General Information

MEMORANDUM

Division of Policy
Office of the Governor

TO: Mary Halloran, Director
Division of Policy

DATE: Jan. 28, 1988

FROM: R.A. Fineberg and Joan Kasson
Division of Policy

SUBJECT: Commercial Real Estate Background Report

This background paper provides an overview of data available on commercial real estate loans made by Alaska banks and the AIDEA bond program, the current commercial real estate market, information from other states and observations based on interviews conducted in the course of putting together this information.

A. Data on Commercial Real Estate Loans

1. As of Sept. 30, 1987, approximately 29% of all real estate loans held by Alaska banks and the Alaska Industrial Development & Export Authority (AIDEA) were non-performing or overdue by more than 90 days. One year earlier, this figure was 17% (see Table 1, attached).[1]

2. Since most residential loans are held by mortage holders rather than banks, almost all of these real estate loans involve commercial real estate.

3. Between Sept. 30, 1986 and Sept. 30, 1987, real estate owned by Alaska banks increased from $98 million to $165 million.[2]

4. These figures exclude participating shares and loans by "outside" lenders and thus provide a rough estimate of the

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[1] As of Sept. 30, 1987, approximately $340 million of nearly $1.2 billion in loans involving commercial real estate made by Alaska banks and the AIDEA bond program were past due by more than 90 days or classified as "non-accruing" or non-paying by banks, according to data provided by the Division of Banking, Securities and Corporations and AIDEA. (Note: These figures include real estate loans that subsequently passed into the hands of the Federal Deposit Insurance Corporation due to bank failures.)

[2] "Other real estate owned," compiled from Division of Banking, Securities and Corporations reports. This figure represents real estate that banks have taken over but have not liquidated (see note 1).

dimensions of the commercial real estate problem Alaska institutions face at this time. According to the Division of Banking, Securities and Corporations, commercial real estate is essentially uninsured.

5. These figures include a relatively small but unknown portion of residential real estate in the possession of banks, as well as construction loans secured by real estate. Additionally, it is estimated that less than one percent of the loans secured by real estate were made for business operations.[3]

6. The lending bank has not reserved or written off an unknown percentage of non-accruing loans because the borrower, in the estimation of the bank, has sufficient collateral to pay off the loan if and when required.

7. State-wide data on the breakdown of commercial real estate debt by region, type of real estate, lender and current status are not readily available.

8. AIDEA past-due debt on loans underwritten by bond sales is $48.7 million. A break-down of those loans by area and type (Table 2, attached) indicates that 69 loans averaging about $705,000 each are delinquent. Of these loans, 56 are in the Anchorage and south-central region. By dollar amount outstanding, these loans total 90% of AIDEA's delinquent debt. By dollar amount and by number of loans, over 80% of the delinquent AIDEA loans are offices, shopping centers or retail structures, warehouses or multi-family dwellings. Ten percent are restaurants and hotels or motels. Thus over 90% of AIDEA's troubled loans involve commercial real estate. Several informed observers said AIDEA's portfolio may be representative of bank commercial real estate loans.

9. Telephone interviews with loan officers or senior representatives of eight banks revealed a wide range of problems and attitudes concerning commercial real estate loans.

== One bank estimates that it has only six loans involving commercial real estate, none over $400,000.00.

== Two banks have no problems with commercial real estate.

== Two banks acknowledged problem loans in this area but apparently have adequate reserves to handle their problems.

== One bank said most of its problems were in multi-family residential and retail properties, but that it had few multi-family property loans.

== One bank acknowledged serious problems in this area.

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[3] Information from the Division of Banking, Securities and Corporations.

10. By virtue of its position as receiver or liquidator for failing banks, the Federal Deposit Insurance Corporation (FDIC) has become a major player in the Alaska commercial and residential real estate markets. The FDIC recently expressed its interest in selling its property. Its portfolio comprises 658 pieces of real estate acquired from three banks with a book value of over $30 million. More than 500 pieces are single-family housing, condominiums or lots; less than 50 pieces are commercial structures. The FDIC property list includes:

== 330 single family residence lots,
== 56 single family residence dwellings,
== 167 condominiums,
== 26 multi-family dwellings,
== 30 trailers and commercial lots, and
== 49 commercial buildings.[4]

B. The Alaska Real Estate Market

1. Compared to the early 1980's, commercial real estate rental rates and property assessments are down, while vacancy rates are up. Nevertheless, if Anchorage data are any indication (see paragraph B.3., below), the sharp decline of 1986 did not continue in 1987.

2. Reduced rental prices provide renters with an opportunity to move up to higher quality facilities. When they do so, they forsake older, less well-appointed buildings that are liable to remain empty. Due to the upgrading phenomenon, rental and vacancy problems are markedly more severe in lower-quality real estate than in relatively high-rent real estate.[5]

3. Both of these trends can be seen in Anchorage rental market surveys by Shorett and Riely., by mid to late-1987, both the decline in rental prices and the increase in vacancies had slowed markedly. The vacancy rate in lower-qualities commercial properties was still increasing rapidly, but the vacancy rate for higher-quality commercial vacancies was only slightly higher than the figure six months earlier (86% occupancy in January 1987 to 84% occupancy in July). Apartment vacancies in both the third

[4] FDIC, "Real Estate Owned as of December 24, 1987" (attachment to letter from Thomas B. Ruch, Assistant Specialist in Charge, FDIC, to Commissioner of Admninistration Tony Smith, January 14, 1988).

[5] The highest class of commercial real estate is known as "Class A." These structures are generally modern, concrete and steel multi-story buildings with elevators. Class "B" real estate includes less expensive structures that offer less in the way of amenities such as landscaping and parking. Class "C" structures tend to be older, frame construction.

and fourth quarters of 1987 were down slightly from those of the same quarters one year earlier (23.8% in fourth quarter 1987 to 24.7% twelve months earlier). A decrease in high-rent apartment vacancies stood in contrast to the continued increase in vacancies at the lower end of the spectrum.[6]

C. Other States

1. A canvass of other states and national organizations specializing in state and local government affairs indicates that other states with economic problems have not tried or have not been significantly successful in dealing with the commercial real estate aspect.

2. Some state banking divisions have relaxed statutory requirements that non-performing real estate loans be reserved and written off as bad loans. The Division of Banking, Securities and Corporations feels that it already has sufficient latitude in this regard.

3. Where farm states have been hit with real estate problems affecting banks, the problem has generally been found to be beyond the means of state governments.

4. In 1987, Governor Henry Bellmon of Oklahoma sought a General Fund bail out of marginal banks through creation and funding of a bank investment authority that could, among other things, provide capital through purchase of stock in those banks. Bellmon also tried to set up a bank consortium to purchase and refinance troubled commercial real estate loans. According to Bellmon's staff, the legislature did not enact the legislation, while Oklahoma banks and real estate investors could not reach agreement on a price for purchase of the assets held in that state by the FDIC.[7]

D. Observations

1. Alaska real estate owners who borrowed at high interest rates to buy or build during the boom of the late 1970's and early 1980's now face a basic problem: in many communities, the real estate supply exceeds the demand. The effects of this problem have been exacerbated by lower interest rates and lower construction costs for new buildings and a general economic downturn. These three factors add to the basic

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[6] Shorett & Riely, Anchorage Apartment Vacancy Surveys (1987 Fourth Quarter [December 31, 1987] and Third Quarter [November 5, 1987]) and Anchorage Office Space Market Analysis Summary (mid-year, 1987).

