assistance

of AHFC, we identified the following as significant items affecting changes over the five-year period:

- *Increases in Unrestricted Net Liquid Assets*
 - Collateral which is pledged to specific bond issues but which will be released because the bond will be retired. Collateral includes investments, mortgage-loans, and mortgage-backed securities
 - Interest earned on mortgage loans and investments of the Corporation. This is interest on short- and long-term investments, and interest on mortgage loans held by the Corporation in its Operating and General accounts and scheduled for pledging to bond issues
- *Reductions in Unrestricted Net Liquid Assets*
 - Interest rate subsidy provided to home buyers whose loans are purchased by AHFC. The subsidy is an amount based on the difference between AHFC's cost of funds and the rate the loans are purchased for, if the cost of funds is greater than ten percent (nine percent for veterans). The interest rate subsidy is a component of the original overcollateralization of a bond issue. That is, the total principal of loans and investments pledged to a bond issue is greater than the aggregate principal of the bonds
 - Overcollateralization of bonds also includes a "credit enhancement" component which presently allows for the Corporation to obtain a high credit rating on bonds. It should be pointed out that this overcollateralization theoretically will be released to AHFC after the specific bond issue against which the collateral pledged against is retired
 - Bond sales costs. These costs were assumed to be one percent of the bond issue, except for tax-exempt veterans bonds, which costs were assumed to be 1.75 percent of the bond issue
 - Reserve accounts. These were assumed established for the veterans mortgage bonds issued (at five percent of the total bond issue) and for the taxable and HOAP III bonds issued (at ten percent of the total bond issue)
 - An additional \$50 million of State financed loans. These loans were assumed purchased over the five-

year projection period, using monies drawn from AHFC's accounts and not from the proceeds of bond issues

- Interest costs on short-term borrowings. These are the costs of borrowing for Corporate working capital through Euro commercial paper or other mechanisms
- Estimated losses on mortgage loans purchased in the future and losses on dispositions of properties acquired in the future through foreclosures (real estate owned)
- General and administrative costs of AHFC (for example, salaries and benefits).

We estimated the cumulative total dollar amount of each of the items listed above over the five-year projection period. We then added the total estimated five-year increases and subtracted the total five-year reductions to arrive at a net change in unrestricted net liquid assets through June 30, 1994.

B. PROJECTION ASSUMPTIONS

A number of assumptions were made for baseline case projections¹. These assumptions are presented in Exhibit B-1, following this page. An implicit assumption we made for preparing our projections was that interest rates over the projection period would remain at their current rates, or in fact decrease slightly over the next five years. This was based on a review of interest rate projections made by various forecasters, including a consensus forecast prepared by a group of Wall Street economists, and a forecast prepared by Business Week magazine.

We developed two baseline scenarios for discussion purposes. The first (*Baseline A*) is based on assumptions shown in Exhibit B-1. The alternative baseline (*Baseline B*) assumes interest rates will rise by two percent in fiscal year 1990/91 and remain at the higher rate through June 30, 1994. As a result, for the alternative baseline scenario (B) we assumed that the subsidy on the taxable program would be two percent through fiscal year 1993/94, and for the veterans mortgage bond program, there would be a 0.5 percent subsidy through fiscal year 1993/94. This increased rate was assumed to have no effect on tax-exempt bond programs.

We also assumed that annual interest earnings on loans and investments of the Corporation remain constant over the five-year projection period. In reality, these earnings will fluctuate depending on actual interest rates, the number of loans held for pooling, the number of days loans are held by AHFC, and total dollars invested. We did not attempt to model changes in loan or investment balances, although these fluctuations will occur over time. Therefore, interest earnings could actually be more for those scenarios where we project an increase in unrestricted net liquid assets, and less for those scenarios where we project a decrease in unrestricted net liquid assets.

¹ The "baseline" case generally assumes as-is conditions over the five-year projection period. A comparison with this baseline case is our measure of the impact of alternative policy option scenarios.

Summary of Assumptions Used to Prepare Projections of AHFC Financial Position

Subsidy

No subsidy on tax-exempt or veterans mortgage bond program

A 0.75 percent subsidy on taxable program

A 2.5 percent subsidy on HOAP II program in FY 1989/90, a 2.0 percent subsidy on HOAP III program

Changes in AHFC subsidy were assumed not to have an impact on the total demand for loans statewide.

Total collateral released from retirement of debt over the five-year projection period was assumed to be as follows:

SAM D	\$38.9 million
SAM H	2.2 million
SAM I	(3.9) million ¹
SAM J	(0.8) million ¹
SAM K	0.4 million
SAM L	0.4 million
SAM M	10.5 million
SAM N	9.0 million
FNMA #4	16.5 million
FNMA #5	<u>7.5 million</u>
Total	\$80.7 million

(SAM = State Assisted Mortgage bond program)

AHFC Loan Activity

AHFC's volume of loan activity over the next five years was assumed to be approximately the same level as the previous five fiscal years. We reviewed these with AHFC financial personnel. Specifically, the total purchases of loans over five years was assumed as follows:

Tax exempt	\$300 million
Veterans	\$150 million
Taxable	\$680 million
HOAP III	\$100 million
State financed	\$50 million.

Other Changes In Unrestricted Net Liquid Assets

Investment interest earnings were assumed to be equal to FY 1989/90 actuals. Interest earnings on loans held by AHFC were assumed equal to eighty percent of the average earnings over the last five years, which approximated the FY 1988/89 loan interest

Borrowing arrangements (Euro commercial paper) remain in effect, short-term borrowings remain constant, and debt covenant restrictions on assets and equity remain the same

AHFC general and administrative expenses were assumed to be \$10 million annually, approximating the annual budget for fiscal year 1989/90

Net loan losses and REO losses total \$50 million over five years.

Bond Sales and Retirements

Bonds sold by AHFC were assumed overcollateralized by two percent in order to improve the bonds' credit rating

Total bond sales over the five-year projection period were assumed to be as follows:

Tax-exempt	\$348 million
Veterans	\$145 million
Taxable	\$725 million
HOAP III	\$90 million.

¹ A negative number represents contributions from AHFC required to accommodate payment of principal in full at maturity.

C. PROJECTION RESULTS**1. Baseline Scenario A**

Based upon the assumptions presented in Exhibit B-1 for our first baseline scenario, we have projected that unrestricted net liquid assets of AHFC may decrease by approximately \$107 million through June 30, 1994. Exhibit B-2, following this page, is a summary of the projected increases and reductions in unrestricted net liquid assets over the succeeding five-year period.

We estimated in Section III of this report that, as of June 30, 1989, AHFC had approximately \$10 million of unrestricted net liquid assets after considering debt covenant requirements which are required to be maintained by various short-term borrowing agreements. The projected net decrease of \$107 million over five years would consequently eliminate these net liquid assets.

2. Baseline Scenario B

As an alternative baseline scenario, we assumed the interest rate subsidy on the taxable program would be two percent in fiscal years 1990/91 through 1993/94. This is up from 0.75 percent which we assumed for our Baseline Scenario A. We also assumed that there would be a 0.5 percent subsidy on the veterans mortgage bond program in fiscal years 1990/91 through 1993/94. With these two changes, the total interest rate subsidy was projected to increase by \$48 million over our original (Baseline A) projections.

3. Elimination of the Subsidy

The potential elimination of the subsidy as of June 30, 1990 was discussed in Section VI of this report. In order to project the impact on AHFC unrestricted net liquid assets from this alternative, we made two changes to our Baseline Scenario A assumptions:

- There is no subsidy on the taxable program beginning July 1, 1990 (we had originally assumed a 0.75 percent subsidy)

**Change in Unrestricted Net Liquid Assets
For Five Year Period Ending June 30, 1994
Baseline A
(\$ Millions)**

<i>Increases Over Five Years</i>	
Collateral Released From Retirement of Bonds	\$80
Interest Earnings on Loans and Investments	215
Subtotal of Increases	\$295
<i>Reductions Over Five Years</i>	
Interest Rate Subsidy	\$83
Overcollateralization of Bonds (a)	109
State Financed Loan Purchases	50
Interest on Short-Term Borrowings	60
Loan Losses and Net REO Losses	50
AHFC General and Administrative Expenses	50
Subtotal of Reductions	\$402
Total Five-Year Change in Unrestricted Assets	(\$107)

Assumptions

No subsidy on tax-exempt or veterans bond programs
 A 0.75 percent subsidy on taxable program
 A 2.5 percent subsidy on HOAP II program during FY 1989/90
 A 2.0 percent subsidy on HOAP III program during FY 1989/90 and 1990/91
 Total purchases of loans over five years as follows:

• Tax exempt	\$300 million
• Tax exempt veterans	\$150 million
• Taxable	\$680 million
• HOAP	\$100 million
• State financed	\$50 million

Bonds are assumed overcollateralized by 2 percent for credit rating enhancement.
 Bond sales costs are 1.0 percent of bond sale (1.75 percent for Veterans bonds).
 Reserve accounts for taxable bonds equals 5 percent, and for HOAP bonds,
 10 percent. No reserve accounts assumed for tax-exempt or Veterans bonds.
 Annual interest expenses and earnings of Corporate and General accounts are
 assumed equal to 80 percent of the average of the previous five years.
 (a) This line item also includes bond sales costs and reserve accounts.

- There is no subsidy for HOAP III loans purchased in fiscal year 1990/91 (we had originally assumed that there would be a two percent subsidy, the maximum allowed by the program).

As a result of these two new assumptions, we estimated that the total amount of overcollateralization necessary to fund the interest rate subsidy over the projection period would decrease by approximately \$43 million from our Baseline Scenario A case. All other increases and reductions noted for the Baseline Scenario A (Exhibit B-2) remain unchanged.

4. Elimination of the Taxable Program

The policy option of returning AHFC to its original legislative intent was discussed in Section VII of this report. As presented in Section VII, this essentially involves phasing out the taxable program. For purposes of preparing a projection of the impact of this option on AHFC's financial position, we made the following changes to the Baseline Scenario A assumptions:

- No subsidy for the HOAP III program beginning fiscal year 1990/91
- No taxable bonds sold after June 30, 1990.

Based upon these two changes to our Baseline Scenario A assumptions, we projected a \$19 million net reduction in unrestricted net liquid assets over the five-year projection period. This compares with a \$107 million decrease over the same five years under our Baseline Scenario A assumptions, or an \$88 million difference.

5. Summary of Results

Table 1, following this page, summarizes the five-year projected change in AHFC unrestricted net liquid assets, under the various scenarios evaluated. There usually will be differences between the projected and actual results, because events and circumstances frequently do not occur as expected, and those differences may be material. Therefore, we provided a possible range of estimates (i.e., using two baseline scenarios) of the change in

AHFC financial position over the five-year period, rather than a point estimate of the final June 30, 1994 balance.

Table 1
Five-Year Projected Change in Unrestricted Net Liquid Assets
(\$ Millions)

Scenario	Baseline A (No Increase in Interest Rates)	Baseline B (A Two Percent Increase in Interest Rates)
No Change in Programs	(\$107)	(\$155)
Eliminate Subsidy July 1, 1990	(\$64)	(\$64)
Eliminate Subsidy and Taxable Program July 1, 1990	(\$19)	(\$19)

APPENDIX C

**SURVEY OF THE ALASKA
REAL ESTATE MARKET**

Ernst & Young

APPENDIX C

SURVEY OF THE ALASKA REAL ESTATE MARKET

In order to evaluate the potential effects of changes in State policy on the housing market and on AHFC, it is necessary to understand the recent history of the market and its current status. In this appendix, we review the real estate market in those locations from which AHFC buys most of its mortgages and provides the most market support.

This appendix is organized as follows:

- *Introduction*
- *Anchorage Real Estate Market*
- *Fairbanks Real Estate Market*
- *Matanuska-Susitna Valley Real Estate Market*
- *Juneau Real Estate Market*
- *Kenai Peninsula Real Estate Market*
- *Ketchikan Real Estate Market*
- *Sitka Real Estate Market.*

A. INTRODUCTION

The Alaska residential real estate market has seen substantial changes since 1985. A general decline in the economy brought hard times to most locations in Alaska, although the depth of the decline in real estate values varied from place to place, and some locations are showing a strong recovery already.

In investigating the Alaska real estate market, we attempted to gain a good understanding of recent events in each location, current volumes and prices, and industry views of likely future market conditions. To do this, we depended on data supplied by local governmental entities, real estate associations, multiple listing services, brokers, appraisers, and financial institutions.

Much of the data gathered were "hard" data compiled from large numbers of actual sales. Other data, especially in smaller locations, was judgmental in nature and involved estimates by industry sources. In small or thin markets, the judgment of professionals is often more valuable than statistical information due to non-comparability of data from period to period.

Our market investigation focussed on several key points. The questions we felt had to be answered included:

- What has been the history of the market?
- What is the current status and direction of the market?
- What are current annual sales volumes?
- What is the distribution of sales by price range?
- How important to market health is the AHFC subsidy?
- How important to market health is AHFC participation in the broader sense?

The answers to some of these questions varied from place to place. Others received similar answers in most locations.

The areas investigated represent about 96 percent of AHFC's total portfolio as shown in Table 1, below.

Table 1
Areas Investigated and Portfolio Performance

Location	Percent of AHFC Portfolio	Delinquency Index	Foreclosure Index
Anchorage	57.99%	1.01	1.15
Fairbanks	13.15	1.18	0.92
Mat-Su Borough	7.68	1.38	1.67
Juneau	7.11	0.71	0.38
Kenai Peninsula	5.91	0.76	0.62
Ketchikan	2.36	0.79	0.08
Sitka	1.57	0.63	0.13

In the table above, the "delinquency index" is the ratio of each location's delinquency rate to the delinquency rate of AHFC's overall portfolio as of October 31, 1989. The "foreclosure index" is defined similarly. Thus, the areas worst hit by the real estate market downturn, as defined by the calculated "foreclosure rate", are Mat-Su Borough, Anchorage, and Fairbanks, in that order. The Kenai Peninsula market was damaged somewhat less, and Southeast locations suffered the least damage.

The following sections describe the real estate market in each of the above locations. Disproportionate space is given to Anchorage in this description, for three reasons:

- Anchorage represents almost 60 percent of AHFC's portfolio and an even higher percentage of foreclosures. Anchorage is AHFC's biggest customer and biggest problem
- Detailed data from various sources in Anchorage support considerable analysis, generating findings that may be generally relevant in other Alaskan communities
- The history of the Anchorage housing market, which is presented in some detail, parallels the histories of other markets, even those in Southeast.

B. ANCHORAGE REAL ESTATE MARKET**1. General**

The Anchorage area is the main focus of AHFC mortgage purchase activity. As of October 31, 1989, Anchorage represented 60 percent of AHFC's portfolio by value. Anchorage's delinquency and foreclosure rates were both above total portfolio average for AHFC.

The Anchorage market peaked in late 1985 and early 1986. Since that time demand has fallen, caused mainly by a net population outflow. Housing prices have decreased dramatically, and many Anchorage homeowners have negative home equities. Foreclosures are a continuing problem.

Vacant units represent ten years' demand at current absorption rates. Although the drop in single-family home prices appears to have slowed or stopped, substantial recovery is probably a long ways off. Condominium prices remain at extremely depressed levels. Financing is difficult because of a number of factors. Foreclosures appear to be slowing but remain a significant problem.

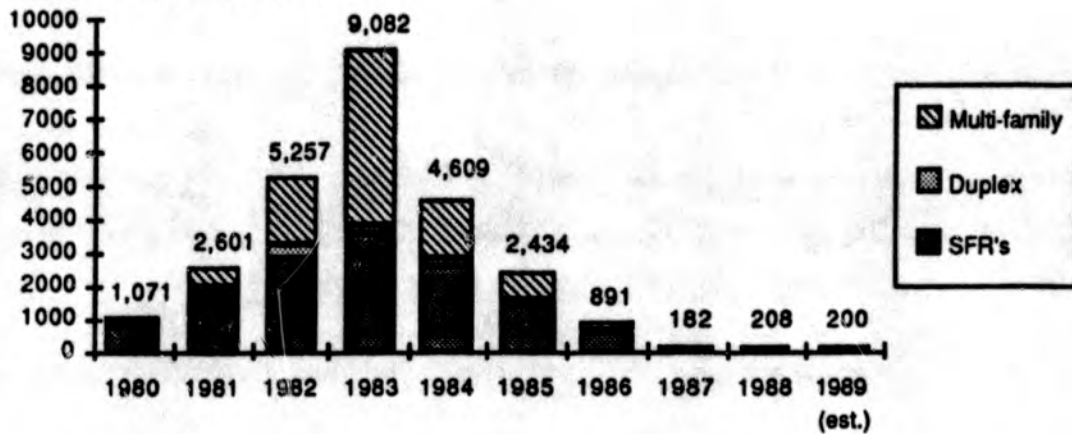
The 1989 population increase appears to have affected mainly the rental market—rental vacancies in larger projects have dropped from 24 percent to 8 percent over the past twelve months. Otherwise, the market remains depressed and signs of recovery are few.