[7] "Belmon Bank Plan Flops," Oklahoman, Aug. 7, 1987 (information from banking liaison Melissa Nager and Assistant Press Secretary Wendy Johnson).

over-supply problem, further increasing vacancies and lowering rental prices.

2. While the state can play a role in bringing private parties together to deal with entities such as FDIC, direct aid to a narrow class or geographic segment of investors might fail fundamental public policy tests of equity.

3. Many observers believe that an infusion of money from state sources would tend to prop up real estate prices at artifically high levels, thus prolonging the problems of market imbalance without alleviating them.

4. Several informed observers suggested that the imbalance between supply and demand may drive prices still lower. However, some economists believe effects of the real estate imbalance are likely to be limited. Scott Goldsmith of the Institute of Social and Economic Research, for example, believes the results of the Alaska real estate decline may resemble those of the October 1987 stock market crash, which wiped out $1 trillion in wealth but is expected to have a very modest effect on the national level of aggregate demand. Additionally, some economists suggest that the effect of a real estate collapse will be to lower the costs of doing business in Alaska, making it easier for entrepreneurs to establish a business or expand operations. Some areas have turned falling real estate prices into an integral selling point for economic recovery programs.

6. One possible solution to the commercial real estate problem is a quasi-public entity that would seek external sources of capital to purchase distressed real estate, remove it from the market and hold it as a long-term, speculative investment.[8] This approach would have beneficial effects on supply and on price because some property would be taken off the market and prices would not be subsidized (and hence propped up artificially). At the same time, it must be recognized that the sellers of distressed property would not be made whole. Additionally, when the quasi-public entity put its property back on the market, it would be liable to have a negative effect on real estate prices.

[8] The Department of Commerce & Economic Development is exploring this possibility along with concepts such as real estate investment trusts.

E. List of Attachments

1. Table 1. Alaska Commercial Real Estate Loan Data
   [Summary of data from bank reports and AIDEA]

2. Table 2. Delinquent AIDEA Bond Loans by Area and Type
   [Data compiled by AIDEA]

3. History of Class "A" Office Rents and Historic Office Occupancies
   [graphs from Shorett & Riely mid-1987 Anchorage survey]

4. Synopsis of 1987 Fourth Quarter Anchorage Apartment Market Vacancy Survey
   [Shorett & Reily Anchorage survey]

Table 1

Loans Involving Alaska Commercial Real Estate ($ Millions)

As of:	9/30/87	6/30/87	3/31/87	12/31/86	9/30/86	6/30/86	3/31/86	12/31/85
Loans by Alaska Banks								
1. Total Estimated Commercial Real Estate Loans /1	$956.9	$1,015.4	$1,031.2	$1,037.0	$1,096.1	$1,104.1	$1,088.2	$1,059.7
2. Past-Due & Non-Accruing Comm. R. E. Loans /2	$292.3	$295.2	$258.8	$221.7	$212.0	$145.5	$100.1	$97.6
Loans from AIDEA Bond Sales								
3. Total Commercial Real Estate Loans /3	$227.5	$238.8	(N.A.)	(N.A.)	$245.0	(N.A.)	(N.A.)	(N.A.)
4. Delinquent Commercial Real Estate Loans /4	$47.5	$41.8	(N.A.)	(N.A.)	$16.8	(N.A.)	(N.A.)	(N.A.)
5. Total Commercial Real Estate Loans (1 + 3)	$1,184.4	$1,254.2	(N.A.)	(N.A.)	$1,341.1	(N.A.)	(N.A.)	(N.A.)
6. Total Troubled Comm. R. E. Loans (2 + 4)	$339.8	$337.1	(N.A.)	(N.A.)	$228.8	(N.A.)	(N.A.)	(N.A.)
7. % Troubled Comm. R.E. Loans (6 / 5)	28.69%	26.87%			17.06%			
8. Real Estate Owned by Banks / 5	$165.2	$148.0	$136.3	$108.5	$98.3	$86.5	$64.9	$46.9
9. % Increase in R.E. owned over previous quarter	11.65%	8.53%	25.68%	10.33%	13.60%	33.36%	38.3[illegible]%	(N.A.)

1/ Compiled from quarterly call reports of state and national banks (items 1a and 1e); excludes residential loans purchased by other entities; includes loans for land, construction loans and business loans secured by real estate.

2/ Compiled by Division of Banking, Securities and Corporations; includes loans past due 90 days or more and all non-accruing loans.

3/ Estimated by Division of Policy from AIDEA data; AIDEA financed 80-90% of these loans, Alaska banks the remaining 10-20%.

4/ Estimated by Division of Policy from AIDEA data; these loans are delinquent 90 days or more.

5/ Compiled by Division of Banking, Securities and Corporations ("Other Real Estate Owned"); real estate in bank possession as a result of non-performance by borrower.

Note: These data include assets now held by the Federal Deposit Insurance Corporation (FDIC).

Division of Policy, 1/4/88 [rev.]

Table 2

Delinquent AIDEA Bond Sale Loans by Area

Region:	Number of Loans	Loan Amount ($ Millions)
North Slope	3	$ 1.2
Interior	5	2.2
Southwest	1	0.3
Anchorage	44	37.8
South Central	12	5.9
Southeast	4	1.3
Total	69	$ 48.7

Delinquent AIDEA Bond Sale Loans by Type

Type:	Number of Loans		Loan Amount ($ Millions)	
Commercial Real Estate:				
Office	18		$ 11.8	
Warehouse	14		8.7	
Retail/Shopping Center	15		13.2	
Hotel/Motel	3		1.7	
Restaurant	6		3.2	
Multi-Family	8		9.0	
Subtotal:		64		$ 47.5
Other:				
Industrial Manufacturing	1		0.6	
Equipment	2		0.3	
Vessel	2		0.3	
Total	69		$ 48.7	

Source: AIDEA (12/23/87)

SHORETT & RIELY
REAL ESTATE APPRAISERS & CONSULTANTS
310 K STREET, SUITE 501, ANCHORAGE, ALASKA 99501-2046

ANCHORAGE (907) 276-1851
SEATTLE (206) 441-4900
SAN JOSE (408) 294-6733

December 31, 1987

SYNOPSIS OF
1987 FOURTH QUARTER
ANCHORAGE APARTMENT MARKET VACANCY SURVEY

Attached are the results of the fourth quarter, 1987, Anchorage Apartment Rental Vacancy Survey. The overall vacancy for the fourth quarter of 1987 was 23.8%. This is 1% higher than the 22.8% overall vacancy in the third quarter of 1987, and it also represents an approximate 1% decline from the 1986 fourth quarter vacancy of 24.7%. Although the vacancy rate indicates a slight decline from 1986 to 1987, the rental rates for apartments have also dropped. As to price classification, the vacancy rate for low cost units has significantly increased between the fourth quarter 1986 and the fourth quarter 1987. In contrast, the vacancy for mid and high cost units has decreased during the same time period.— The changes are summarized as follows:

	Fourth Quarter 1986 Vacancy Rate	Fourth Quarter 1987 Vacancy Rate	% Change
Low Cost	30.0%	42.0%	+ 40%
Mid Cost	21.7%	17.2%	- 21%
High Cost	21.6%	13.6%	- 37%
Overall Vacancy	24.7%	23.8%	- 4%

Please refer to the attached summary sheet for additional information. I would like to thank all of the apartment and property managers for cooperating in this survey and I look forward to talking with you soon for the first quarter, 1988 survey.

Sincerely,

Ken E. Kincaid

Ken E. Kincaid, Appraiser

KEK/lh

OFFICE OF
MANAGEMENT & BUDGET
JAN 19 1988
STRATEGIC PLANNING

ANCHORAGE OFFICE SPACE
MARKET ANALYSIS SUMMARY
MID-YEAR, 1987

Prepared by

Ronald W. Bunn, MAI
Shorett & Riely
310 "K" Street, Suite 501
Anchorage, Alaska 99501

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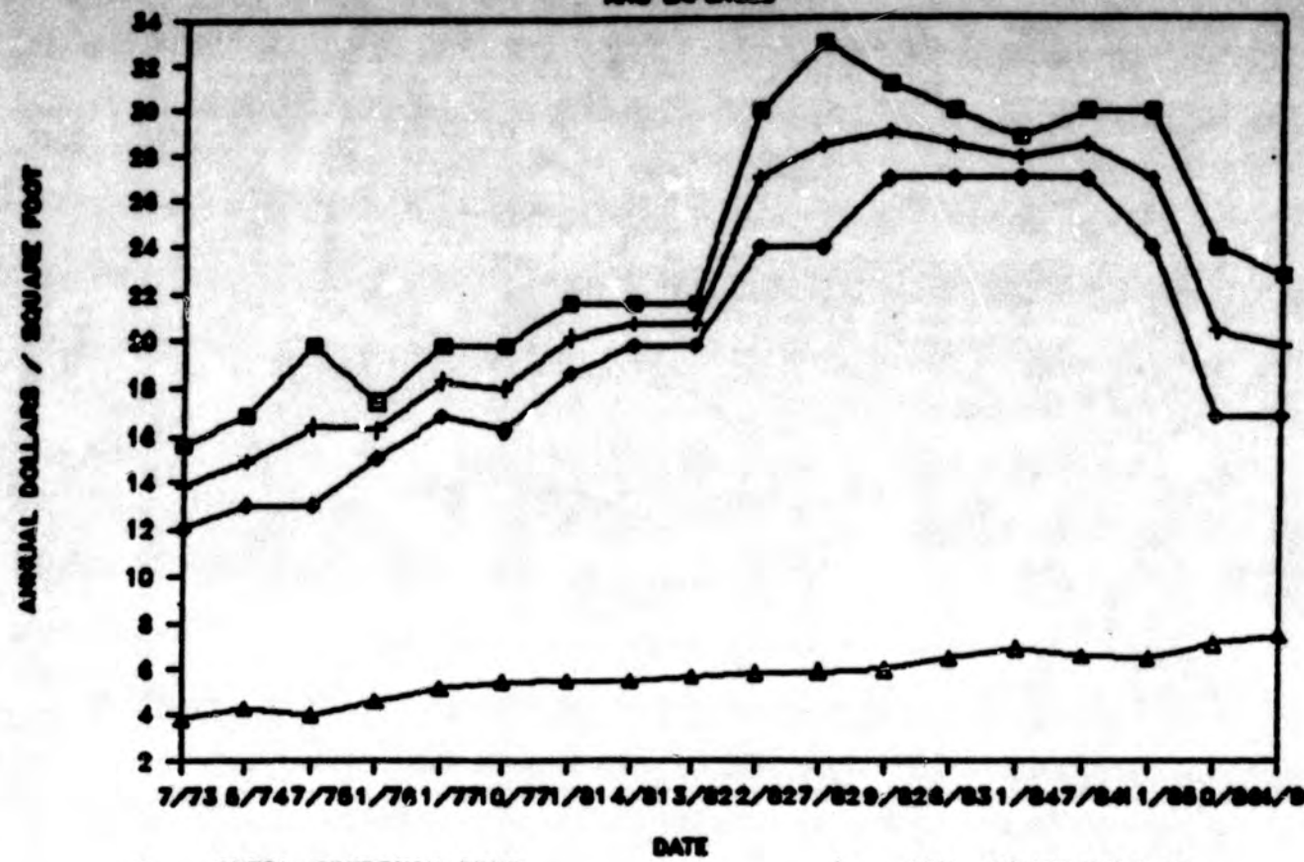
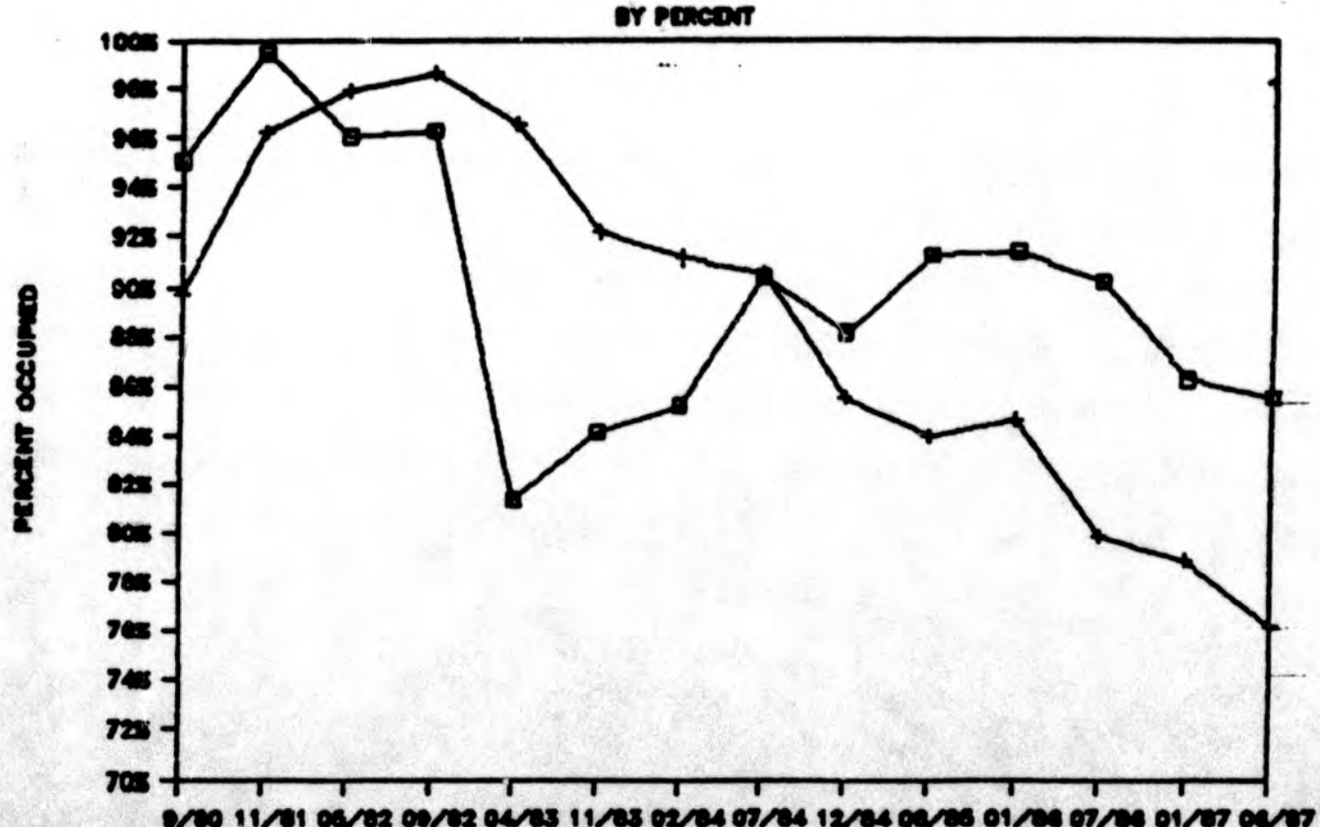
HISTORY OF CLASS "A" OFFICE RENTS