2. Supply and Demand

Housing starts in Anchorage increased nine-fold between 1980 and 1983, peaking at over 9,000 units in 1983 (see chart below):

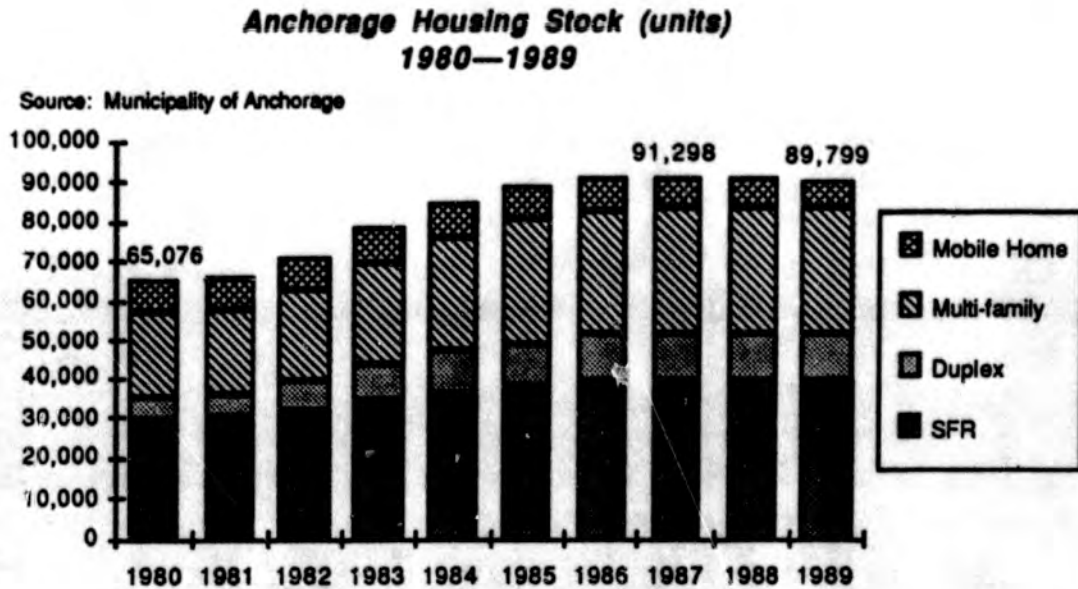
**Anchorage New Housing Units Authorized
1980—1989**

Source: Municipality of Anchorage



After 1983 starts decreased quickly and have hovered around 200 per year since 1987. Most starts currently are higher-end detached single family residences, ranging from \$140,000 to \$250,000 or higher.

Total stock peaked at 91,298 units in 1987 and had declined to 89,799 units by 1989 (mid-year):



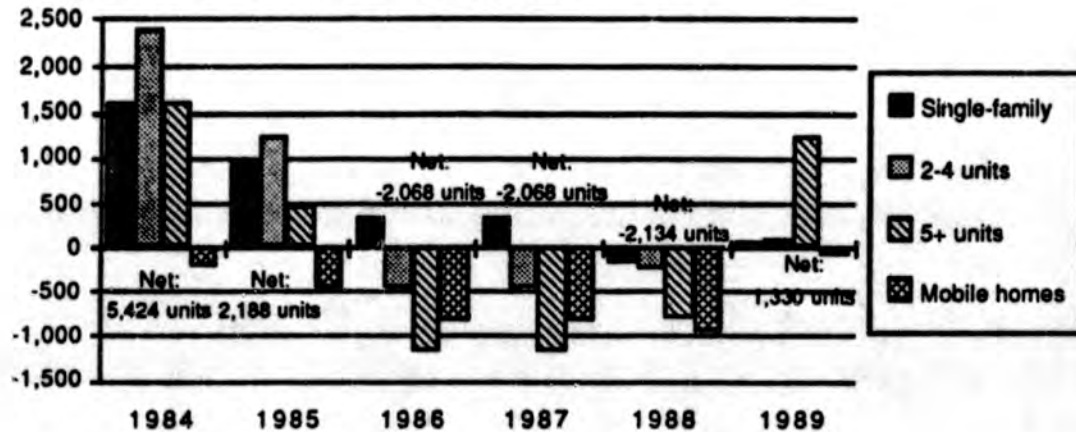
The decrease in units has been due to demolition or removal from the State of a substantial number of mobile homes and the boarding up of about 550 residential units in properties slated for demolition.

Net absorption was negative in 1986, 1987, and 1988, totalling about 6,300 units: That is, by 1989 there were 6,300 fewer occupied units in Anchorage than in 1985.

The year 1989 (twelve months through July) saw the first positive net absorption in several years. On July 1, 1,330 more units were occupied than one year previously:

**Anchorage Net Absorption of Housing Units
1984—1989**

Source: Anchorage Economic Development and Planning



This increase was almost entirely in multi-family housing and appears to be mostly rental in nature. The annual Anchorage rental survey revealed that rental occupancy of projects with 20 or more units dropped from 24 percent in 1988 to 8 percent in 1989 (mid-years). Ken Kincaid of Shorett and Riely, who performs the annual rental survey, lays the increase in rental occupancy to three causes:

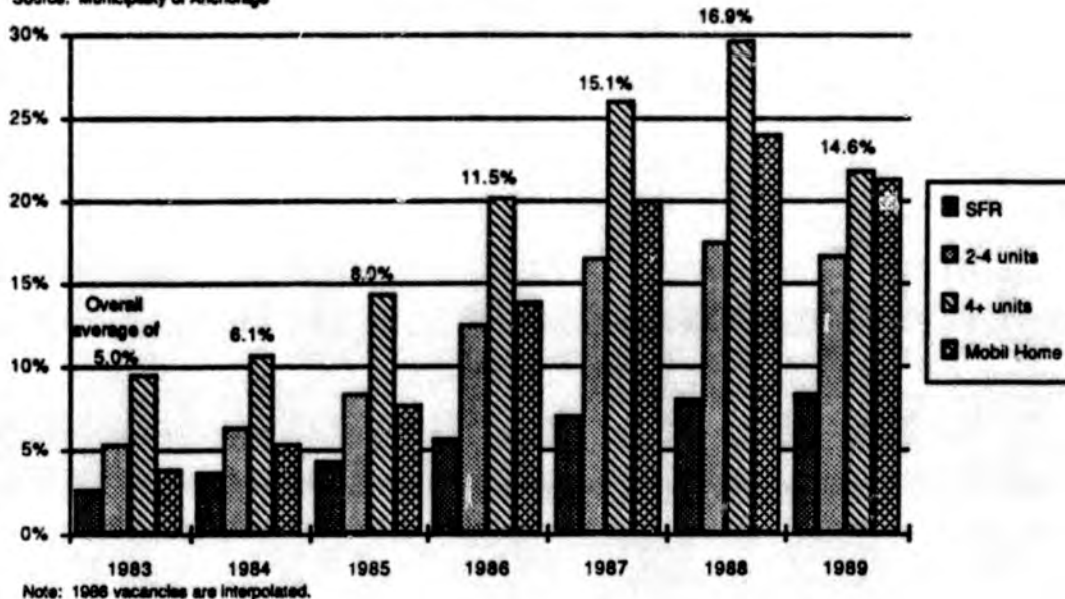
- Temporary population increase from oil spill activity
- Long-term population increase from an improving economy
- Rental demand by former homeowners who have undergone foreclosure and do not wish to leave the city.

Only the second of these three factors contributes to long-term demand for housing unit occupancy.

Vacancies peaked in 1988 at 16.9 percent and have declined somewhat in 1989 to 14.6 percent, with the improvement led by multi-family housing:

Anchorage Vacancies by Housing Type
1983-1989

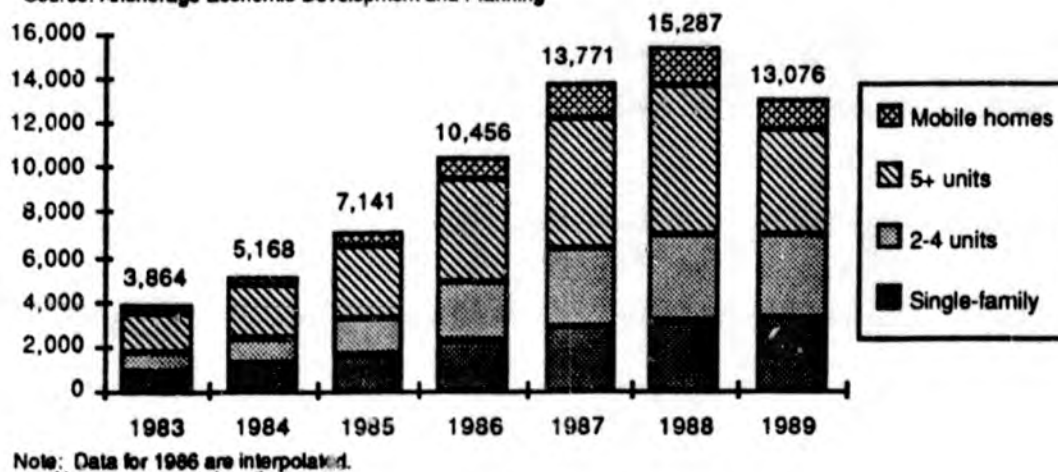
Source: Municipality of Anchorage



Single-family residences (including zero lot lines) have the lowest vacancy rate at about 8 percent, 2- through 4-plexes run about 17 percent, while condominiums and apartments show about 22 percent vacancies. Mobile homes have improved from 1988's 24 percent to about 22 percent, reflecting demolition or out-of-state shipment of many units. Overall vacant stock is still over 13,000 units:

Anchorage Vacant Units
1983-1989

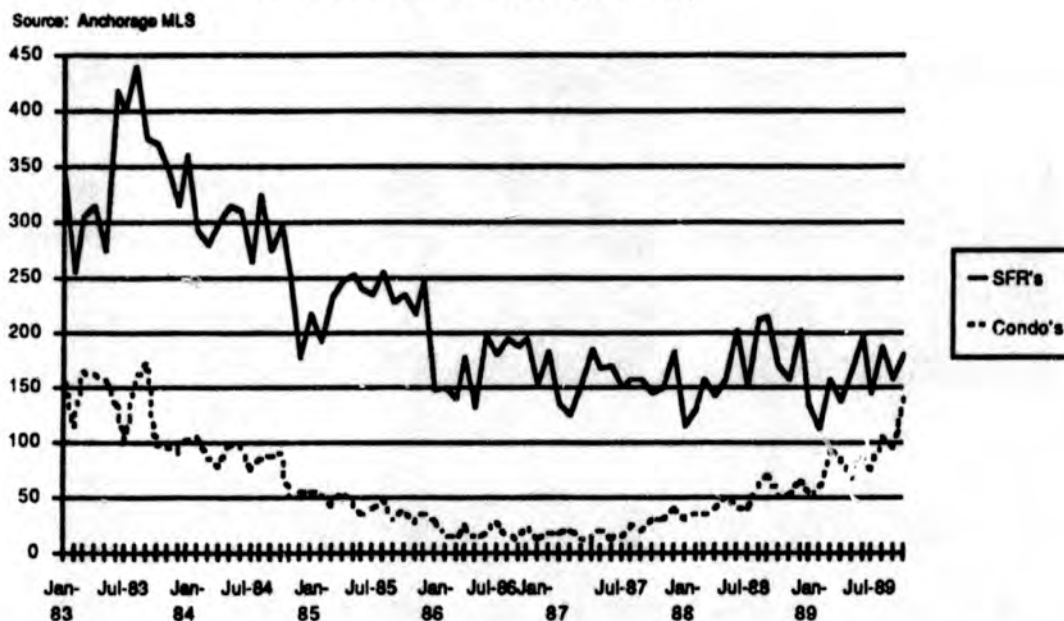
Source: Anchorage Economic Development and Planning



This represents about 10 years of demand at the 1989 absorption rate of 1,330 units. But since 1989 absorption was probably artificially high due to the oil spill, the actual picture may be even worse.

A good indicator of market activity is sales volumes in units, as shown in the graph below:

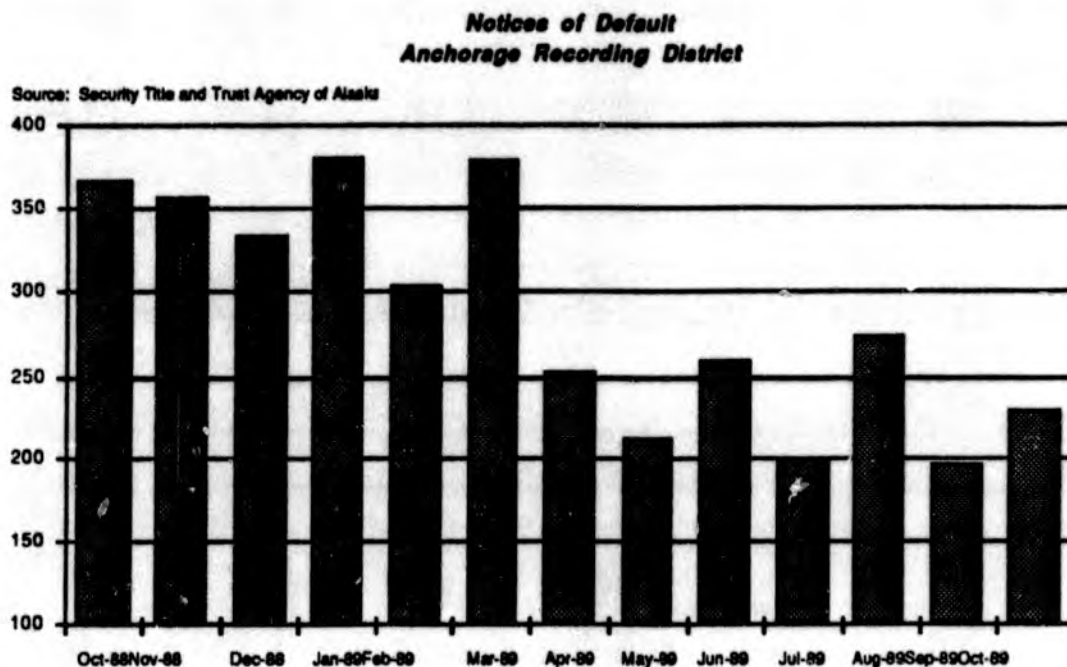
**Anchorage Unit Sales, Single Family Homes
and Condo's, 1982-1989 (MLS only)**



Sales of single family residences, which peaked at over 400 per month in the summer of 1983, showed a steady decline to their current levels of 120-150 per month (winter) and 150-200 per month (summer) by 1986. There has been no apparent increase in activity through October 1989, at least considering only MLS figures; direct REO sales are now a significant portion of the market, and lack of data in this area may mask a slight upward trend.

Sales of condominiums dropped from a level of 100-150 per month in 1983 to under 20 per month in the 1986-1987 period. There has been an upward trend since mid-1987, however, to over 100 sales per month; there were almost 150 sales in the latest known month, October, 1989. This trend appears to be due to investment buying and purchases by low-income families brought about by depressed prices and availability of attractive financing programs from some REO holders.

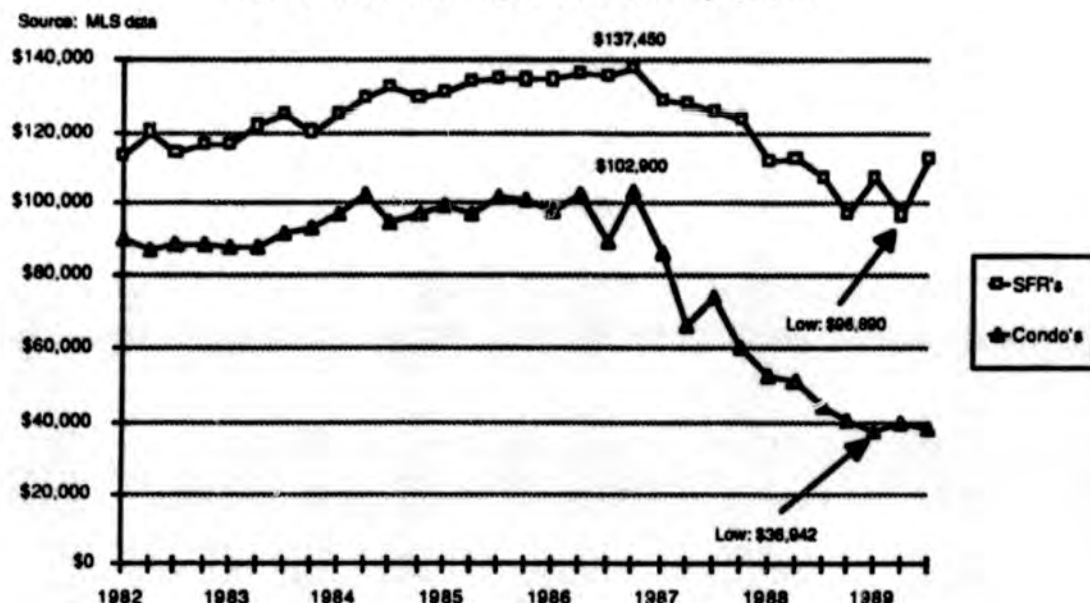
There is little doubt that, without a substantial boost to Anchorage's economy from some outside source, the large stock of unoccupied properties will continue to depress prices for some time to come. There is an additional danger that FDIC review of its portfolios will result in an additional REO spike, adding to the problem, but for the time being it appears that REO generation through foreclosure is slowing down. As the following graph shows, foreclosures from all sectors (but mainly residential) in the Anchorage Recording District have declined over the past year from a level of 300-400 per month to about 200-250 per month:



3. Prices

A general review of price movements in the Anchorage market is presented in the graph below:

**Housing Prices, Single-family Homes
and Condo's, Anchorage, 1982-1989 by quarter**



Although the MLS data presented in this graph are not corrected for mix of types and qualities sold in each period and do not include substantial REO sales by various parties, the general picture is clear—real estate prices peaked near the end of 1986 (well after the economic downturn began) and have declined precipitously since.

Single family home prices averaged \$137,450 in the peak quarter of 1986. They fell to a low of \$96,890 by the second quarter of 1989, a drop of 29.51 percent. Prices rose to \$112,512 in the third quarter, reflecting a possible recovery; but in October (the latest month available), single-family homes prices averaged only \$103,171. It is unclear, therefore, whether recent price moves signal a recovery in this segment of the market.

Condominium prices fared far worse than single family prices. A peak of \$102,900 was reached in 1986; prices then plummeted to a low of \$36,942 in the first quarter of 1989, a drop of 64.10 percent. Prices were a bit stronger in the second and third quarter, but in October (the latest month) they averaged only \$34,699.

In summary, prices for Anchorage homes appear to have stabilized at low levels. Some recovery may be present in the single family home segment, but condominium prices remain flat.

Stratification of prices follows, in Table 2, below. These figures are derived from total MLS sales in Anchorage for the latest three months available, August through October, 1989, and reflect actual sales prices for mixes of all residential property types:

Table 2
Price Stratification of Housing Sales in Anchorage

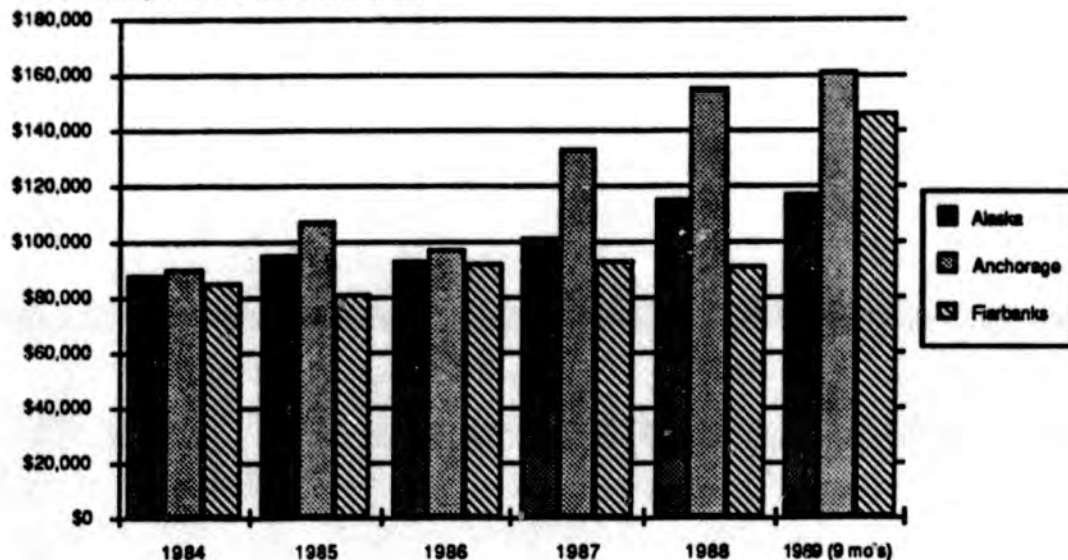
Price Range	Percent of Sales
Under \$86,850	62.69%
Under \$135,000	84.67%
Over \$235,000	2.72%

The high percentage of home sales under \$86,850 reflects a ready availability of low-priced condominiums in the Anchorage market and is not typical of some other areas in Alaska (see other market analyses, following).

As noted above, some housing construction continues in Anchorage (estimated at 200 units in 1989). This construction is almost exclusively confined to higher-value homes in the \$150,000 and up price ranges. Industry sources state that most of these homes are being built for oil company executives who are transferring into Anchorage and have difficulty locating suitable housing in the higher price ranges. The following graph, illustrating this trend, shows average construction cost for homes in Alaska, Anchorage, and Fairbanks by year:

**Average New Home Construction Cost
Alaska, Anchorage, and Fairbanks, 1984-1989**

Source: Anchorage Economic Development Corporation



Note that these costs do not include land, furnishings, or profit. They are simply the basic construction cost of the house. As can be seen, the average cost of a new house in Anchorage has increased from under \$90,000 in 1984 to over \$160,000 in 1989, reflecting almost exclusively the shift away from lower-quality housing and condominiums to high-end housing.

4. Factors Affecting Future Market Activity

In the long-term, improvement in the Anchorage real estate market will depend on increases in population and employment. Meanwhile, existing vacant stock will deteriorate, leading to demand for new units. Based on current trends, either of these two processes will take some years to show an effect.

Specific events which might cause short-term improvements in the market include:

- A sharp increase in oil prices, leading to an increase in State spending
- Construction of a gas pipeline

- Exploitation of the ANWR fields, leading to increased pipeline flows and increased State spending
- Expansion of Anchorage's role as an air transportation hub, one sign of which may be Federal Express's recent decision to base worldwide distribution services in Anchorage
- Increased military presence in the Anchorage area as a result of Stateside deployment of troops presently overseas, resulting from decreased international tensions (but see below)
- Some other unforeseeable event which improves the general economic climate in Anchorage.

The probability of any of these events occurring is problematical. It is equally likely that other events may retard market recovery or even cause further depression:

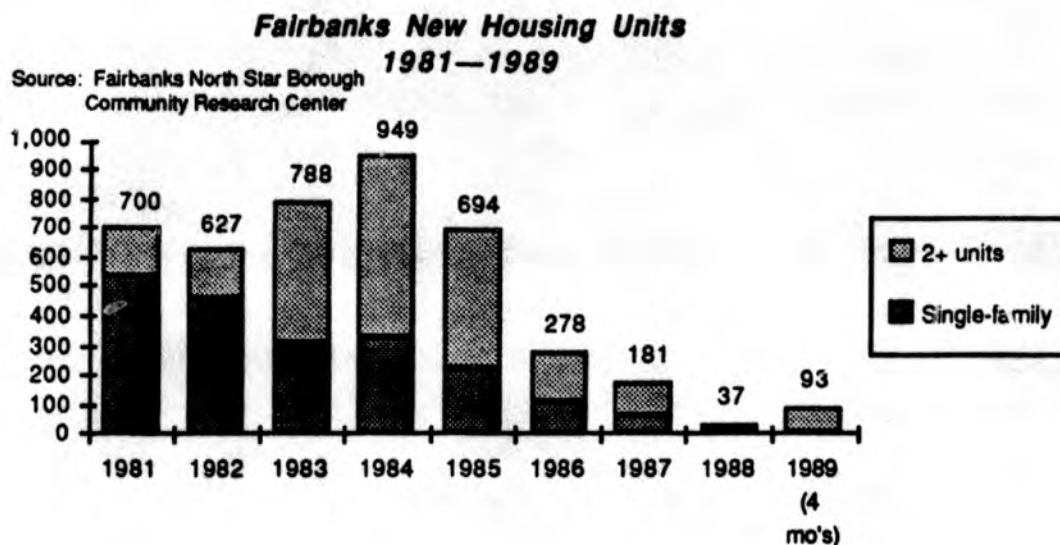
- Lowered State spending in anticipation of oil revenue decreases
- Movement of military personnel out of Alaska due to federal military spending cutbacks
- Possible new REO production as the FDIC reviews its portfolios in Anchorage for non-performing loans and increases foreclosures.

Given a very subjective view of the relative probability of these events, both positive and negative, it is difficult to feel overly optimistic about the near-term future of the housing market in Anchorage.

C. FAIRBANKS REAL ESTATE MARKET

Fairbanks represents AHFC's second largest market concentration, accounting for 13.15 percent of AHFC's total portfolio. Its delinquency rate is above Anchorage's, and above portfolio average, but its foreclosure rate is below average.

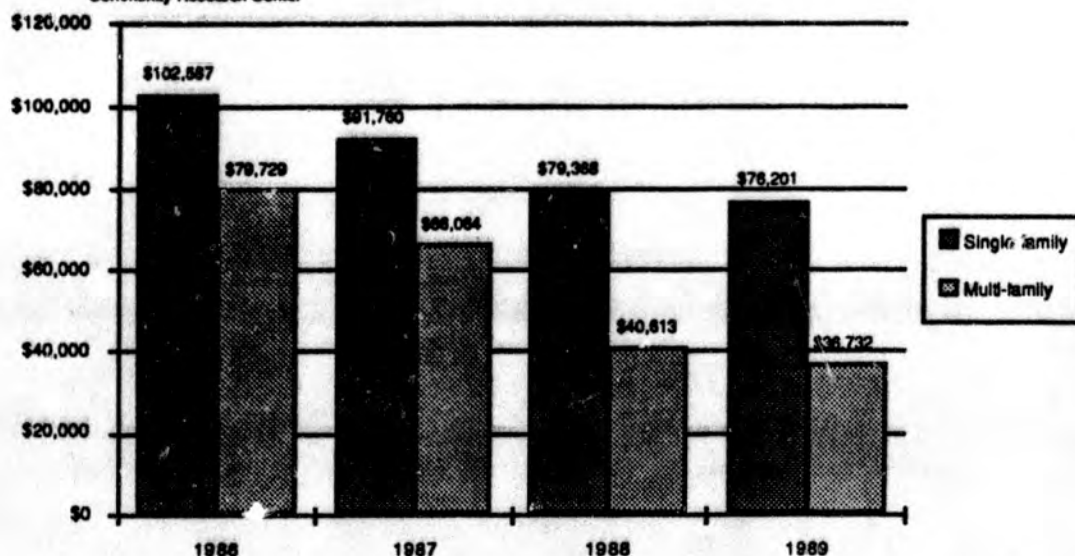
Fairbanks, like Anchorage, was hard hit by the real estate market downturn in 1986. Market supply anticipated the downturn, but not by enough. The following graph shows new units supplied to the Fairbanks market annually:



Since 1984 was the peak supply year (one year after Anchorage's peak of 1983), the oversupply situation in 1986 and years following was serious. This oversupply, combined with the economic downturn in Alaska generally, contributed to a continuing trend of lowered housing prices:

**Fairbanks Home Sales Prices
By Year, 1986-1989**

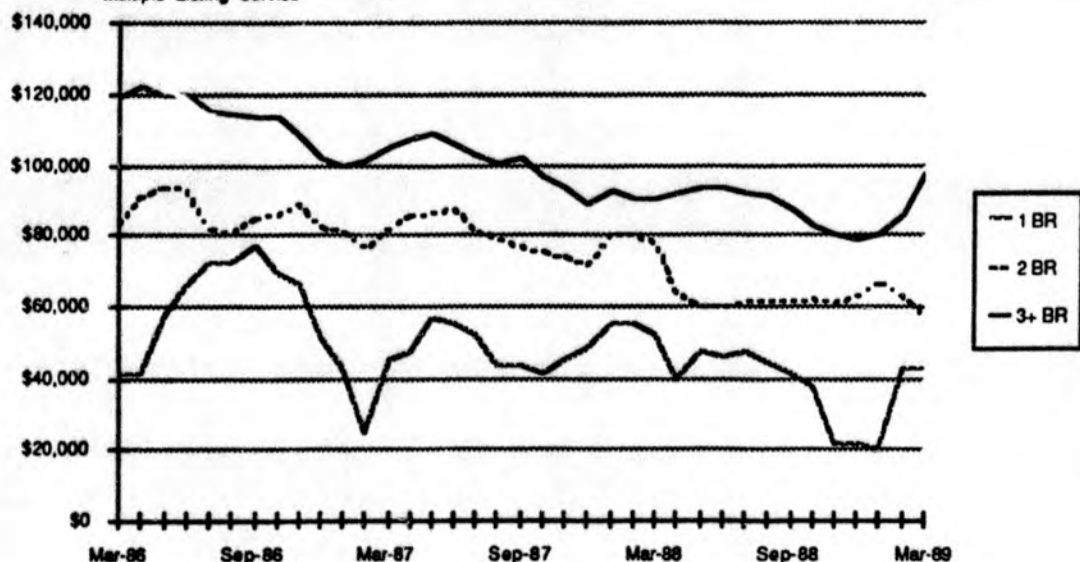
Source: Fairbanks North Star Borough
Community Research Center



Detached single family home prices also may be viewed on a monthly basis. Although the accompanying chart only shows prices through March 1989, the average annual prices per the chart above, which show 1989 prices through December 4, confirm a continuing downward trend in 1989:

**Fairbanks Average Sales Prices
MLS Sales, 1986-1989**

Source: Greater Fairbanks Board of Realtors
Multiple Listing Service



Mobile home sales are also tracked by industry sources in Fairbanks, who offer an estimate of \$18,880 as an average price in 1989.

Activity levels in the Fairbanks market remain reasonably high. The Greater Fairbanks MLS, which accounts for about 80 percent of all Fairbanks housing sales, showed the following closing counts for 1989 through December 4 in Table 3, below.

Table 3
Sales by Housing Type in Fairbanks

Housing Type	Number of Closings
Single-family	515
Townhouse/Condominium	104
Mobile home	20
Total closings	639

Demand for housing by price range is reflected by sales in the current market. Based on MLS closing price data for 358 sales in 1989, demand is stratified in Table 4, below, as follows:

Table 4
Price Stratification of Housing Sales in Fairbanks

Price Range	Percent of Sales
Under \$86,850	59.22%
Under \$135,000	91.62%
Over \$235,000	1.12%

These data are partly confirmed by industry estimates in Fairbanks that of about 200 sales in the past six months, one was at \$235,000, one at \$215,000, and the remainder at \$155,200 and below.

D. MATENUSKA-SUSITNA VALLEY REAL ESTATE MARKET

The Mat-Su Valley is AHFC's third largest market concentration, at 7.68 percent of AHFC's total portfolio. Of all areas in Alaska where AHFC maintains a substantial portfolio of loans, the Mat-Su Valley has been the hardest hit by the real estate market downturn. As of October 31, 1989, it had the highest delinquency and foreclosure rates of all AHFC geographic concentrations.

Local sources state that the reasons are twofold:

- The Valley is largely a bedroom community for Anchorage, and was thus directly affected by Anchorage's problems. This problem was exacerbated when Anchorage prices fell and deep vacancies occurred: Many Valley residents moved into Anchorage under the new, more affordable, conditions, and Anchorage's vacancies were to some extent "exported" to the Valley
- The Valley was home to many North Slope oil workers. As cutbacks occurred in the oil industry, the Valley felt the pinch harder than most.