AND EXPENSES



HISTORIC OFFICE OCCUPANCIES

BY PERCENT



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Chapter IV. THE HOUSING MARKET AND POLICY OPTIONS

In earlier chapters we described the grim effects of the recession on Alaska's economy and housing market. We believe that the recession will end in 1988 and a gradual recovery begin. But some of the effects of the recession, including effects on the housing market, will not disappear overnight. A crucial question for AHFC and other major lenders is whether they can do anything that will speed the recovery of--or at least stabilize--the housing market.

This chapter assesses how a number of different policies that AHFC might try would influence the Anchorage housing market over the next five years. We don't have enough information to make such assessments for housing markets in other areas of the state, but movements in the Anchorage market will reflect general trends in housing markets throughout Alaska--with some obvious regional differences.

To project the effects of different policies we use a housing market model developed by ISER. These projections are of likely change in the Anchorage housing market, based on certain assumptions about future economic activity and specific housing policies. They are not "forecasts" of what is going to happen in the housing market. Chapter II assesses the likely range of economic activity in Alaska through the mid-1990s. The level of economic activity will of course be the most important influence on the housing market during the coming years. But the next most important influence on the housing market will be the housing policies that AHFC and other lenders choose. We could only forecast the path of the housing market if we knew for certain the state economic future and the policies lenders will choose.

The crucial policy choice AHFC and other lenders must make is how fast and at what prices to sell the thousands of foreclosed properties they have acquired and continue to acquire. As Table 3.6 in Chapter III shows, AHFC and other lenders were holding more than 4,000 houses, condominiums, and mobile homes as of June 1987, and in the preceding 18 months they had sold an additional 1,600 foreclosed units. Under what we consider the most likely level of economic activity, sales of foreclosed properties (particularly condominiums) will strongly influence the stability of the Anchorage housing market--including the numbers of future foreclosures--in the next few years.

More than 60 percent of the foreclosed properties in Alaska in mid-1987 belonged to AHFC, and most were concentrated in Anchorage and nearby areas. Of the state's major mortgage lenders, AHFC will continue to be hardest hit by defaults until the recession ends, because it holds about eight out of ten new mortgages written in Alaska in the first half of the 1980s. Decisions of AHFC about how to handle its inventory of foreclosed properties will therefore be

critical to Anchorage's housing market in the next few years, as will decisions of other lenders whose foreclosure holdings are smaller but still substantial.

Below we br'efly explain why sales of foreclosed units will so strongly influence the condition of the Anchorage housing market over the next few years. Next we outline the structure of housing markets in general, discuss our model, and then assess the relative effects of selected housing policies.

Sliding Prices and Rising Defaults: A Vicious Circle

The faster AHFC and other lenders and insurers put foreclosed properties on the market--at the extreme, through auctions similar to one a major lender held in Anchorage last fall--the more prices will be depressed and the more defaults will persist, if not increase. The result will be that the lenders will end up holding more properties through foreclosures.

Why selling large numbers of foreclosed properties in a short period results in more borrowers defaulting is easy to explain. Putting a great many foreclosed properties on the market quickly pushes prices down. As prices go down, more and more homeowners find themselves with negative equity--that is, their mortgages are larger than the market prices of their properties. When owners with negative equity are forced to sell, they will likely default because they are unable or unwilling to make up the sometimes substantial difference between what they owe and what the properties will sell for.

Holding foreclosed properties off the market is of course also expensive for lenders and insurers: they pay in the neighborhood of $18 to $30 per day for each unit, depending on the size of the outstanding mortgage and the interest rate. What AHFC and others must weigh are the relative costs: what choices will turn out to be most costly and the most beneficial in the next few years and in the longer term?

Sliding property values and rising defaults have already cost Alaska lenders, insurers, and borrowers tens of millions of dollars. In addition to the costs we've already noted, the foreclosure process that follows default can cost thousands of dollars in administrative and legal fees that are borne by borrowers, lenders, and taxpayers. Costs of judicial foreclosures--in which the lender goes to court to try to have the borrower declared liable for losses when the property is re-sold--are particularly high. And falling property values also have other social costs; for example, some homeowners who could find better jobs elsewhere don't move because they can't sell their houses for what they owe on them and they don't want to default.

A continuing cycle of dropping prices and growing defaults will also make national lenders and insurers and bond investors less willing to put money into the Alaska housing market in the future. That lack of confidence will translate into higher costs for AHFC and other lenders and therefore higher costs for Alaska homeowners in general--higher costs for insurance, for instance, or higher interest rates on bonds AHFC sells to finance mortgages.

As a government entity, AHFC is also justified in intervening to limit the effects of falling prices on the quality of Alaska housing. When there is more housing than there is demand, some houses sit vacant or may be rented at rates that aren't adequate to pay maintenance costs. Deterioration sets in. If just the poorest quality stock deteriorated, government intervention might not be justified, because we could assume that the poorest stock was being eliminated and Alaskans in general were moving into better quality housing.

But there are two reasons why deterioration might spread to better housing. First, when poor-quality houses deteriorate, that deterioration may reduce the value of nearby higher quality housing. Second, even though declining prices mean buyers can afford better quality housing, many potential buyers are also borrowers who already own lower quality housing with negative equity--and therefore they can't sell their current homes and buy better ones. So again, better housing might sit vacant and deteriorate. Nonetheless, refined AHFC policies might be able to limit the extent of such deterioration.

Given the situation we've just described, public policies that could stabilize prices and decrease both present and future defaults and foreclosures merit serious consideration. Below we describe housing markets in general and how we have modeled this market.

Structure of Housing Markets

The housing market, like all markets, can be described in terms of supply and demand. In fact the housing market is not a single market but rather a number of markets with similar but not identical goods: housing varies in size, location, and construction type; it may be occupied by owners or renters. While at any given moment a person can live in only one type of housing--for instance, an owner living in a single-family house--the various markets are related and the price in one market affects demand in all the others.

The market clearing process for housing--the process by which supply and demand come into balance--is complicated by imperfect

information, price floors imposed by mortgages, and costs associated with moving. These market imperfections make it hard to observe the housing market in equilibrium, where prices clear the market. Buyers and sellers have only limited information about what price houses will sell for. They may know what specific houses sold for in the recent past, but they may know little of overall market adjustments since those sales. Also, because there are so many different types of houses, information about the selling price of one particular house may not be relevant to the selling price of others. Over time, as many buyers and sellers adjust their asking and offering prices, the market moves toward a market clearing price.

Two other elements hinder movements toward a market clearing price, particularly in a market where prices are falling. Prices might not fall as low as they otherwise would because loan amounts limit how low they can go: a seller who accepts a price that is less than what he still owes on the property would have to make up the difference--so the mortgage amount may set a floor for the selling price. Also, there are other monetary and social costs involved in moving from one type of house to another. These moving and transaction costs may make families or individuals less willing to move to houses that might be better for them, even in the face of declining prices.

These complexities notwithstanding, the housing market still operates like most other markets. The demand for housing in a given community depends mainly on how many households there are in the region. The demand for particular types of housing determines how households are distributed among the various types. The most important determinants of housing demand are household income, wealth, family size, mortgage rates and terms, and prices.

At any given time there will be a supply of newly constructed houses and older houses up for sale. When builders can construct a house and sell it for more than the building and selling costs, they will build any type of house. Thus builders respond to the expected price of homes and the construction costs. They also consider how long it would take to sell or rent a new house. Another important element affecting the supply of housing is the number of sellers who are either leaving the state or moving into a different type of housing. Generally such changes are tied to changes in the economic positions or the demographic characteristics of households. Thus, the overall level of economic activity affects the supply of housing.

Modeling the Housing Market

Our housing market model, and other housing models developed in the U.S. over the past 25 years, are described in detail in Chapters II and III of ISER's November 1986 report, The Effect of Changes in the Alaska Housing Finance Corporation Mortgage Programs, Final

Report. Appendixes C and D of this report provide model documentation. Below we briefly discuss some of the difficulties inherent in modeling the housing market.

Housing markets are extremely complex. Our housing market model reflects this complexity; it is designed to take into account relationships between dozens of variables, and it is built on hundreds of assumptions about future economic activity and about how housing markets work. The three major economic variables we use in the housing market model are (1) the number of Alaska households; (2) the per capita income of Alaskans; and (3) the Alaska cost of living. The number of households and per capita incomes affect the demand for housing, while changes in the cost of living affect the costs of construction and the supply of housing. The housing model incorporates the economic assumptions and projections presented in Chapter II.

Our model provides a good picture of how the Anchorage market may react to different policies. But it is after all a computer simulation model--not a crystal ball. It is impossible for a model to capture all aspects of a market as complicated and as subject to so many forces as the housing market. Furthermore, it is limited by lack of information about some aspects of the economy and the housing market. We can not, for instance, project the effects of various policies on Alaska housing markets other than Anchorage.

Projections made with the model are of course only as accurate as what goes into the model. We believe our assumptions about likely economic activity between now and 1992 are good ones, but we all know the Alaska economy is volatile: no one can be entirely sure what will happen. To create a computer model, we have to build in relationships between many variables--and we have constructed those relationships by looking at what they have been historically. In the future those relationships could be different from what they have been in the past. The fact that most of our historical data is from a period when the Anchorage housing market was on the upswing posed a particular difficulty--although we were able to incorporate some historical information from the early part of the decline. Another complexity is that computer models do not generally reflect changes immediately; changes often show up only after some time lag.

Finally, no computer model can ever precisely incorporate people's expectations. What Alaskans believe is going to happen to the economy will affect their spending and investment decisions and therefore influence what does happen in the economy. This is not to say that Alaskans can end the recession by spending and investing more, but rather that Alaskans' perceptions about the economy can have some effect on just when the economy begins turning around: Alaskans acting on their beliefs about the future might end the recession a bit sooner or somewhat later than we expect.

General Policy Options

This section talks broadly about what options AHFC has for influencing the Anchorage housing market, and some of the ways those policies might be implemented. Any policy AHFC undertook that increased or decreased housing prices would have broad effects on other lenders, insurers, homeowners, renters, landlords, and others with interests in the Alaska housing market. Our computer model can't project specific effects of different policies on all those groups, but we can talk in general terms about how AHFC policy choices could affect others, and about some other broad policy considerations that the model can't capture. In the next section we use our housing market model to look more narrowly at how some specific policies would affect housing prices and other market variables.

Policies can affect either the supply or demand side of the housing market. In addition, policies may improve the market adjustment process. Five possible strategies are: allowing prices to adjust to clear the market; increasing the demand for owner-occupied housing; reducing the stock of housing; using market power to maintain a floor price; and limiting mortgage liability. Each of these general strategies would be implemented differently, would have effects on several housing objectives, and would have various costs and benefits.

Allow Prices to Adjust to Clear the Market

Under this policy, AHFC would auction off its foreclosed units. If auctions were held regularly, AHFC could clear its inventory of foreclosed properties and the prices paid would provide information for the rest of the sellers in the market. An important consideration in this type of program would be the rate at which foreclosed properties were auctioned. If all properties were auctioned at one time, prices would drop sharply. To prevent that, AHFC could clear its accrued properties over a period of time.

Such a program would lower the price of homes offered for sale and reduce the number of private (non-auctioned) homes sold. The price decline required to clear the foreclosures would depend on the relative elasticities of demand and supply for the various types of housing and the rate at which houses were auctioned. Since owner and rental housing are substitutes, this policy would also result in a decline in the price of rental housing.

This policy would increase the default rate. Reducing the price of owned homes would increase the number of households at risk of default, since it would increase the number of homes with negative equity.

How much prices would fall and how many new defaults would be created by auctions would depend on the economy. The demand for housing will depend on future population and income growth. The number of those at risk who actually default will also depend on economic conditions.

By auctioning foreclosed properties, AHFC and other mortgage holders would be trading potential losses on the mortgages--selling at prices lower than the mortgage amounts--for reductions in holding costs. Whether selling at depressed prices would be more or less costly than holding on to the properties would depend on expectations about future price changes. If prices were expected to rise enough so that holding costs would be less than loan losses, it would pay to hold the units. If price declines encouraged future defaults, auctioning properties could increase both future loan losses and holding costs.