In any event, prices have reflected the state of the market. Because the Valley MLS was part of the Anchorage MLS until relatively recently, a documented summary of historical price movements is difficult to compile. But industry sources estimate that housing prices fell violently in 1987, and are only now starting to recover as shown in Table 5, below:

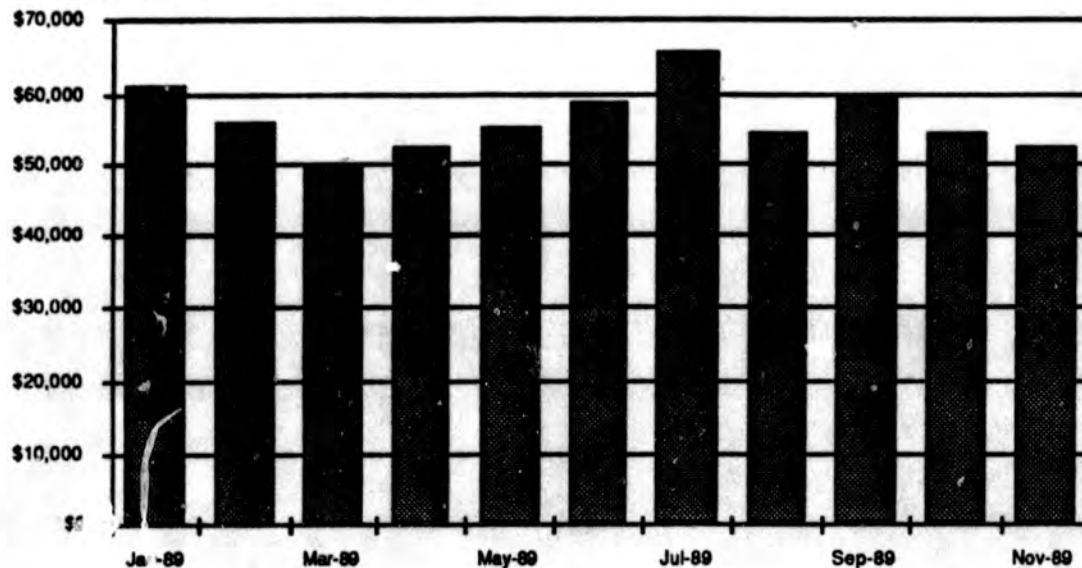
Table 5
Price Movements in Mat-Su Valley

Year	"Typical" 3-Bedroom Home
1985	\$110,000
1986	\$110,000
1987	\$55-60,000
1988	\$55-60,000
1989	\$60-65,000

Price movements in 1989 are shown in the following graph:

**Mat-Su Valley Residential Prices
All MLS Sales, 1989**

Source: Valley Board of Realtors

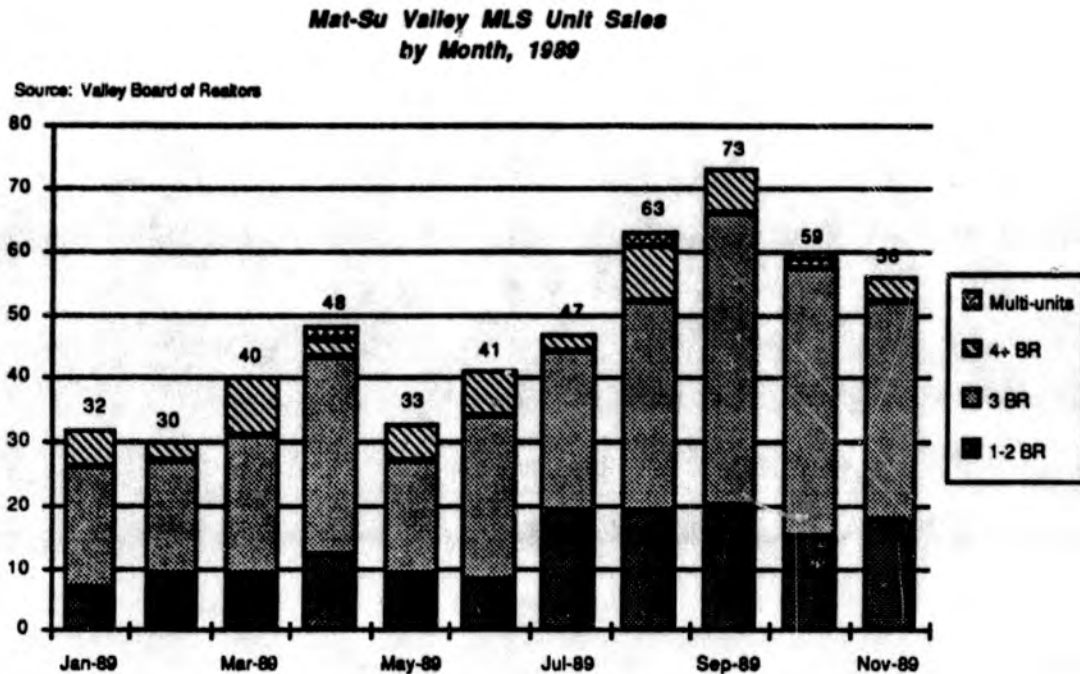


As can be seen, the average price of a home is in the high \$50,000's, and has not shown a strong recovery through the year. Some industry sources, however, feel prices should recover about 5 percent during 1990.

These sources state that school enrollment and telephone hookups are up a bit in 1989, possibly portending a further improvement in the market. Rentals are also tight, but quite a few 2-4 plexes are "off the market" and could loosen up rentals when marketed.

MLS volumes in the Valley market are running about 50 sales per month, of which most are single-family residences. Condominium sales account for only about 1.5 percent of total sales. In general, the Valley marketplace is not condominium-heavy like Anchorage's.

The following graph shows market activity for 1989:



This graph appears to show market activity picking up somewhat as the year progresses, but it would be premature to announce a trend from these data.

Market stratification, based on all MLS sales for the first eleven months of 1989, is shown in Table 6, below, as follows:

Table 6
Price Stratification of Housing Sales in Mat-Su Borough

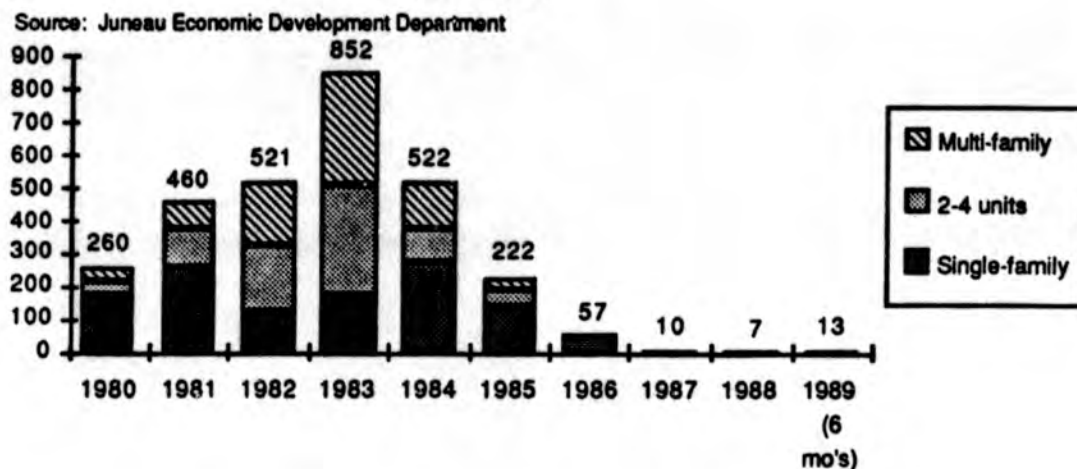
Price Range	Percent of Sales
Under \$86,850	89.45%
Under \$135,000	97.70%
Over \$235,000	0.00%

E. JUNEAU REAL ESTATE MARKET

Juneau represents 7.11 percent of AHFC's portfolio by dollar amount. Its delinquency and foreclosure rates are well below the average for AHFC's portfolio.

To a certain extent, the history of the Juneau housing market parallels the cycle of overbuilding and then oversupply experienced in Anchorage:

**Juneau New Housing Units
1980—1989**



As in Anchorage, construction peaked in 1983 and has since practically ceased altogether.

But in contrast to the Anchorage, Fairbanks, and Mat-Su Valley markets, Juneau real estate is showing a strong recovery from the downturn. Local industry sources state that prices are up, inventories are tight, and that above-list offers must often be made in order to buy desirable properties. These sources also state that local appraisers are applying inflationary factors to older comparables when valuing properties as shown in Table 7, below.

Table 7
Appraisal Escalation Factors in Juneau

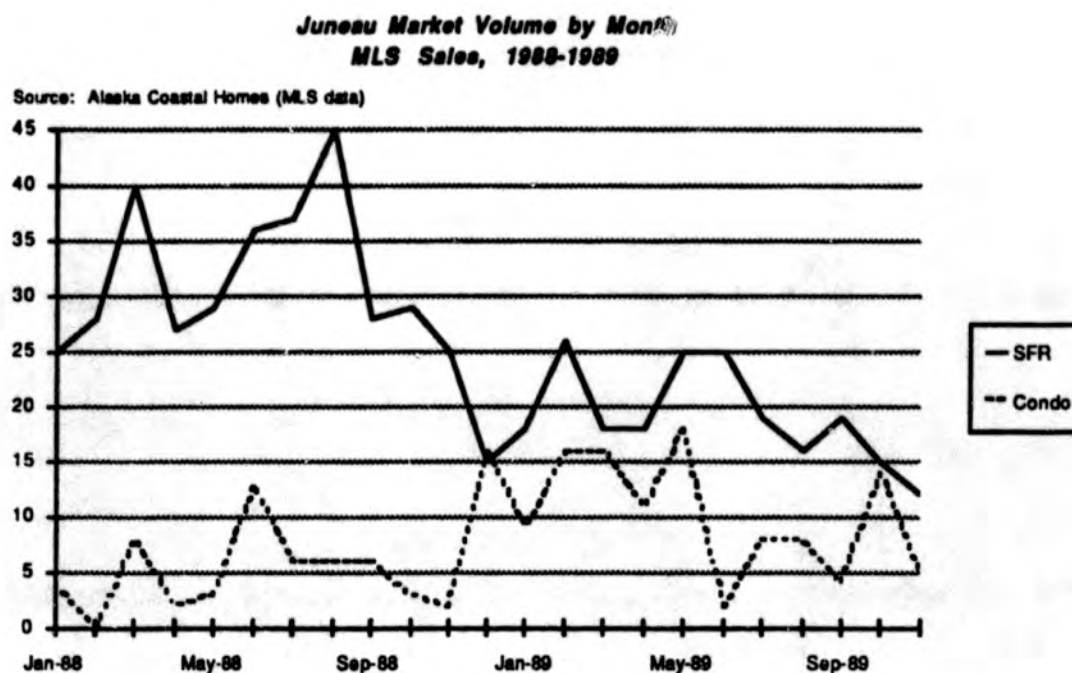
Type of Property	Escalation Factor
Single-family	1%/month
Zero lot line	3%/month
In-city condo	1/2%-1%/month

Volumes of sales handled through the Juneau MLS in recent years are summarized in Table 8, as follows:

Table 8
Volume of Sales in Juneau

Year	Number of Sales
1986	256
1987	299
1988	459
1989	400

The drop-off in 1989 is not due to a worsening market, but to fewer properties listed and higher prices. The pattern of housing sales over the past two years is shown below:



Dependable price information in Juneau is hard to obtain because of lack of MLS statistical reporting. Industry sources estimate the following trend of prices since 1986 as shown in Table 9:

Table 9
Housing Price Movements in Juneau

Type of Home	1986	1987	1988	1989
Single-family detached	\$105,000	\$78,500	\$85,000	\$105,000
Zero lot line	\$80,000	\$59,500	\$59,500	\$68,000
Condominium	\$56,000	\$23,000	\$28,000	\$35,000

The same industry sources estimate price stratification within the Juneau market as presented in **Table 10**, as follows:

Table 10
Price Stratification of Housing Sales in Juneau

Price Range	Percent of Sales
Under \$86,850	65-70%
Under \$135,000	80%
Over \$235,000	1/4%

F. KENAI PENINSULA REAL ESTATE MARKET

The Kenai Peninsula market consists mainly of Kenai, Soldotna, and vicinity areas. This market represents 5.91 percent of AHFC's portfolio by dollar volume. It has experienced below-average delinquency and foreclosure rates.

Activity in this market has shown some improvement, although average time-on-market figures indicate slow sales as noted in Table 11:

Table 11
Market History in Kenai Peninsula

Year	Sales per Month	Days on Market
1987	16.25	162
1988	27.33	190
1989 (11 months)	23.45	223

Average sales prices for all classes of homes declined about 12 percent from 1987 to 1988, and an additional 4 percent in 1989, described in Table 12, following:

Table 12
Housing Price Movements in Kenai Peninsula

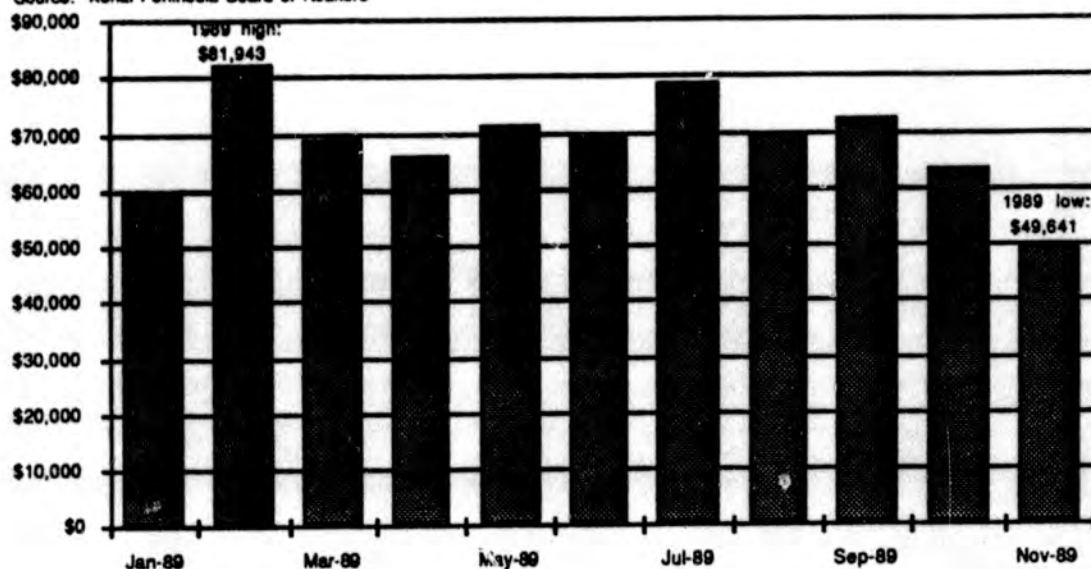
Year	Average Home Price
1985	\$105,000 (1)
1986	\$105,000 (1)
1987	\$80,852 (2)
1988	\$70,556 (2)
1989	\$67,889 (2)

Notes: (1) Industry estimates. Home prices did not drop generally in 1986, but sales slowed down dramatically.
(2) MLS averages of closings. Drop in 1989 is said to be due to the mix of homes sold, not to generally lower prices.

Movements in home sales prices can be seen in the following chart:

**Kenai Peninsula Average Sales Prices
MLS Sales, 1989**

Source: Kenai Peninsula Board of Realtors



An analysis of 258 MLS sales over the first eleven months of 1989 gives the following demand stratification presented in Table 13, below:

**Table 13
Price Stratification of Housing Sales in Kenai Peninsula**

Price Range	Percent of Sales
Under \$86,850	78.29%
Under \$135,000	96.51%
Over \$235,000	0.00%

G. KETCHIKAN REAL ESTATE MARKET

Ketchikan represents 2.36 percent of AHFC's portfolio. It has a below-average delinquency rate and the lowest foreclosure rate of any specific geographic concentration tracked by AHFC.

The Ketchikan real estate market was not hit badly by the economic downturn, at least when compared with Anchorage, Fairbanks, and Juneau. Overbuilding was largely prevented by unavailability of land and difficult terrain, and builders tended to bypass Ketchikan in 1983-4 for the greener pastures of Anchorage and Mat-Su Valley. As a result, the "overhang" of properties when demand slackened was not great. Also, Ketchikan lost only about 1 percent of its population in the downturn (as opposed to about 15 percent in Anchorage), limiting the damage.

It must also be noted that the real estate market in Ketchikan (as in Sitka, which follows) is driven not so much by financing considerations as by relatively small changes in population or jobs. A new enterprise employing twenty people may cause a considerable change in vacancies and prices in these markets, while a similar occurrence in Anchorage would have little or no effect on the market.

While exact numbers are not available, industry sources state that housing prices are already slightly above their peak levels of 1985, and that appreciation of good properties is currently about 1/2 percent per month. Rentals are difficult to obtain. Lot sales, which had been extremely depressed, are now beginning to pick up, and new rental housing is expected to come on the market as a result.

The market is predominantly single family detached housing. Some condominiums exist; perhaps 100 units are "real" condominiums, while there are about 200 additional units converted from apartments which are of lower quality and not generally susceptible to FHA or AHFC financing. Less than 10 percent of property sales are condominiums.

Activity levels in the market have been as shown in Table 14:

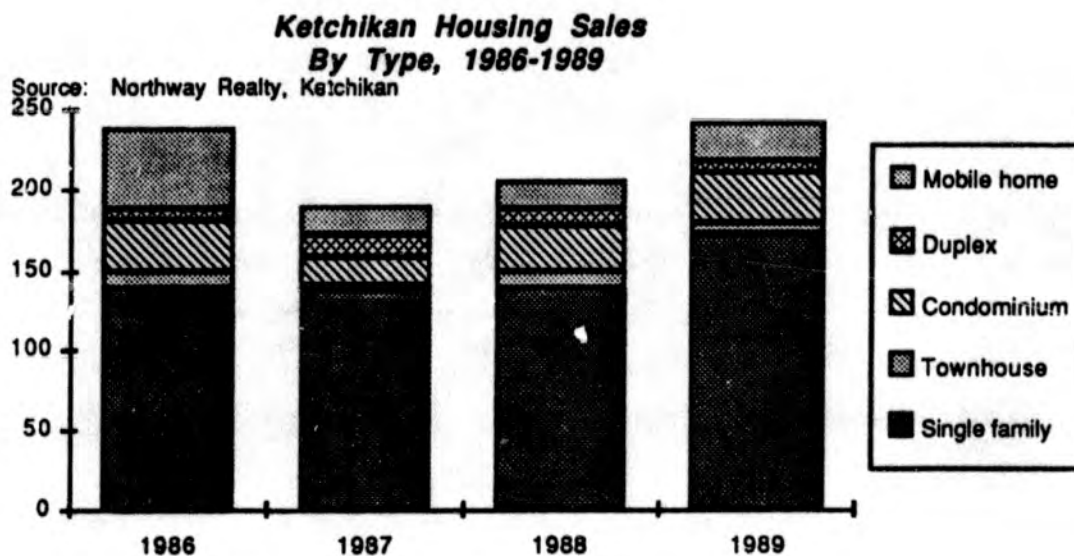
Table 14
Annual Housing Sales in Ketchikan

Year	Annual Sales
1984	250 (1)
1985	225 (1)
1986	236 (2)
1987	188 (2)
1988	204 (2)
1989	241 (2)

Notes: (1) Industry estimates.

(2) Figures per Northway Realty, Ketchikan.