Mortgage insurers would also be affected by auctions of foreclosed properties. The liability of mortgage holders depends on the extent to which their mortgages are covered by insurance. If the mortgage on an auctioned property were fully insured, the insurer would bear the losses described above. If the mortgage were not fully insured, the loss might be shared by the lender and the insurer, although the insurer would be liable for the first portion of the loss.

Property owners would see a decline in their home equity if such auctions took place. For certain home owners, this decline would result in negative equity. Homeowners wouldn't realize actual losses unless they were forced to sell.

Owners of rental property would suffer a decline in rents paid and in the value of their properties, because owning and renting are substitutes. Renters, on the other hand, would gain from this program, since it would reduce their rents and make it cheaper to buy houses.

By reducing the cost of housing, an auction program would allow buyers to get better quality housing for less money.

Increasing the Demand for Owner-Occupied Housing

In periods of limited population growth or even decline, stabilization policies can be aimed at increasing the rate of homeownership. Homeownership can increase in a stable population as the population ages, household income grows, and family size increases. In declining markets, uncertainty about future economic status or expectations of future price declines may keep people from buying homes. Additional factors that may limit housing demand are required down payments, restrictions on AHFC loans, and the level of

interest rates. AHFC and Mortgage Guarantee Insurance Company (MGIC)--the insurer for a large number of AHFC loans--have recently undertaken condominium marketing programs that reduce down payments, loosen loan restrictions, and offer interest rates that are generally below those of other lenders.

Lower mortgage rates in general increase the demand for owner-occupied housing. Both the overall number of houses bought and the types purchased will change with changes in the mortgage rates. But any nonproportional offer of subsidies may simply shift the demand between types and not increase the overall demand. In addition to the lower interest rates AHFC and MGIC are now offering through their condominium sales program, AHFC also has a program (the HOF program) that effectively subsidizes interest rates for lower income buyers.

Some Alaskans who might want to buy homes may be able to meet the monthly payment on a loan but not make the required down payment--and AHFC and other lenders have recognized that by reducing required down payments in some cases. A variation on these reduced down payments would be a lease option program. AHFC could establish this program with its foreclosed properties; the corporation could lease these units with an option to buy. A portion of the lease payment each month could go toward the down payment. Such a program would counter the effects of uncertainty on the housing market; lease holders would not suffer the long-term risks of a change in their economic status or a decline in the price of housing.

AHFC's 70 percent ownership rule for condominium complexes may have limited demand until recently; that rule says that AHFC loans will be available only in complexes where 70 percent of the units are occupied by owners rather than renters. By loosening that ownership share requirement, AHFC has increased the portion of condominium stock eligible for AHFC loans. AHFC might also consider replacing the ownership requirement with long-term leases that included an agreement to pay the condominium association fee; these lease agreements could be enforced by the condominium association.

AHFC's recent policy changes sharply increased the number of condominiums AHFC sold in Anchorage in the summer of 1987, and the other kinds of actions described above might increase demand more. Increased demand should tend to shore up prices. AHFC and MGIC are of course bearing extra costs for these new marketing measures, and any additional measures would mean more costs. For example, additional rate subsidies would require funds from either AHFC's reserve or additional state appropriations to buy down market interest rates. Additional funds might also be necessary if reducing the ownership requirement in condominium projects results in increases in the rates AHFC pays on bonds. Second, AHFC may have to establish an insurance fund to support the lower down payment

program. The cost of a lease option program with foreclosed units would be the lost capital gains if housing prices rose in the future.

But if these measures help stabilize prices, AHFC and others will also benefit. The rate of defaults and therefore foreclosures should be reduced, reducing future loan losses and holding costs.

Property owners should also ultimately benefit from these types of programs, if the programs help increase the value of their homes and improve their chances of selling them. Owners of rental property, however, could be made worse off. By reducing the costs of owning and increasing the access to homeownership, these programs could reduce the demand for rental units. That in turn would reduce rents and the value of rental property.

By reducing the costs of both renting and owning homes, these programs could also improve the quality of housing Alaskans live in and increase the rate of homeownership. One general problem with programs that reduce the value of rental property is that this reduction could result in long-term declines in the quality of the stock, because landlords are more likely to defer maintenance.

The total effects and costs of such programs would depend on the future level of population. If the economy grows faster than expected, the cost of the programs would increase and add to the upward pressure on prices.

Removing Housing Stock

The most direct strategy for stabilizing the housing market in the face of "excess" supply is simply removing a portion of the supply. This reduction in supply would put upward pressure on prices. Two types of housing would lend themselves to removal: mobile homes and poor quality multi-family housing.

Mobile homes could be shipped to other markets; at some price, it would pay to export at least some of the newer mobile homes. Removing other types of units would be more difficult. The state's urban areas have few poor-quality units, and most that exist are rental units. Taking those poor-quality units out of the housing stock would require the state to buy them--or trade for foreclosed units--and tear them down. If AHFC traded foreclosed units with private owners, a number of steps would be involved. First, the remaining condominium owners in the selected complexes would have to be relocated (this would require refinancing) to foreclosed units in other complexes. Second, the condominium complex would have to be traded for the apartment unit; the trade might involve additonal cash. Finally, the tenants of the rental unit would have to be relocated and the building demolished. One variant of this strategy would be to trade foreclosed property with the Alaska State Housing Authority (ASHA). On a smaller scale, single-family units on lots zoned for other uses might be removed through trade.

Removing stock in this manner should help stabilize prices in the owner-occupied market and have a limited effect on the rental market. The extent of the increase in prices would depend on the proportion of excess stock removed; the smaller the share removed, the smaller the effect. The small quantity of poor-quality housing available for use in such a program suggests that the effects would be limited.

The costs of such trades to AHFC would be the market value of the traded property, the relocation costs of renters and condominium owners, and the demolition costs. There would be a number of benefits for AHFC, including a reduction in the loan loss and holding costs of foreclosed properties and a reduction in the rate of future foreclosures.

Depending on their level of participation, the insurers would have to be paid market values of the properties. Their participation might be based on how much they would benefit if their future losses were limited.

Property owners would be better off to the extent that this program stabilized housing prices. Owners of rental property would be no worse off, since the rental stock would remain the same and owner stock would be reduced. Renters should likewise see no change, since the amount of rental stock would be the same.

The overall quality of the housing stock would be improved through this program, because it would concentrate renters and owners in better quality housing and limit deterioration of the stock.

The costs of this program would depend on the economic future; further declines in the value of the housing stock would reduce the costs of improving the quality of the stock. Eliminating stock would also increase inflationary pressure should there be a surprise rapid turnaround in the economy.

Using Market Power to Maintain a Floor Price

AHFC's stock of foreclosed properties makes it, as we have noted, a major seller in the housing market. This control of a large share of the market gives AHFC power to influence prices. AHFC could act to prevent a decline in prices simply by establishing a floor price for its units and holding them until they could be sold for that price. The floor price could be established to minimize the average loan loss on foreclosed properties.

If AHFC were able to stabilize prices by establishing a floor price, there would be various costs and benefits. AHFC and its mortgage holders would see two benefits: reduced loan losses on

sales of foreclosed property, and fewer defaults in the future. However, holding costs would be higher, since maintaining the price above the market clearing level would increase the length of time foreclosed properties were held. But as we noted earlier, AHFC and its insurers face large expenses in holding foreclosed properties off the market--in the range of $18 to $30 per day for each unit. Whether the holding costs would outweigh other benefits would be the critical issue for AHFC and its insurers. The policy would save money overall if the holding costs up until the time of the sale were less than the loan losses would have been if a property had been sold earlier at a lower price.

For those loans completely covered by mortgage insurance, the costs and benefits outlined above would accrue to the insurers. On loans only partially covered by insurance, the costs and benefits would be distributed between the insurers and the lenders.

Owners of both homes and rental units would benefit if this program stabilized prices. Homeowners who wanted to sell would have a better chance of doing so simply by offering their houses below AHFC's floor price. Renters could be hurt by this program, because it would increase the costs of buying and renting.

Limiting Mortgage Liability

Falling prices over the past eighteen months have left many Anchorage homeowners--particularly those who bought when prices were at their peak--with negative equity: that is, they owe more on their houses than the houses can be sold for. That negative equity is a market barrier with serious consequences. First, it pushes many borrowers into default if they are forced to try to sell and are unwilling or unable to make up the sometimes substantial difference between what they owe on their houses and what the houses will sell for. Second, it prevents some homeowners from taking advantage of lower prices and buying better quality houses--because they are unable to sell their existing houses for what they owe on them.

AHFC and other lenders might mitigate the market barrier posed by negative equity--and thereby reduce defaults and increase demand--if they limited borrowers' mortgage liability in some circumstances. There are a number of ways lenders could go about limiting mortgage liability.

One way would be for AHFC and its insurers to negotiate write-downs of loan liability for borrowers who had to sell. Such write-downs would be similar to the pre-foreclosure sale agreements currently being used by mortgage insurers. Steps involved in such a process might include having the home appraised by a certified appraiser approved by AHFC; forgiving the borrower some percentage or all of the amount owed above the appraised value (or

the sale price); having the seller pay closing costs; and splitting the loan losses between AHFC and its insurers, in shares proportionate to their total liability on each loan.

Of course the lenders would establish guidelines for determining when they would write down mortgage liability rather than pursue foreclosure: a blanket policy of writing down liability for borrowers unable to sell their houses for what they owed on the houses would encourage more defaults. And, such a blanket policy of not pursuing foreclosures could in turn make mortgage insurers and bond investors reluctant or even unwilling to buy or insure mortgage loans in Alaska in the future.

But in some circumstances mortgage write-downs could save lenders and insurers money, if the alternative were going through foreclosure proceedings, taking possession of the house, holding it for re-sale, and taking a loss on the re-sale. A single judicial foreclosure can cost the state in the range of $5,000 to $10,000--plus costs of holding foreclosed units ($18 to $30 per day for each unit). In addition, potential losses on re-sale of a property could be as great as the amount of a loan write-down. AHFC would have to weigh the relative costs and benefits in making its decisions about whether and when to write-down mortgage liability.

Another possible method of limiting mortgage liability in some circumstances would be to allow homeowners who wanted to sell their existing houses and move into better ones in Alaska to defer a part of their mortgage liability until prices went back up. These homeowners would, in a manner of speaking, be taking their negative equity along with them. A homeowner with negative equity on his current house would be allowed to sell that house for less than the outstanding mortgage and buy another house in Alaska, with the proviso that he had to repay the lender later, when property values and incomes increased. That repayment could be handled in a number of ways--the borrower could, for instance, carry the negative equity to the new house in the form of a second mortgage, or repay the lender out of his capital gains when he sold the second house. Still another way the lender could recoup the loan loss on the first house would be to build a graduated payment schedule into the mortgage on the second house--so that after a few years, a portion of the borrower's higher payments would be used to repay the lender his loss on the first loan. However the transfer was handled, it would be a means of helping stabilize the Anchorage market by increasing sales.

Effects of Selected Policies

We now use our housing market model to assess the relative effects of specific policy options on the Anchorage housing market between now and 1992. All the policy cases discussed below assume

the level of economic activity projected in the medium (base) case in Chapter II. We believe that case represents the most likely rate of economic growth over the next five years, but it is always possible that the economy will grow faster or slower than we expect. In the final section of the chapter we discuss how faster or slower economic growth would affect the Anchorage housing market.

Aside from the assumptions about future economic activity, the crucial variable in all the policy cases is the rate of sale of foreclosed condominiums and single-family houses--but particularly of condominiums.

It is much easier to re-sell single-family houses than condominiums. Most buyers prefer single-family houses when they can afford them, and when prices are down more buyers can afford houses. Buyers are scarce in the Anchorage market today, but more of those fewer buyers are choosing houses over condominiums. As we noted earlier, we anticipate that the existing stock of condominiums and other multi-family units (including rental units) will likely exceed the projected demand for multi-family housing in Anchorage through 1992. Condominiums are more difficult to re-sell because they are the second choice of many buyers and because there are so many of them out there.

We do not attempt to project future prices for mobile homes under the different policies; we don't have enough information on the mobile home market to make such price projections. We expect that the existing supply of mobile homes will more than meet demand from now through 1992, and that AHFC may in fact ship some mobile homes outside the state for sale.

We can group the policy cases this way: the three main cases (base, hold-all, auction) assume different rates of sale of the total inventory (AHFC's and other lenders') of foreclosed houses and condominiums in Anchorage. Three additional cases (limit liability, remove, and subsidy) assume the same rate of sale of foreclosed inventory as in the base case, but also look at the effects of additional policy changes. The limit liability case looks at how limiting mortgage liability of borrowers or allowing them to defer a portion of mortgage liability until later would affect defaults and the lenders' inventory of foreclosures. The remove case assesses the effects of simply removing--not re-selling--some condominiums from the inventory of foreclosed condominiums. Finally, we also assess how subsidizing mortgage interest rates would affect some aspects of the Anchorage condominium market, which is much more depressed and where re-sales are much more difficult than in the market for single-family houses. We present results from these last three cases only when they are significantly different from base case results.

Variables and Their Relationships

We examine the relative effects of the various policies on prices, private sales, inventory of foreclosed properties, and construction of condominiums and single-family houses between now

and 1992. We also assess how each is likely to affect equity of homeowners and rental rates. We will of course use some numbers in discussing these various effects, but what we consider most important is not the specific numbers--which are approximations--but rather what the numbers show about the relative effects of different policies. For instance, we don't pretend to know that the average price of single-family houses would be precisely $139,265 in 1989 if the lenders sold a given number of foreclosed units--but we can say whether prices would tend to be higher or lower if the lenders sold more of fewer houses.

The housing market variables we examine are of course related, and change in one affects the others. In general, our housing market model says that higher prices tend to reduce defaults, increase equity, encourage construction, and increase private sales. Conversely, lower prices mean more defaults, lower equity, less construction, and fewer private sales.