Distribution of sales by housing type over the past four years is shown in the graph following:



Industry sources estimate that historical movement in prices, based on a hypothetical 3-bedroom house in two neighborhoods, is presented in Table 15, as follows:

Table 15
Price Movements in Ketchikan

Year	"Desirable" Area	"Less Desirable" Area
1985	\$100,000	\$100,000
1986	98,000	90,000
1987	98,000	90,000
1988	100,000	96,000
1989	110,000	105,000

The same sources estimate the stratification of the market as shown in Table 16, as follows:

Table 16
Price Stratification of Housing Sales in Ketchikan

Price Range	Percent of Sales
Under \$86,850	45%
Under \$135,000	90%
Over \$235,000	0%

H. SITKA REAL ESTATE MARKET

The Sitka market represents one of the smallest geographic concentrations of AHFC activity, making up 1.57 percent of AHFC's total portfolio. It has the lowest delinquency rate of AHFC concentrations, and the second lowest foreclosure rate.

Unlike many other areas in Alaska, Sitka maintained a stable real estate market through the last half of the 1980's. It had experienced an earlier downturn, however. Industry sources estimate that a home which would have cost \$180,000 in 1982 had declined in value to about \$150,000 by 1985. Home prices remained stable at 1985 levels through 1988, and have increased in value approximately 6 percent during 1989.

This recent increase in prices is laid to lack of available stock on the market. Of Sitka's approximately 2,000 housing units, 160 were on the market in Spring 1988; by Fall on 1989, only about 60 were available for sale. Current sales rates are estimated at 35-50 properties per year, with little change from 1988.

The lack of available stock is affecting lot sales in anticipation of new construction. Land values have been increasing at 3-4 percent per year for the past three years, and 6-12,000 square foot lots now sell for between \$35,000 and \$50,000.

One problem with the Sitka market is quality of housing. Many units were built in a haphazard fashion and some are now showing foundation and other defects which preclude them from FHA-insured financing. Since private mortgage insurance is largely unavailable in Sitka (and elsewhere in Alaska), FHA/AHFC financing is the preferred and often the only financing method for buyers unable to make a down payment of at least 20 percent. As a result, these units are difficult to finance, limiting sales.

Industry sources estimate stratification of the housing market as depicted in Table 17, as follows:

Table 17
Price Stratification of Housing Sales in Sitka

Price Range	Percent of Sales
Under \$86,850	10%
Under \$135,000	65%
Over \$235,000	1%

The lack of units under the tax-exempt limit is laid to the predominance of detached homes in the area and the scarcity of condominium units. If mobile homes were included in this category, approximately 15 percent of demand would be under the tax-exempt limit.

APPENDIX D

**EVALUATION OF HOUSING
ASSISTANCE FUND
MORTGAGE LOAN PURCHASE
BY AHFC**

Ernst & Young

APPENDIX D
EVALUATION OF HOUSING ASSISTANCE FUND
MORTGAGE LOAN PURCHASE BY AHFC

Legislation was introduced in 1989 (Senate Bill 245) which would require the AHFC to purchase at par value home mortgage loans from the Housing Assistance Division (HAD). These loans are primarily for homes in rural Alaska, and have interest rates which are set by law at one percent less than AHFC rates. The Housing Finance Task Force requested an evaluation of this proposal, including its impact on AHFC loan programs, and whether the purchase should be at par value or market value.

Our analysis and conclusions regarding the SB 245 proposal is presented in the following subsections:

- *Description of HAD Purchase Proposal*
- *Impact on AHFC of Purchasing HAD Loans*
- *Conclusions Concerning Purchase of HAD Loans.*

A. DESCRIPTION OF HAD PURCHASE PROPOSAL

Senate Bill 245 was introduced by the Senate Finance Committee in 1989, and would require the AHFC to purchase at par value (i.e., the outstanding principal balance) at least \$80 million of mortgage loans from the Housing Assistance Loan Fund. The bill did not set a ceiling on the dollar amount or number of loans to be purchased.

The loans in question are primarily for homes in rural areas of the State, and were financed by State funds appropriated to the Housing Assistance Division (HAD) of the Department of Community and Regional Affairs (DCRA). None of the loans are insured. The loans were originated by HAD and are serviced by various financial institutions.

There were 1,566 HAD loans as of September 30, 1989, with a principal balance owing of \$154.5 million. In fiscal year 1988/89, HAD originated 167 new loans. For the three months ending September 30, 1989, only two new loans were made by HAD.

All loans made by HAD are State funded. Total appropriations by the State for the HAD loan program have been \$191.5 million since fiscal year 1980/81, the year HAD was created by the Legislature. Because all the loans are funded by the State it is difficult to determine if the HAD loan program has broke even. The financial statements prepared for the program do not include the opportunity costs, or the imputed interest costs, of the State funds. This is different from AHFC practices which impute a cost of funds for all bond proceeds and State funds used to purchase loans.

B. IMPACT ON AHFC OF PURCHASING HAD LOANS

The proposal is effectively a removal of assets from AHFC because it allows the State to take monies from AHFC. The loans would be transferred from DCRA to AHFC in return for cash (equal to the purchase price) given from AHFC to DCRA. The State could then have the option of appropriating the monies from DCRA.

Such an extraction of Corporation assets could affect AHFC's ability to raise new capital and keep existing loan programs functioning. The AHFC raises capital through "general obligation" bond sales, with the bonds backed by the financial strength of the Corporation. Because of this "general obligation" of AHFC behind each bond, the bonds receive the highest credit rating and a lower interest rate. An extraction of assets such as proposed would damage AHFC's financial health, weaken the security for existing bonds, and raise concerns about the vulnerability of AHFC to future withdrawals. This kind of environment will make investors uneasy and cause concern for the rating agencies, both of which could translate to higher interest costs and difficulty in maintaining existing AHFC loan programs.

The financial impact on AHFC would be greatest if the loans were purchased at the face amount of the outstanding principal owed (par value). The current par value of the loans is estimated by DCRA to be \$154 million. The market value of the properties securing many of the loans may be less than the loan balance, according to DCRA, especially in light of recent declines in real estate prices statewide. In its own internal analysis of the potential purchase, AHFC estimated that the HAD portfolio of loans is worth 76 percent of the principal balance of the loans.

Senate Bill 245 does not consider market value, but would require AHFC to purchase at least \$80 million in HAD loans, regardless of the actual, or market value of the loans. This would mean an additional premium paid to the State by AHFC. The rural home owners would not receive any financial benefit from the proposed purchase.

These loans are uninsured which means AHFC would be 100 percent at risk for any delinquent payments, interest lost from late payments, and, if the property were foreclosed on, the loss in value of the property. In addition, there would be attorney fees,

taxes, insurance, and other holding costs for any foreclosed property, all of which would have to be paid by AHFC if it owned the loans. This again would only weaken further the current financial position of AHFC and damage its ability to raise additional capital at a reasonable cost.

Earlier, in Section III of this report, we presented estimates of net unrestricted assets of the Corporation. Given that AHFC may only have \$10 million of liquid assets which are not restricted by existing bond covenants or short-term borrowing agreements, there are not sufficient funds to purchase the HAD loans, unless AHFC issues new debt.

If the purchase of HAD loans is funded through the sale of bonds by AHFC, the net effect on AHFC assets would be less, although not necessarily zero. Proceeds from a bond sale could be used to purchase the loans, and the loans could be used as collateral for the bonds. This was done in fiscal year 1986/87 when AHFC made a similar purchase, at par value, of \$70 million in HAD loans, financing this purchase with the sale of floating and fixed rate bonds.¹ If the cash flow from the loans, net of servicing fees, is sufficient to repay the bonds,² then the impact on AHFC assets could be minimal. If delinquencies and foreclosures occurred, or if the interest received from the loans was less than the interest costs of the bonds, then any shortfall in funds available for debt service would have to be provided by the Corporation.

The financing bond covenants for the first purchase of \$70 million in HAD loans required that AHFC replace any delinquent loan used as security for the bonds with a "good" loan from AHFC's own portfolio (i.e., a loan which is not delinquent). Approximately 80 of the original HAD loans have gone into delinquency, and AHFC has had to replace approximately \$4 million in delinquent HAD loans with \$4 million in non-delinquent AHFC loans.

¹ All of the HAD loans purchased by AHFC were loans for homes in urban areas, and are still owned and managed by AHFC.

² The annual cash flow from the loans may or may not exactly match the required annual debt service payments on the bonds issued. However, total loan cash flows, prepayments, and reinvestment income over the life of the loans, when discounted back to today's dollars, could theoretically equal the present value of all payments on the debt issued to purchase the loans.

It is unclear at this time how the cash flow from the HAD loans can be used if purchased by AHFC. In 1988, the Legislature passed, and the Governor signed into law, House Bill 555 which contained the following provision:

"(10) Purchase loans from the Housing Assistance Loan Fund (AS 44.47.380) if and only if:

- (A) the payments of principal and interest on the loans are deposited in a separate fund of the Corporation to be used for the purposes, and subject to the standards and criteria, of AS 44.47.360 -- 44.47.560 as those statutes provided on June 10, 1988; and
- (B) the Corporation has established a source of mortgage insurance for new loans subject to the provisions of AS 44.47.360 -- 44.47.560."

It appears that the cash flow from the HAD loans can only be used to make more HAD-type loans. It cannot be used to repay bonds, to collateralize new bonds, to make new AHFC loans, or for any other activities of AHFC. Under our interpretation of HB 555, the cash flow from the HAD loans is restricted to making only loans and the loans made must meet HAD criteria.

A final point should be made regarding servicing the loans. The DCRA is organized to service home buyers in rural Alaska, with satellite offices in seven locations. The DCRA makes money available to home buyers which might not otherwise be able to obtain financing. The DCRA has less stringent requirements for its loans than does AHFC. The DCRA does not require mortgage insurance on loans, nor is approval required by the Department of Environmental Conservation, both of which are required for AHFC loans. Also, the interest rate provided by DCRA is one percent below AHFC interest rates. In order for AHFC to provide the same level of service, significant changes would need to be made to AHFC operations and underwriting criteria, which could impact AHFC high credit rating and ability to raise money to continue its loan programs.

C. CONCLUSIONS CONCERNING PURCHASE OF HAD LOANS

Because of concerns identified previously regarding the potential purchase, we conclude that AHFC should not be required to purchase the HAD loans. Such a transaction could weaken AHFC's ability to continue its loan programs because the direct extraction of assets from the Corporation would make it difficult for AHFC to raise funds for its existing bond-financed programs. In addition, existing State law may limit or prevent the use of the loans for current AHFC activities. Existing law should be clarified and possibly amended if the purchase of HAD loans by AHFC were actually made. Finally, a purchase by AHFC of HAD loans would diminish the attention rural Alaskan homebuyers now receive from the Department of Regional and Community Affairs. Even if AHFC were to purchase only the urban HAD loans (as was done in the first, \$70 million purchase two years ago), there may not be enough urban loans in the HAD portfolio to meet the \$80 million minimum established by SB 245.

If SB 245 were signed into law, and AHFC were to purchase HAD loans, it would make more sense to purchase all HAD loans, and not try to split the portfolio into HAD administered loans and AHFC administered loans. Splitting the portfolio would weaken the attention rural Alaskans now have, duplicate State services, and create inefficiencies. If the purchase were made, all the loans should be purchased.

If all the loans were purchased, the price paid should be based on the market value of the properties and not the par value (or unpaid principal balance) of the loans. The market value is the only fair price for the loans and should reflect delinquencies, potential foreclosures, and net realizable value from the sale of the property.

Determination of market value can be performed by a number of underwriters, mortgage bankers, or independent consulting firms, some of whom AHFC already uses for structuring bond sales. Generally, these firms require a magnetic tape containing the history, type, and performance of every loan in question. Although the methodologies used by each firm may differ, the actual purchase price can be determined based on factors such as prepayment characteristics, interest rates, loan-to-value ratios, delinquency rates, foreclosures, and net losses on loans which default. These firms also can evaluate the quality of the original loan origination and underwriting, and the ability of the loan

servicers to collect payments and pursue foreclosures. Finally, interest rates at the time of the purchase are considered in establishing an appropriate discount or premium on an individual group (pool) of loans with similar fixed interest rates.

APPENDIX E

**LEGAL REVIEW BY DELANEY,
WILES, HAYES, REITMAN
& BRUBAKER, INC.**

Ernst & Young

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January 11, 1990

James A. Gibson
Project Director
Ernst & Young

Dear Mr. Gibson:

You have requested our opinion as to certain matters pertaining to your consulting contract with the Alaska Housing Finance Corporation ("AHFC").

In responding to your queries, we have performed extensive legal research including a thorough review of relevant provisions of the United States and Alaska Constitutions, provisions of the Alaska Statutes, together with numerous cases interpreting such constitutions and statutes, other judicial authorities and commentaries. We find that most of the issues raised in your queries have not been ruled upon by either the Alaska Supreme Court or other courts of last resort.

We have endeavored to provide you with our best legal analysis of the issues presented by your queries and with our view of the likely outcome if the issues were presented to the Alaska Supreme Court.

The attached format follows the organization of the queries which you presented.

STATEMENT OF QUERIES PRESENTED

I. GENERAL

1. Define AHFC. Is it unique from other Alaska state agencies (e.g., Alaska Railroad Corporation)? Is AHFC different from a private corporation?
2. Under the existing statutes, does AHFC have the power and authority to issue revenue bonds as to a specifically identified group of mortgages?

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3. Are there any legal constraints to establishing a new agency to implement only the original legislative intent programs of AHFC?
4. Can the legislature by appropriate legislative enactment exempt AHFC from the provisions of the Executive Budget Act?
5.
 - (a) Can the legislature by appropriate legislative enactment terminate the AHFC taxable bond program?
 - (b) Can the legislature by appropriate legislative enactment terminate the AHFC tax-exempt bond program?
 - (c) Can the legislature by appropriate legislative enactment terminate the tax-exempt veterans mortgage bond program?
6. Can specific AHFC programs be removed from AHFC and incorporated into a new entity?
7. What legal constraints are there to modifying the public corporation status of AHFC so that it functions like a private corporation, but still is a state organization?

II. TRANSFER OF ASSETS

1. Can the state legally expropriate funds from AHFC?
2. Does AHFC have any legal responsibility to provide a return on capital to the state?
3. Can the legislature direct AHFC to purchase specific assets?
4.
 - (a) Will an extraction of any, but not substantially all, unrestricted or unpledged assets from AHFC by the state give rise to a valid claim by bondholders against the state?
 - (b) Will an extraction of any, but not substantially all, restricted or pledged assets from AHFC by the state give rise to a valid claim by bondholders against the state?

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- (c) Will an extraction of substantially all the assets from AHFC by the state give rise to a valid claim by bondholders against the state?
- 5. Are there any legal grounds for AHFC to compel the state to appropriate or transfer funds to AHFC?
- 6. If AHFC, pursuant to legislative enactment, purchases loans from the HAD program, is the application of payments of principal and interest received on such loans restricted to making future HAD loans?

III. SUBSIDY

- 1. If the interest reduction subsidy is legislatively eliminated as of June 30, 1990, can the proceeds of bonds sold prior to this date be used to finance loans under the new legislation?
- 2. Can AHFC change the eligibility requirements for loans made from bond proceeds, if the bonds are already sold?
- 3. Are there legal constraints to discontinuing or diminishing the interest rate subsidy by appropriate legislative enactment?
- 4. What legally needs to be done to implement a change in the interest rate subsidy?
- 5. Is AHFC an unlawful monopoly in restraint of trade because of its market position?

IV. CHANGE OF OWNERSHIP

- 1. Are there any legal constraints to:
 - (a) AHFC issuing and selling common stock in AHFC, thereby transferring 100% of ownership and control of AHFC to a private party?
 - (b) AHFC selling all assets?
 - (c) AHFC selling its REO disposition operation to a private party?
 - (d) AHFC selling loans within a bond program, i.e., where loans have been pledged as collateral?

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- (e) AHFC selling a loan not used as collateral for a specific loan program?
- 2. Are there legal constraints to AHFC entering into a partnership?

ANALYSIS

I. GENERAL

- 1. Define AHFC. Is it unique from other Alaska state agencies (e.g., Alaska Railroad Corporation)? Is AHFC different from a private corporation?

AHFC is a public corporation created pursuant to statute as opposed to a private corporation which is created by the issuance of a certificate of incorporation by the State of Alaska upon the filing of articles of incorporation. AHFC has neither articles of incorporation nor a certificate of incorporation.

AHFC is a separate legal entity; however, this separate legal existence serves only to accommodate a centralized business-type of corporate management and the isolation of certain state activities within a functioning unit. The essential test to determine whether an entity such as AHFC is a state agency is the financial nexus between the entity and the State of Alaska and the actual control or lack of control of the entity by the State of Alaska. Various factors are applied in determining the actuality of financial nexus or dependency and control. "An administrative agency may be called a commission, board, authority, bureau, office, officer, administrator, department, corporation, administration, division or agency. Nothing of substance hinges in the choice of name. . . ." Alaska State Housing Authority v. Dixon, 496 P.2d 649, 651 (Alaska 1972) quoting 1 K. Davis, Administrative Law, § 1.01, at 1 (1958) (emphasis added). The Alaska Supreme Court has expressly stated that independent corporate status does not prevent a finding of state agency. Alaska Commercial Fishing & Agriculture Bank v. O/S Alaska Coast, 715 P.2d 707, 711 (Alaska 1986). Rather, the court considers a state agency's separate corporate status as a neutral factor. Id. at 710.

While the Alaska Supreme Court has repeatedly stated that a determination of whether an entity is a state agency depends on the

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particular facts and circumstances presented and the purpose of the inquiry, certain factors have been consistently applied by the Alaska Supreme Court in determining status. These factors, referred to as the "DeArmond factors", balance an entity's authority against the state's retained control. The factors considered include: (a) whether the creation and funding of the agency fulfilled a public purpose, (b) whether the statute expressly locates the agency within a department, (c) the submission of annual reports to the state, (d) certified copies of minutes sent to the governor, (e) appointment by the governor of at least some of the board of directors, (f) financial contributions by the legislature to the annual budget, and (g) any additional controls retained by the state. Alaska Commercial Fishing & Agriculture Bank ["CFAB"], supra at 709-712 citing DeArmond v. Alaska State Development Corp., 376 P.2d 717 (Alaska 1962), Walker v. Alaska State Mortgage Ass'n, 416 P.2d 245 (Alaska 1966), Alaska State Housing Authority v. Dixon, supra, Alaska State Operated School System v. Mueller, 536 P.2d 99 (Alaska 1975).

AHFC has characteristics similar to other public corporations which have previously been determined to be "state agencies" in other contexts in the aforementioned cases. See also University of Alaska v. National Aircraft Leasing, Ltd., 536 P.2d 121 (Alaska 1975).

In addition to state controls over AHFC, constitutional concerns also weigh in favor of the status of AHFC as an agency rather than an entity with complete autonomy from the state. The Alaska Constitution requires substantial ties between a public corporation and the executive branch. The Alaska Constitution provides that all executive and administrative functions shall be placed within not more than 20 principal departments and that each department shall be under the supervision of the governor. Alaska Const., article III, sections 22 and 24. If AHFC is regarded as an entity with complete autonomy entirely independent from the State of Alaska, as opposed to an agency, a constitutional challenge would foreseeably be mounted against the statute creating AHFC on the basis that it attempts to create an overly independent agency in violation of article III, sections 22 and 24, of the Alaska Constitution. Article III, section 22 states:

All executive and administrative offices, departments, and agencies of the state government and their respective functions, powers, and duties shall be allocated by law among and within not more than twenty principal departments, so as to group them as far as practicable according to major purposes. Regulatory, quasi-judicial, and temporary agencies may be established by

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law and need not be allocated within a principal department.

Article III, section 24 states:

Each principal department shall be under the supervision of the governor.

Pursuant to statute, AHFC is expressly located within the Department of Revenue. AS 18.56.020. Executive controls over AHFC are present which were also found to exist in the above-referenced cases. The express classification of AHFC within the Department of Revenue weighs in favor of a determination that AHFC is an instrumentality or agency of the state as opposed to being an entity which is "independent" of the state. Further, AHFC does not appear to fall within one of the three exceptions to the constitutional requirement that all agencies of the state be allocated within twenty principal departments. See Walker, supra, at 249, n. 11, wherein the Alaska Supreme Court affirmed the determination that Alaska State Mortgage Association (ASMA) was not an agency independent of the state and that ASMA was not a regulatory, quasi-judicial, or temporary agency of the state within the exceptions provided under article III, section 22 of the Alaska Constitution.

AHFC is unique from other state agencies in the sense that it is performing unique public purposes in the provision of housing to residents of the state through mortgage loan subsidies.

AHFC is significantly different from a private corporation in that:

- (a) A private corporation has shareholders, AHFC has no issued or outstanding stock. However, the courts generally state that the "interests" in public corporations are held by the state. The term "interests" being used in place of references to the rights of shareholders.
- (b) The board of directors of a private corporation are elected by the shareholders. The board of directors of AHFC consist of five members who all are, in effect, appointed by the governor.
- (c) The board of directors of a private corporation generally have a duty to apply the assets and funds of the corporation with a view towards earning a profit and providing a return to the shareholders. The board of

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directors of AHFC, on the other hand, has a duty to apply the funds and assets of AHFC in fulfillment of the public purposes for which the entity was created and to specific programs adopted by legislative enactment.

AHFC would seem to be different from the Alaska Railroad. While the Alaska Railroad is also a public corporation, its purpose is generally to provide a reliable, safe and efficient means of transportation throughout the railbelt, and also to be self-sustaining (AS 42.40.100) and presumably generate a profit if possible.

2. Under existing statutes, does AHFC have the power and authority to issue revenue bonds as to a specifically identified group of mortgages?

It would seem that under the presently existing statutes AHFC does have the authority to issue limited purpose obligations in the form of revenue bonds as to a specifically identified group of mortgages.

Alaska Statute 18.56.110(f) provides that AHFC has the power to pledge to any payment or purpose all or any part of its revenues to which its right then exists or may thereafter come into existence. Under such provision AHFC could determine to pledge the revenues from a specifically identified group of mortgages as a source of payment of limited purpose obligations or "revenue bonds".

We have considered AS 18.56.110(b) which provides:

The principal and interest on these bonds or notes, except state guaranteed bonds, is payable from corporation funds, excluding funds in the housing development fund. (emphasis added);

and AS 18.56.170 which provides:

Obligations issued under the provisions of this chapter other than state guaranteed obligations do not constitute a debt, liability or obligation of the state or of any political subdivision of the state or a pledge of the faith and credit of the state or of a political subdivision but are payable solely from the revenue or assets of the corporation. (Emphasis added.)

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It would seem that the provisions of AS 18.56.170 and 18.56.110(b) are provisions of liability limitation in the sense that they seek to limit the recourse of bondholders to AHFC funds, revenues, or assets as opposed to limiting the power of AHFC to issue limited purpose obligations which appears to be generally granted in the statute.

As a practical matter, we would recommend specific enabling legislation as to limited purpose obligations to remove any doubt as to the authority to issue such bonds and enhance the marketability of such bonds.

It appears that revenue bond funds are not subject to expropriation and are therefore an exception to the constitutional prohibition against dedicated funds.

3. Are there any legal constraints to establishing a new agency to implement only the original legislative intent programs of AHFC?

Focusing only on the transfer of "original legislative intent programs" presently administered by AHFC to a new agency, we find no constitutional impediments under either the United States or the Alaska Constitutions. By appropriate legislative enactment a new state agency could be created and the implementation and administration of the "original legislative intent programs" could be transferred to such agency. AHFC, being a state agency (see discussion under I.1 above), could not itself create such a new state agency and transfer to it the "original legislative intent programs". While a private corporation might create a subsidiary corporation and spin-off a division or branch into such a new corporate entity, such action is not within the power or authority of AHFC because while it is a public corporation it remains a state agency.

It would also seem that the governor would have the power by executive order to create a new state agency to implement the "original legislative intent programs" of AHFC. However, because AHFC was originally charged with the implementation and administration of such programs by legislative enactment, such changes would "require the force of law" and pursuant to article III, section 23, of the Alaska Constitution be subject to legislative approval. The case of Suber v. Alaska State Bond Committee, 414 P.2d 546 (Alaska 1966) would seem to so indicate.

The rights of bondholders must also be considered in regard to such restructuring. While legislative enactment would effect

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such restructuring, the transfer of program and assets from AHFC may be a technical breach of outstanding bond indentures. Consent of bondholders should be sought to avoid the potential of such a challenge and would seem likely obtainable in the context of an economically viable plan of restructuring.

4. Can the legislature by appropriate legislative enactment exempt AHFC from the provisions of the Executive Budget Act?

The legislature by appropriate legislative enactment may exempt AHFC from the provisions of the Executive Budget Act.

Legislative enactment has previously exempted at least one public corporation from the provisions of the Executive Budget Act (AS 37.07.10-37.07.130). The Alaska Railroad Corporation is a public corporation, an instrumentality of the state within the Department of Development. It is stated to have a legal existence independent and separate from the state (AS 42.40.010). In AS 42.40.920 the legislature has specifically exempted the Alaska Railroad Corporation from the provisions of the Executive Budget Act.

The legislature appears to have indicated past legislative intent that it could include or exempt AHFC from the application of the Executive Budget Act. The Executive Budget Act was enacted in 1970 (Ch. 188, § 4, SLA 1970). However, it was not until 1980 that the legislature enacted AS 18.56.089 specifically making the operating budget of AHFC subject to the Executive Budget Act for fiscal years beginning after June 30, 1981 (Ch. 106, § 20, SLA 1980).

5. (a) Can the legislature by appropriate legislative enactment terminate the AHFC taxable bond program?

The legislature may by appropriate legislative enactment terminate the AHFC taxable bond program. This program is generally established under AS 18.56.098(a). While AHFC has the authority to adopt regulations implementing the taxable bond program, it cannot unilaterally terminate the program without appropriate legislative enactment.

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5. (b) Can the legislature by appropriate legislative enactment terminate the AHFC tax-exempt bond program?

The legislature may by appropriate legislative enactment terminate the tax-exempt bond program. The AHFC tax-exempt bond program is likewise referenced in AS 18.56.098 and it would likewise seem that AHFC is without the power to unilaterally terminate the program without appropriate legislative enactment.

5. (c) Can the legislature by appropriate legislative enactment terminate the tax-exempt veterans mortgage bond program?

The legislature may by appropriate legislative enactment terminate the tax-exempt veterans mortgage bond program.

We note that in 1982 article IX, section 8, of the Alaska Constitution was amended to permit the issuance of state debt (general obligations) authorized by law for housing loans for veterans. However, state statutes authorize and create the tax-exempt veterans mortgage bonds program (AS 18.56.098(g) and AS 18.56.101). Accordingly, the legislature by appropriate legislative enactment may terminate the tax-exempt veterans mortgage bond program. Since the program is referenced in the state statutes, it would seem AHFC unilaterally is without the power to terminate the program without appropriate legislative enactment.

6. Can specific AHFC programs be removed from AHFC and incorporated into a new entity?

Specific AHFC programs may be removed from AHFC and incorporated into a new entity by appropriate legislative enactment or executive order (see discussion under I.3. above). The governor is without power to transfer programs to a private entity and while the legislature may do so by proper legislative enactment, it must be for a valid public purpose (see discussion under IV. below).

Again, the rights of bondholders must be considered as to any such restructuring. (See discussion under I.3. above.)

It is relevant to note that in 1981 amendments changed CFAB's organic act. Ch. 109, §§ 2 and 3, SLA 1981. The legislature deleted from former AS 44.81.010(a) the language which stated:

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The bank is a public corporation and government instrumentality in the Department of Commerce and Economic Development, but also has a legal existence independent of and separate from the state.

Also deleted by the 1981 amendments was the language that the exercise by the bank of its powers is considered "an essential governmental function of the state." The 1981 amendments also stated that CFAB employees were not state employees and that CFAB directors were not to be reimbursed as though they were members of state boards. CFAB is owned by its members. The state owns non-voting stock which CFAB is obligated to repurchase. AS 44.81.010, 44.81.220. Thus, although CFAB was created by the state, it will ultimately be privately owned. However, the exercise by the bank of the powers conferred to it continue to be considered to be for a public purpose.

7. What legal constraints are there to modifying the public corporation status of AHFC so that it functions like a private corporation, but still is a state organization?

Generally, the state may not transfer the assets of AHFC other than for a valid public purpose.

It would seem that, subject to the rights of bondholders (see discussion under I.3. above), by proper legislative enactment a private corporation could be created and all of the stock of the private corporation held by the State of Alaska as the sole shareholder of the corporation. The assets of AHFC could then be transferred to the private corporation. This would seem to be a change in form rather than substance in that the new so-called "private" corporation would, in effect, still be a public corporation and state agency because it would continue to serve a public purpose, the directors of the corporation would continue to be appointed by the State of Alaska, an annual report would be due the State of Alaska as the sole shareholder of the corporation, and substantial assets of the corporation would seem to remain dedicated to the purposes for which AHFC was established and those assets would serve as collateral for outstanding bonds.

Any transfer of outstanding shares to a third party would have to be for a valid public purpose and the modification itself seemingly would have to also be for a valid public purpose. (See discussion under IV.1. below.)

AHFC presently has no responsibility to operate on a self-sustaining basis or to yield a profit. It would appear somewhat

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inconsistent with the purposes for which AHFC was organized and with the loan subsidy program. It would seem however, that the legislature could by proper legislative enactment, simply provide for an interest rate subsidy without unjust discrimination and otherwise require that AHFC seek to operate on a self-sustaining and profit-making basis.

II. TRANSFER OF ASSETS

1. Can the state legally expropriate funds from AHFC?

AHFC is a state agency (see discussion under I. 1. above) and is subject to the Executive Budget Act (AS 37.07.010-37.07.130). As such AHFC is subject to expropriation of its funds.

We have considered whether the holdings in DeArmond and Walker, supra, compel a conclusion that the state is without power to expropriate monies from the AHFC revolving loan fund (AS 18.56.82). We conclude that such cases do not so hold. In DeArmond, at 722, the court implicitly held that funds generated from the sale of bonds by the Alaska State Development Corporation (ASDC) were not public funds in the limited context of considering whether the issuance of bonds by ASDC constituted either a transfer of public funds in violation of article IX, section 6, of the Alaska Constitution or the use of public credit for other than a public purpose likewise in violation of such constitutional provision. The court held that the issuance of the bonds did not constitute the transfer of public funds stating that "it is clear enough that its (ASDC's) objective must be accomplished without the use of public funds and state credit." No statement is made by the court as to whether the proceeds of the ASDC bonds were either funds of the State of Alaska or were subject to expropriation. In DeArmond the court did not so state, but apparently was also considering article IX, section 8, of the Alaska Constitution. That is, whether the bonds of ASDC constituted debts of the state within the scope of such provision.

In Walker, the court again considered whether bonds issued by the Alaska State Mortgage Association were debts of the state within the scope of article IX, section 8, of the Alaska Constitution. The Walker court referred to DeArmond as concluding that funds realized through the sale of ASDC bonds did not constitute debts of the state and that the proceeds of the bonds were not public funds. Again, there is no ruling whether the funds were funds of the State of Alaska or whether the funds were subject to appropriation by the State of Alaska.

While the earlier cases of National Bridges v. Alaska Housing Authority, 375 P.2d 696 (Alaska 1962), Aircraft Leasing, Walker,

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DeArmond, and Dixon, supra, were arguably not completely definitive as to the status of AHFC as a state agency, (which arguably, but not necessarily might suggest that the funds of AHFC were or were not subject to expropriation), the recent CFAB case when compared to the earlier referenced rulings, seems to clearly indicate AHFC is a state agency. Such status serves to further support the conclusion that the funds of AHFC are subject to expropriation by the State of Alaska.

AHFC has entered into covenants to replace from its general funds any deficiencies in pledged mortgage loan funds, that is to draw from the revolving loan fund to maintain collateral at a given level to secure outstanding bonds. However, such covenants on the part of AHFC cannot impede or frustrate the power of the legislature and governor to appropriate such funds even though the appropriation of such funds may result in a technical violation of the covenants by AHFC if it is not otherwise able to maintain such levels of collateral.

Such conclusion is required by article IX, section 8, of the Alaska Constitution as well as other provisions of the Alaska Constitution.

The power to appropriate is vested in the governor and the legislature under article IX, section 12, of the Alaska Constitution. Section 13 of article IX would be violated if the provisions of AHFC covenants as to the potential use of the revolving loan fund are held to be paramount over the power of the governor and the legislature to appropriate. Section 13 provides that no obligation for the payment of money shall be incurred except as authorized by law.

Article IX, section 7, of the Alaska Constitution should also be considered in determining whether the legislature has the power to expropriate from the AHFC revolving loan fund. To hold that the legislature did not have such power and that the bond covenants of AHFC are paramount would in effect permit AHFC to dedicate funds in violation of such section to at least the extent that the source of the funds could be initially traced to state appropriations.

MK Engineering Co. v. Alaska Power Authority, 662 F.Supp. 303 (D. Alaska 1986), would also suggest the revolving loan fund was subject to expropriation by the state and that a contrary result would violate article IX, section 7, of the Alaska Constitution.

While our view is as set forth above, it is simply our view as legal technicians. We would recommend that appropriate consideration be given to the foreseeable impact or reaction in the

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market place to any expropriation of the AHFC funds and that in connection with any such expropriation, consideration also be given to adopting specific enabling legislation which might provide appropriate assurances to bondholders and protect the future marketability of AHFC obligations.

2. Does AHFC have any legal responsibility to provide a return on capital to the state?

AHFC has no legal responsibility to provide a return on capital to the State of Alaska. AHFC is charged with the public purpose of assisting in the provision of housing in certain areas and circumstances and is not required to operate on a self-sustaining basis. AHFC may not waste its assets, but must apply them to the purposes for which it was created.

3. Can the legislature direct AHFC to purchase specific assets?

The legislature may direct AHFC to purchase specific assets so long as there is a valid public purpose served by the purchase of such assets.

4. (a) Will an extraction of any, but not substantially all, unrestricted or unpledged assets from AHFC by the state give rise to a valid claim by bondholders against the state?

Bondholders would not have a valid claim against the state by virtue of an extraction by the state in the exercise of its powers of appropriation of any unrestricted assets from AHFC.

It is our understanding the only state guaranteed bonds which have been issued by AHFC are qualified veterans mortgage bonds which were authorized by constitutional amendment in 1982. With that exception, the bonds issued by AHFC are payable solely from the revenue or assets of AHFC and neither the faith and credit nor the taxing power of the state is pledged to the payment of such bonds (AS 18.56.170).

Some of the indenture covenants and related documents of obligation and security may well require AHFC to maintain given levels of certain unpledged assets. Accordingly, while bondholders may have a valid claim against AHFC due to such extraction, depending upon the specific language of the various trust indenture

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covenants, bondholders would not have a claim for such breach of covenant against the state.

4. (b) Will an extraction of any, but not substantially all, restricted or pledged assets from AHFC by the state give rise to a valid claim by bondholders against the state?

Bondholders would not have a valid claim against the State of Alaska by virtue of the extraction of a pledged asset from AHFC by the State of Alaska.

The analysis under II.4.(a) above applies. The state has the power to appropriate the funds and assets of AHFC despite the fact that the assets may have been specifically pledged by AHFC. The extraction of a pledged asset by the state from AHFC would give rise to a valid claim against AHFC by bondholders to whom the asset had been pledged. It would seem, however, that this claim can be satisfied only to the extent of the unrestricted assets of AHFC and does not constitute a valid claim against the state. This is not to suggest that such an extraction would necessarily be a prudent endeavor or without significant negative impact on the future sale of bonds by the state, its political subdivisions or AHFC.

4. (c) Will an extraction of substantially all the assets from AHFC by the state give rise to a valid claim by bondholders against the state?

The extraction of all or substantially all the pledged and unpledged assets of AHFC away from AHFC by the State of Alaska would give rise to substantial claims by bondholders against the State of Alaska which would likely be upheld.

The AHFC bonding statute specifically provides that the credit of the state is not pledged as to AHFC bonds except as to state guaranteed bonds which presently would only include the VA bonds described above (AS 18.56.170). However, the financial statements of AHFC indicate that a substantial portion of its assets have been pledged as collateral for issuance of outstanding bonds. Further, stringent covenants have been undertaken by AHFC as to the maintenance of certain asset levels. It would likely be held that there have been at least implicit, if not express, continuing promises, representations, covenants, contracts, and undertakings by the State of Alaska that the bulk of the assets of AHFC would remain available for recourse by bondholders and that bondholders have relied on same to their detriment. Thus, in the context of an extraction of all or substantially all of the assets of AHFC by the State of Alaska, it would seem that bondholders

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would prevail in their claims against the state at least to the extent of the assets extracted.

5. Are there any legal grounds for AHFC to compel the state to appropriate or transfer funds to AHFC?

There are no legal grounds for AHFC to compel the state to appropriate or transfer funds to AHFC. AHFC is a state agency (see discussion under I.1. above). It is not a branch of government such as the judiciary which might in appropriate circumstances compel the appropriation to it of funds.

6. If AHFC, pursuant to legislative enactment, purchases loans from the HAD program, is the application of payments of principal and interest received on such loans restricted to making future HAD loans?

AHFC could not unilaterally apply payment of principal and interest on Housing Assistance Loan Fund (HAD) loans to other than the purposes set forth in AS 18.56.210(10). Such purposes are to make further HAD loans in accordance with HAD loan criteria as they existed on June 10, 1988.

The legislature and governor could appropriate such payments of principal and income to other purposes. Further legislative enactment could remove the restriction on AHFC to make such applications of payments of principal and interest on HAD loans.

III. SUBSIDY

1. If the interest reduction subsidy is legislatively eliminated as of June 30, 1990, can the proceeds of bonds sold prior to this date be used to finance loans under the new legislation?

The proceeds of bonds issued prior to June 30, 1990 may by appropriate legislative enactment be directed to be applied to finance loans under the new legislation. Such application, however, may be a technical breach of outstanding bond indentures. Consent of bondholders should be sought to avoid such a challenge and would seem likely obtainable as the elimination of the subsidy would appear to further enhance the economic viability of AHFC and the bond programs involved.

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2. Can AHFC change the eligibility requirements for loans made from bond proceeds, if the bonds are already sold?

Whether AHFC can subsequently change the eligibility requirements for loans made from bond proceeds would depend on the bond covenants set forth within each particular indenture. Changing an eligibility requirement subsequent to the sale of a particular issue of bonds may be a technical breach of the particular bond indenture. Consent of bondholders should be sought and again would seem likely obtainable if the eligibility requirements were made more financially stringent.

3. Are there legal constraints to discontinuing or diminishing the interest rate subsidy by appropriate legislative enactment?

It is unlikely any successful constitutional challenge could be made to legislation prospectively discontinuing or diminishing the interest rate subsidy on new loans. Such legislation could possibly result in a constitutional challenge being brought on the basis that such legislation violated either the equal protection or due process clauses of the United States and Alaska Constitutions.

Equal Protection.

The guarantee of equality of treatment prohibits legislation which denies to one group of persons the enjoyment of certain rights which are afforded to another group, if when considering the purpose of the legislation, there is no reasonable basis for the disparity. Leege v. Martin, 379 P.2d 447, 452 (Alaska 1963).

It does not appear that changing the interest rate subsidy would result in any classification of persons into separate groups.

Equal protection claims under the Alaska Constitution are measured by a different test than equal protection claims under the United States Constitution. State v. Erickson, 574 P.2d 1 (Alaska 1978). In the course of our research we have examined possible equal protection claims under both the United States and Alaska Constitutions. However, as it is our view that discontinuing or diminishing the interest rate subsidy will not result in a classification of persons, we are not in this opinion providing further analysis of equal protection rulings.

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Due Process.

Procedural due process (notice and an opportunity to be heard) may be due to individuals who have loan applications pending with AHFC at the time of the effective date of any legislation discontinuing or diminishing the interest rate subsidy. This issue can be avoided by making the new legislation applicable only to loan applications received after a given date.

Assuming the issue is not avoided, in order for procedural due process protection to apply, there must be state action and the deprivation of an individual interest of sufficient importance to warrant constitutional protection. Nichols v. Eckert, 504 P.2d 1359, 1362 (Alaska 1973). It is highly questionable whether the interest of one who has a loan application pending is sufficient to require procedural due process.

A property interest invokes due process safeguards whereas a "mere expectancy" has been held not entitled to due process protection. Estate of Miner v. Commercial Fisheries Entry Commission, 635 P.2d 827, 829-30 (Alaska 1981).

In Estate of Miner, the Alaska Supreme Court determined the applicant's interest under the scheme of the Limited Entry Act (AS 16.43.010-16.43.990) represented a property interest entitled to due process protection. In so holding the court clearly stated that not every application for a state benefit represents a property interest entitled to due process protection. Id. at 831.

In State, Department of Natural Resources v. Universal Education Society, 583 P.2d 806, 809 (Alaska 1978), the Alaska Supreme Court determined that an application for a mining lease was not a property interest entitled to due process safeguards.

Seemingly, a loan application would be more accurately characterized as a "mere expectancy" as opposed to a vested property right and a loan applicant would not therefore be entitled to due process safeguards with respect to a loan application.

Procedural due process requires notice and an opportunity to be heard. Notice must be reasonably calculated under all circumstances to apprise the individual of the pendency of the deprivation and to afford an opportunity to present objections. Aguchak v. Montgomery Ward Co., 520 P.2d 1352, 1356 (Alaska 1974).

In determining what procedural due process, if any, should be afforded concerning change in the interest rate subsidy, considerations should include legislative notice and hearings as

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to the legislation changing the subsidy, whether, and to what extent, AHFC has in the past undertaken to inform the public of the statute and its requirements and past changes in interest rate subsidies.

4. What legally needs to be done to implement a change in the interest rate subsidy?

The interest rate subsidy change would need to be implemented by appropriate enactment by the legislature.

5. Is AHFC an unlawful monopoly in restraint of trade because of its market position?

AHFC is an agency of the State of Alaska. (See discussion under I.1.) Accordingly, its acts and conduct must be viewed as acts of the State of Alaska. The Sherman Antitrust Act was not intended to restrain a state or its officers from activities directed by the state legislature. See Parker v. Brown, 317 U.S. 341, 63 S.Ct. 307, 87 L.Ed 315 (1943). The acts of AHFC in purchasing home mortgages and in assisting in the provision of housing for residents of the State of Alaska is an act of government and accordingly the market position resulting from such acts is not an unlawful monopoly in restraint of trade.

IV. CHANGE OF OWNERSHIP

1. Are there any legal constraints to:

- (a) AHFC issuing and selling common stock in AHFC, thereby transferring 100% of ownership and control of AHFC to a private party?
- (b) AHFC selling all assets?
- (c) AHFC selling its REO disposition operation to a private party?

If there is no valid public purpose served in selling AHFC in its entirety or selling all of the assets of AHFC, then such transfer could be subject to constitutional challenge on the basis that it violates the Alaska constitutional prohibition against transferring public property.

A constitutional challenge might be brought against legislation transferring AHFC to the private sector through either

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a direct transfer of assets or through a spinoff of AHFC to a third party as a private corporation. Such action arguably constitutes a transfer of public property in violation of article IX, section 6, of the Alaska Constitution. This provision of the Alaska Constitution prohibits transferring public property except for a public purpose.

The Alaska Supreme Court has stated that the term "public purpose" is a concept which will change as changing conditions create changing public needs. DeArmond v. Alaska State Development Corporation, 376 P.2d 717, 721 (Alaska 1962). Whether a public purpose is being served must be decided in the light of the particular facts and circumstances of each case. Id. Most courts look to the entire factual and governmental context to determine whether a plan of action serves a public purpose. The Alaska Supreme Court generally defers to the legislature's judgment as to what constitutes a public purpose. Comtec, Inc. v. Municipality of Anchorage, 710 P.2d 1004, 1005 (Alaska 1985). The Alaska Supreme Court has stated it is not likely to strike down a plan because it does not serve a public purpose unless the plan is plainly foolhardy, or if it amounted to the pledging of credit or the giving away of assets without any corresponding discernible benefit. Wright v. City of Palmer, 468 P.2d 326, 331 (Alaska 1970). In Lien v. City of Ketchikan, 383 P.2d 721 (Alaska 1963), the Alaska Supreme Court determined that the purpose of a hospital did not become non-public simply because the city leased it to a private organization. The court found that the use of the public hospital would not be changed by the lease and the public purpose would therefore continue to be served.

In the present situation, there is arguably a public purpose served in selling any AHFC assets which are causing either a negative cash flow to AHFC and/or an undue financial burden on AHFC. It would seem a public purpose may be served in selling the REO disposition operation in order to allow AHFC to eliminate the financial burden of holding and maintaining the REOs.

Under outstanding bond indentures the REOs will be found to be collateral for outstanding bonds. Accordingly, consent of bondholders should be sought as to AHFC selling the REO disposition.

A sale of the REO disposition operation might be structured in terms of either substitution of collateral for outstanding bonds or transfer of REOs to a third party for administration and servicing with the collateral rights of the bondholders in the REOs continuing. In either of such forms the transfer may further

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enhance the economic viability of AHFC thus suggesting the consent of bondholders may be obtainable.

If, however, a sale of the REO disposition together with a change in the interest subsidy allowed AHFC to operate profitably, then a sale of AHFC to the private sector could be considered to be in violation of article IX, section 6, on the basis that there is no valid public purpose served in selling a profitable public asset.

Affordable housing being available to lower income citizens of the state is a legislative objective of AHFC. There is a question of whether this public purpose of AHFC would continue to be served if AHFC was privately owned. Relief and support of the poor has been recognized as an obligation and a public purpose of the government. Suber, supra, at 552. Seemingly there would be no obligation by a private entity to maintain such a public purpose unless terms and conditions of a transfer were imposed which required the private owner to continue the public purpose objectives of AHFC. Such terms and conditions would seem to significantly impact the value of the assets thus transferred from AHFC.

1. Are there any legal constraints to:

- (d) AHFC selling loans within a bond program, i.e., where loans have been pledged as collateral, or
- (e) AHFC selling a loan not used as collateral for a specific loan program?

A sample review of outstanding bond indentures indicates loans within a bond program have been pledged as collateral for payment of the outstanding bonds. Accordingly, such loans may not be sold without a violation of the indenture covenants. To avoid a breach of the covenants the consent of the bondholders for which the loan is collateral should be obtained.

The state has the power to sell such a loan, subject to constitutional issues as to the public purpose (see discussion under IV.1.(a), (b) and (c) above) but the sale may constitute a breach of the related indenture covenants.

If a loan has not been used as collateral, the legal constraints as to its sale are the issues of the transfer of public property only for a public purpose (see discussion under IV.1.(a), (b) and (c) above) and the possible violation of indenture

**STATE OF ALASKA
LEGISLATURE**

**HOUSING FINANCE
TASK FORCE**

**Response to Ernst &
Young Report:
Evaluation of Policy Options
Concerning the Future of the
Alaska Housing Finance
Corporation**

February 1, 1990

**ALASKA HOUSING
FINANCE CORPORATION**



520 East 34th St.
Anchorage, AK 99503
(907) 561-1900

P.O. Box 101020
Anchorage, AK 99510

February 1, 1990

Representative C. E. Swackhammer
Chair, Housing Finance Task Force
Room 521, Capitol
P.O. Box V
Juneau, Alaska 99811

Dear Representative Swackhammer:

The Alaska Housing Finance Corporation respectfully submits to you our Response to Ernst & Young's Draft Final Report which analyzes AHFC's programs and future role.

Overall, we are impressed with the report. Ernst & Young did an excellent job of distilling historical information regarding AHFC and its programs with current housing economics to come up with credible options for AHFC's future role. The quality of their product is particularly pleasing given their diligent adherence to the original timing schedule.

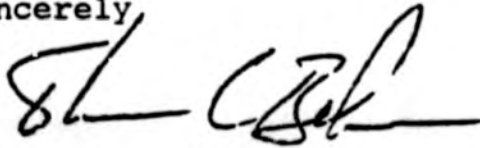
Of particular appreciation was Ernst & Young's observations that certain operational restrictions imposed on AHFC need to be removed or relaxed if the Corporation's existing resources are to be effectively managed. These limitations were put in place during periods when substantial legislative appropriations and program mandates were bestowed on AHFC. They are now unnecessary and serve to prevent the Corporation from mitigating its losses, implementing programs, and taking advantage of revenue enhancement opportunities.

In the course of our review we noted certain minor inaccuracies which should be corrected in the final report. The most obvious of these concern the recommendations for establishment of investment policies and internal audit functions. These suggestions had appeared in previous operational reviews and were implemented last year.

Representative Swackhammer
February 1, 1990
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We look forward to continuing the process of developing a direction for AHFC's future role and are available at your convenience to discuss our accompanying comments.

Sincerely,

A handwritten signature in dark ink, appearing to read 'T. Behan', written over a horizontal line.

Thomas C. Behan
Chief Executive Officer/
Executive Director

cc: Dr. James A. Gibson, Project Director
Ernst & Young
Housing Task Force Members
Legislators
AHFC Board Members

Alaska Housing Finance Corporation

Response to Ernst & Young
Draft Final Report

AHFC's Financial Position and Availability of Funds

Page ES-2 and ES-3

The Report states that "extraction of Corporation assets, in any form, may have a serious impact on Corporate financial health". The Report continues that "if funds were withdrawn, the State could conceivably run the risk of being held responsible for any resultant future losses in the bond programs". Based upon the financial analysis performed by Ernst & Young "after deducting from the \$519 million equity balance those assets considered non-liquid, and adjusting for current borrowing arrangements, we estimated AHFC had only \$10 million in unrestricted net liquid assets as of June 30, 1989. Virtually all of AHFC's \$519 million equity balance is thus restricted".

E&Y further comments that "currently, the Corporation is experiencing liquidity problems as reflected in the most recent year's net loss of income".

The Corporation concurs that its ability to continue to access capital markets for continuation of its various programs could be seriously jeopardized were any of its assets removed. We also believe that insensitivity to the separate legal status of AHFC in the handling of its assets could expose the State to the risk that, in the unlikely event that AHFC were to default on its debt, the State could be held liable for the deficiency.

AHFC financial staff has initiated a detailed analysis of projected activity. This update will assist in determining the reasonableness of the results obtained by Ernst & Young. Initial reviews of the E&Y report raised concerns that the forecasting model developed was too simplistic. Mortgage loan demand, prevailing interest rates as they apply both to the assets of the Corporation and debt that it issues, capital needs for loan subsidization and credit enhancement, and federal laws dealing with the ability to issue tax-exempt debt are difficult to project on their own. An accurate forecasting model, however, must take into consideration the dynamics of each of these major assumptions and the possible effects on the various other components.

The Corporation is not experiencing liquidity problems. The loss posted last year of \$124 million was attributable to adjustments to the carrying values of REO's and increases in the reserve for potential loan losses on its existing portfolio of mortgage loans. The report comment is misleading and just not true.

Policy Option to Change AHFC Subsidy

Pages ES-3 through ES-5

The Report comments that the "subsidy program is presently not desirable because it presents a major drain on increasingly scarce AHFC assets and it prevents the re-entry of outside capital into the Alaska market". The report further states that "a unique window of opportunity exists now to eliminate the subsidy because AHFC's cost of funds is generally below the ten percent threshold rates (although

some slight subsidy is in effect for the taxable program), demand for mortgages is low as compared to the last couple of years, the price of housing appears to be at or near the bottom, and market interest rates are expected to remain stable in the short-term." Recognizing that the window may not always be open, E&Y recommends that, as a "backstop", consideration be given to a more gradual reduction in the subsidy.

The Report states that "only in a worst case scenario (interest rates increasing during the transition period) would any negative effects likely occur" to the housing market from adjustments to the subsidized interest rates. The Report warns that with only \$10 million in available unrestricted net liquid assets, the Corporation cannot continue its subsidized taxable program without causing a default under financing agreements and jeopardizing AHFC's short-term borrowing arrangements for working capital. Eliminating the subsidy will have a net effect over a five period of from \$43 to \$91 million, according to the report.

The Corporation agrees that reductions in the amount of borrower assistance provided through subsidized interest rates is necessary to protect AHFC's future viability. We also agree that interest rates and housing values are at levels which minimize the impact of withdrawing subsidy benefits. Several considerations, however, require a cautious approach to changes in this area.

AHFC is the largest holder of institutionally owned residential real estate in Alaska. In Anchorage, the Corporation maintains from one-half to two-thirds of the available inventory of units at any given point in time.

After considering expected sales prices and holding costs for both its existing inventory and anticipated additions, the Corporation posted a loss for its last fiscal year in excess of \$124 million. Changes which could affect the marketing periods or ultimate sales prices of these units must be approached with care. Cut-backs in or phase outs of existing AHFC programs can affect market psychology. While a detailed economic review of the proposed changes may indicate that there should not be any effect on the value of the existing housing stock, if the public views the change as introducing a risk in the buying decision which had previously not existed, the result could be fewer buyers.

Additionally, care must be taken for any changes not to be perceived by other secondary mortgage market participants as a response to perceived additional risk in originating new loan product. With private mortgage insurance (PMI) currently being written by only one mortgage insuror, were the wrong signals received, the conventional mortgage market could disappear entirely.

It is difficult from the Report to analyze the projected savings attributable to eliminating the subsidy. Several different numbers appear throughout the report, and sufficient detail is lacking to determine the actual changes which were made to the forecasting model. Rather than verifying the assumptions and calculations intrinsic to the report, as mentioned above, AHFC will be preparing a separate financial analysis detailing expected activity and resultant net liquid asset balances.

Policy Option to Return AHFC to Original Legislative Intent
Pages ES-6 and ES-7

The Report projects an increase in AHFC's net unrestricted assets over the next five years as a result of eliminating the taxable program of \$45 million. A phase-out should be done "over an extended period of time". The E&Y Report suggests that a careful phase-out "will avoid market disruption because if any disruption does become evident, mechanisms will then be in place to slow the phase-out and stabilize the situation". The Report recommends the taxable program be eliminated because it "competes directly with private sector sources of financing" and that "in the absence of the subsidy, adds no unique value... over and above the private sector". E&Y does, however, recommend that the program remain intact and "accessible to AHFC, but only on an "as needed" basis".

Removal of the subsidy mechanism from the taxable program will likely result in the elimination of the program. It is difficult for AHFC to compete with other secondary mortgage market sources for quality loans. The national mortgage markets are large with economies of scale such that from an interest rate standpoint, were the subsidy eliminated, AHFC would no longer issue bonds to fund the taxable program.

Policy Option to Change Ownership of AHFC
Page ES-7

The E&Y Report concludes that the sale of AHFC assets to a third party in an effort to "privatize the Corporation" was not feasible. Their stated reasons were that (i) there is little or no interest in the purchase, (ii) the price paid

could be far below the State's investment in AHFC, and (iii) legal problems may exist with respect to the State constitution and various bond covenants. The Report recommends that consideration be given to "contracting out the REO disposition process" as a potential cost-savings option. Flexibility in procurement practices and adjustments to the level of staffing were cited as primary benefits to shifting these responsibilities to a private sector entity.

Currently the foreclosed properties are owned by AHFC. In most cases, the units are still pledged to outstanding bond issues. AHFC attempted to leave the responsibility for protecting these assets with those it had contractual relationships with. Unfortunately, as circumstances changed, most of these private sector institutions ceased providing the level of services necessary to protect the Corporation's properties and rights under various mortgage loan insurance and guaranty agreements. The ultimate responsibility for the care and sale of foreclosed properties lies with AHFC. The responsibility cannot be contracted out.

Under the current procurement and contracting systems, the Corporation incurs substantial risk by moving responsibilities to third parties. The primary reason for this is the lack of direct control which exists when the process does not permit timely corrective action to be taken when circumstances warrant. AHFC's experience with expansion of its property marketing efforts is an excellent example of this. Over two years ago, the need to increase the number of brokers managing and marketing AHFC properties was identified. A determination was made that changes to

existing relationships and additions of new property brokers would need to follow the procedures specified in the procurement code. It is only now that we are finally at the stage of reviewing proposals and making awards in certain areas of the state. With a little luck and a lot of work, we should be able to increase the number of brokers to the levels warranted within the next two months.

While we may be able to be contracted out some of the work, AHFC would still have to monitor the status of the properties and provide guidance to the contractor. As a result, shifting functions to an outside contractor would add another level of bureaucracy into the maze of entities which must review and approve property improvement requests and sales offers. Between AHFC's cost of monitoring and administering the contracts and the profit required by the contractor (absent in AHFC's direct administration) it is unlikely there would be savings potential. It is almost certain, however, to increase the loss exposure of the Corporation, regardless of how carefully the system may be structured.

Conceptualization of an Idealized AHFC

Page ES-8

The E&Y report recommends consideration be given to "a new formal mandate for AHFC in order to redefine its role in the years ahead". This new mandate would focus AHFC on the role of assisting low- and moderate-income borrowers primarily through the use of tax-exempt revenue bonds. Additionally, AHFC would be made more independent to promote efficiency of operations and market responsiveness.

The Corporation believes minimal changes would be necessary to achieve the benefits outlined by E&Y in their discussion of the "Ideal AHFC". As mentioned already, a significant reduction in the amount of subsidy assistance provided will likely remove taxable loans from the menu available to potential borrowers. Modest Statute changes related to the procurement code and Executive Budget Act would enhance AHFC's efforts to once again become profitable. In a profit-making mode, a system of partial dedication of income becomes a real possibility. Expansion of the AHFC Board of Directors to include more private sector participation could enhance oversight which is focused more on revenue enhancement and cost minimization.

The recommendation that the Corporation focus on meeting low-to-moderate income borrower residential needs through the use of tax-exempt mortgage revenue bonds must be considered with the understanding that AHFC's ability to support this type of program is severely limited by federal tax laws. The eligibility criteria for the "First Time Homebuyer" program have, over the last several years, been significantly tightened by Congress. Under current legislation, this program dies entirely on September 30, 1990 unless a further extension is granted. As well, with respect to the tax-exempt financed Veteran's Program, the criteria for eligible veterans results in the available pool of veterans automatically declining each year.

OPERATIONAL CONCERNS

Management and Personnel Recommendations

A.1. Evaluate the Size and Composition of the AHFC Board of Directors. E&Y recommends in the Report that the Board size and composition be reviewed for effectiveness.

The Corporation agrees that consideration should be given to the degree to which the existing Board structure facilitates providing direction and guidance to the AHFC staff. A structure and composition more traditional to a private sector company may be appropriate, with members able to provide more timely consideration of, and become more directly involved in, the strategic planning process and major policy issues affecting the Corporation.

A.2. Conduct a Staffing and Organizational Effectiveness Review. The Report notes that AHFC staff has experienced significant growth in recent years. A study of (1) current and future personnel requirements, (2) salaries as compared to private industry, (3) sufficiency of staffing levels, (4) management structure and (5) effectiveness in fulfilling various components of its legislative mandate is suggested as possibly facilitating orderly development of qualified staff and assisting in evaluating AHFC's performance. Additionally, a program to recruit and retain qualified personnel is suggested for implementation.

The growth in staff and scope of activities undertaken has presented AHFC with many challenges. The need for yet another staffing study is questionable. Rather, more confidence must be given in the AHFC Board and senior

management's abilities to establish goals and monitor performance. The focus should first be on determining the validity of AHFC's mission. This must be embodied in the Corporation's enabling legislation and clearly identifiable. The Corporation itself should then be given the opportunity to pursue the stated mission and provide the reporting mechanisms necessary to evaluate its effectiveness.

A.3. Obtain Authorization and Fill Legal Counsel Position at AHFC. The E&Y Report notes that AHFC's legal affairs are currently handled by the Attorney General's Office. Substantial changes in assigned personnel and significant delays in responses to AHFC requests are cited as indications that the legal needs of AHFC are not being met.

The enhanced control over legal services provided by establishment of a legal counsel position within AHFC would facilitate timely consideration of legal issues. Delays in responses to requests for legal review can result in lost opportunities to reduce costs, implement new programs, or enhance revenues. Statutory changes permitting the Corporation to obtain legal counsel from, and be represented in litigation by, in-house legal staff and/or private sector firms would have a positive affect on the timeliness of legal services.

Changes to the Corporation's enabling legislation removing the AG from designation as AHFC's legal counsel, however, should be made only if adequate budgetary and operational flexibility exists to make staffing adjustments or contract for additional professional services. The AG's office, under the State Procurement Code, maintains substantial discretion

in the procurement of professional services. This same degree of latitude would need to exist within AHFC to assure that adequate resources could be obtained.

A.4. Obtain Authorization to Fill Internal Auditor Position at AHFC. The Corporation hired Pat Salvucci as Internal Auditor on October 30, 1989.

Internal Improvement Recommendations

B.1. Establish a Formal Financial Forecasting System. The Report indicates a need for AHFC to enhance its forecasting techniques to determine working capital and short-term financing needs and to evaluate results of specific loan programs.

The financial management area of AHFC has experienced the same growth phenomenon as other areas of the organization. Existing staff is still operating on many of the "must do" operational activities. Sophisticated, detailed, computerized forecasting systems are in place at AHFC and existing staff has been trained in their use. The detailed review noted in the report is done at least annually for each of the individual bond and loan programs, as generally required under the terms of the related trust indentures.

As well, a comprehensive model for projecting changes to the various working capital and unrestricted asset components over a five year horizon exists and was discussed extensively between staff and members of the E&Y study team. Updating of the forecasting model, however, is currently

sporadic and the existence of additional opportunities in this area is acknowledged.

B.2. Evaluate Adequacy of Existing Management Information System. The E&Y report recommends "a review be conducted of the effectiveness of the existing management information systems and that an upgrading of DP systems and procedures be considered".

The Corporation concurs that its existing information systems should be reviewed. The Corporation is highly dependent upon its electronic information systems. As well, strategic opportunities abound in this area. Previous emphasis has been on keeping systems running. During the period when emphasis of information systems ("IS") departments was shifting to decision support systems, executive support systems, and artificial intelligence, AHFC was trying to accommodate the changes necessary to track REO's and insurance claims.

Recent authorization for staff increases has facilitated an assemblage of talented, competent, IS professionals capable of developing systems to accommodate the needs of management as well as handle the substantial volume of transactions necessary to be processed. Certain enhancements to the management information systems are currently in process.

Recognizing the importance of information systems and related technologies to the Corporation, a program has been initiated to broaden the involvement of both mid- and senior-level management in the process of establishing goals and objectives in this area as well as participating in the establishment of development priorities. This program has

been well received and participants have become more familiar with existing systems and potential for enhancements.

B.3. Improve Cash Management Function. The Report suggests AHFC evaluate the cash management function and implement those changes identified as beneficial.

The cash management function is performed primarily by one individual. The substantial investment activity, and resultant clerical tasks, has resulted in this position becoming mired in transactional paperwork processing. Inadequate time currently exists for this individual to provide active asset management to the degree warranted and desired. An in-house review of available staffing resources to provide administrative relief in this critical area is currently in process.

Opportunities for revenue enhancement in this area exist, have been identified as strategic to the Corporation, and are being pursued by staff. However, due to the magnitude of the dollars involved, an outside review combined with a re-allocation of staff resources may be appropriate.

B.4. Define Formal Investment Criteria. The AHFC Board has adopted formal investment policies, an investment policy committee has been formed, and investment policies put in place. These were accomplished during the 1989 calendar year.

Programmatic Recommendations

. C.1. Re-evaluate Loan Loss Reserves and Exposure to Insurance Losses. The Report suggests a review of the Corporation's loan loss reserves would be beneficial.

Each time the Corporation prepares financial statements (currently no less frequently than quarterly) a review of the adequacy of the loan loss reserves and appropriateness of the carrying values in insurance receivables is performed. The statement in the E&Y report that this review is performed only annually is incorrect.

C.2. Review REO Pricing and Disposition Policies. The E&Y report suggests the Corporation review the three components of its REO policies: pricing, marketing and financing.

It is managements intent to review these policies periodically. In fact, a review is currently in process with participation of two of the Corporation's five Board members.

. C.3. Evaluate Costs of Maintaining Bond Ratings. The Report recommends the Corporation weigh the costs of achieving excellent credit ratings with the anticipated benefits.

This analysis is performed each time the Corporation issues debt. The review process involves senior financial staff with the assistance of the bond underwriter and the

Corporation's financial advisor. Given the interest expressed, staff can formalize the analysis process.

C.4. Implement a Mortgage Insurance Program. The E&Y Report suggests AHFC evaluate the benefits of a self-insured mortgage program and implement one if deemed appropriate.

The Corporation is extremely concerned about the availability of private mortgage insurance in Alaska. On several occasions, attempts to solicit interest of mortgage insurers in writing policies in the State have been attempted. The discussions have included the possibility of risk sharing, establishing an insurance subsidiary, and even purchasing an existing PMI company.

The Corporation provided its own insurance on the Rental Mortgage Program. An insurance fund was established, policy executed, and system for premium collections created. This type of an arrangement provides some of the benefits of mortgage insurance. For the insurance to be recognized by other secondary mortgage market participants, however, the Corporation would need to establish a full-fledged mortgage subsidiary.

The mortgage subsidiary would need to be approved by FNMA and FHLMC and receive ratings from Moodys Investor Services and Standard & Poors. As well, the subsidiary would need to be established under the provisions of the Alaska insurance laws and would need to demonstrate sufficient independence from the Corporation. The establishment of an insurance subsidiary would, therefore, have significant impact on the Corporation's budget. Operation of an insurance subsidiary

subject to the existing provisions of the Executive Budget Act and procurement code would be imprudent. For the subsidiary to be soundly managed, it must be able to act timely and responsibly to circumstances as they arise.

Legislative Recommendation

D.1. Exempt AHFC from the Executive Budget Act. The Report recommends that the Legislature consider removing AHFC from the requirements of the Executive Budget Act.

Until 1980, the Corporation was not subject to the Executive Budget Act. The Corporation concurs with the Report in its statement that "exemption would allow AHFC to respond more quickly to its staffing needs, and operate more effectively as a result". Inclusion in the Executive Budget Act facilitates a "use it or lose it" , "if you're not sure, ask for it" attitude which is contrary to the direction senior management would like to see AHFC headed. Efforts to return AHFC to a profitable institution will be frustrated by continued subjection to the Executive Budget Act and valuable opportunities will be missed.

In governmental accounting terminology, AHFC is an "enterprise fund" of the State of Alaska. Designation as an enterprise fund is appropriate where the operations of the governmental entity are expected to be supported primarily by those to whom services (mortgage loans) are to be provided. In most cases, it is recognized that an enterprise must adopt a "business budget" approach as opposed to the strict dollar limit caps imposed by legislatively mandated expenditure limitations. The

business budget takes a variety of factors into consideration and is required to be approved by the governmental agency's board or commission.

Other Observations of AHFC Regarding the Report

Incorporated Legal Analysis

The Corporation shares the concerns expressed by Eric Wohlforth of Wohlforth, Argetsinger, Johnson & Brecht, AHFC's bond counsel. In his letter of January 19, 1989 to Representative C. E. Swackhammer, Mr. Wohlforth notes some of the major areas in which the opinions and conclusions reached differ from those under which the Corporation and its substantial financing transactions have been based. We are concerned that certain of the legal analysis performed was not given the analysis and consideration comensurate with the significance of the findings. We feel that, as a consequence of inadequate time for a complete review, certain of the analysis is incomplete and that resultant opinions are quite possibly erroneous.

Many of the questions posed to the firm of Delaney, Wiles, Hayes, Reitman & Brubaker, Inc. were complex financial matters which could have a substantial financial impact on AHFC. We are concerned that due consideration may not have been given to some of these critical questions. We noted, however, that many of the conclusions and opinions of the Delaney firm were ignored in the body of the report. Should Ernst & Young share our concerns regarding the correctness of the results, either the body of the report should include

a form of disclaimer or a more extensive and thorough analysis should be performed. If further analysis is to be done, the efforts should be better coordinated with the Corporation's bond counsel and the Attorney General's office.

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