Base Case: We use this case as a benchmark against which to assess the effects of the auction and hold-all cases, where we assume that more or fewer foreclosed units are sold. This is not a "forecast" case in the sense that we consider it the most likely to actually happen; it incorporates a rate of sales that is neither extremely fast nor extremely slow.

In this case we assume that AHFC and other lenders sell 1,000 houses per year from their inventories of foreclosed single-family houses until the inventory falls below 1,000, and then sell off whatever is left in the next year. For condominiums the case assumes that lenders sell a constant percentage of their stock of foreclosures in any given year; in this case that amounts to between 400 and 700 condominiums annually from 1988 through 1992.

Auction Case: The title essentially describes the case: here we examine the effects of lenders selling a very large percentage of their stock of foreclosed condominiums each year--three to four times as many condominiums (between 1,000 and 2,800 per year) through 1992 as under the base case. The case assumes roughly double the number of sales of single-family houses as under the base case--from 1,000 to 2,200 annually until the stock is exhausted.

Hold-All Condominiums Case: Under this case we assess what would happen in the housing market if the lenders sold no foreclosed condominiums at all between 1988 and 1992, and restricted sales of foreclosed single-family houses to just 400 per year during the same period.

Limit Mortgage Liability Case: Here we look at how future defaults and other market variables would be affected if lenders or insurers limited or deferred mortgage liability of property owners who were forced to sell or wanted to move to better homes in Alaska but were constrained by having negative equity in their current houses. The

borrower's liability in such cases would be limited to the sale price of the property, even if the outstanding mortgage were higher. (Assumptions about rates of sale of foreclosed inventories are the same as in the base case.) This case represents an extreme: it shows the results if lenders limited mortgage liability of all those with negative equity who wanted to sell.

Remove Condominiums: This case differs from the base case only in that we look at what would happen if AHFC or other lenders simply took 400 units out of their inventory of foreclosed condominiums in each of the years 1988, 1989, and 1990; these 1,200 units would not be sold but would be demolished or otherwise removed from the market.

Subsidize Interest Rates: This case examines the effects on just the condominium market of subsidizing interest rates and holding rates of sale of foreclosed units the same as in the base case.

Policy Effects on Prices

A key measure of market stability is price. Figures 4.1 through 4.4 show the effects that faster or slower sales of foreclosed properties would have on house and condominium prices--both nominal (not adjusted for inflation) and real (adjusted for inflation) prices--in Anchorage over the next several years. The figures also compare the projected prices with historical prices from 1980 through 1986. Under all the cases, prices of condominiums and houses reach lows in 1987 or 1988 and then begin climbing--but condominium prices drop much further than house prices and take much longer to recover to their historic highs.

Base Case Prices: Under the base case nominal and real average prices of houses would bottom out in 1987 and average prices of condominiums in 1988. Nominal house prices would reach a low of around $109 thousand in 1987 and then begin to rise steadily, rebounding to their nominal 1985 levels by 1989. Real prices--prices in 1986 dollars to account for projected future inflation--would also rise beginning in 1988, but their course would be more jagged: real prices by 1992 would be about 13 percent higher than in 1987.

Average nominal condominium prices under the base case would reach a low of about $73 thousand in 1988 and then begin slowly rebounding, but not reaching their 1985 levels until 1992. Real condominium prices would bottom out at around $68 thousand in 1988 and increase about 19 percent by 1992.

Auction Case Prices: High sales of condominiums in this case would push nominal prices to a low of $58 thousand in 1988--20 percent below projected base case prices in that year. Average condominium prices in 1992 would still be below their nominal 1985 levels. Real condominium prices in this case would also bottom out in 1988 before beginning a slow recovery that would still leave real prices by 1992 about 5 percent lower than they would have been under the base case.

Figure 4.1 Nominal Prices, Anchorage Condominiums, Under Five Cases, 1980-1992
(In Thousands of Dollars)

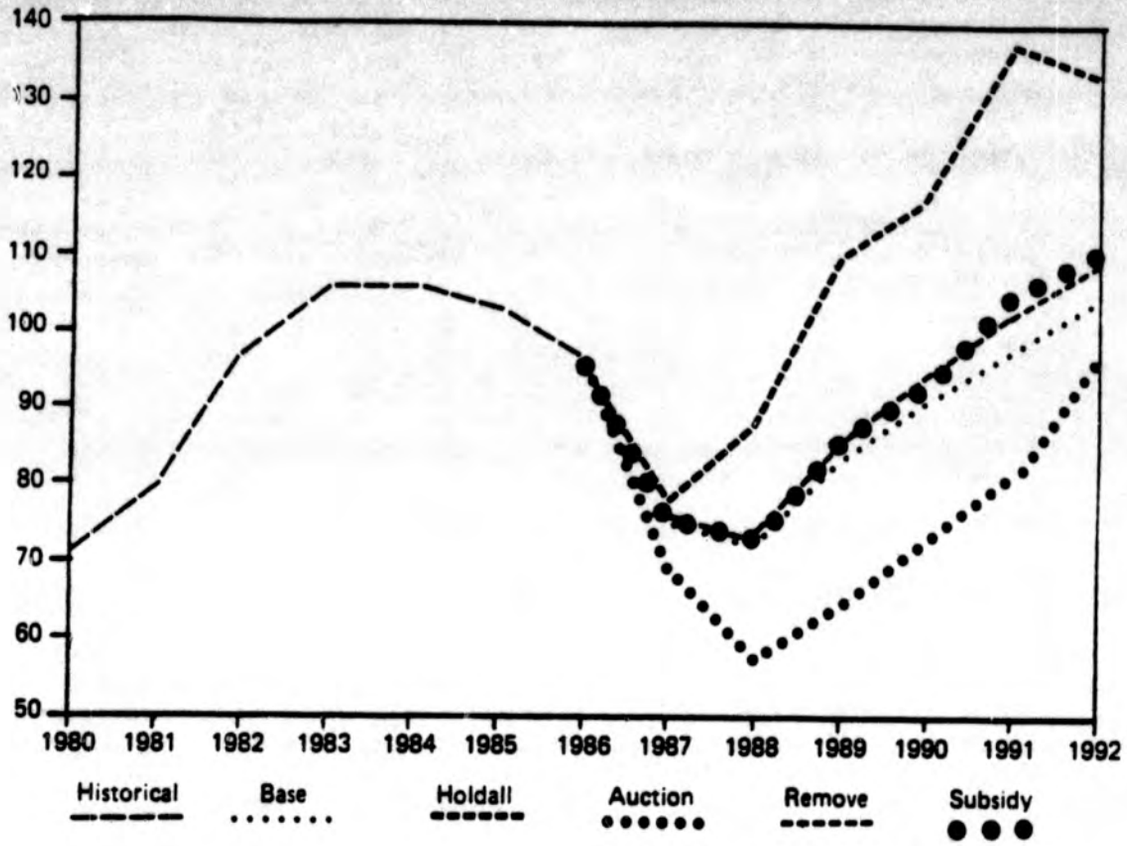


Figure 4.2 Real Prices, Anchorage Condominiums, Under Five Cases, 1980-1992
(In Thousands of 1986 Dollars)

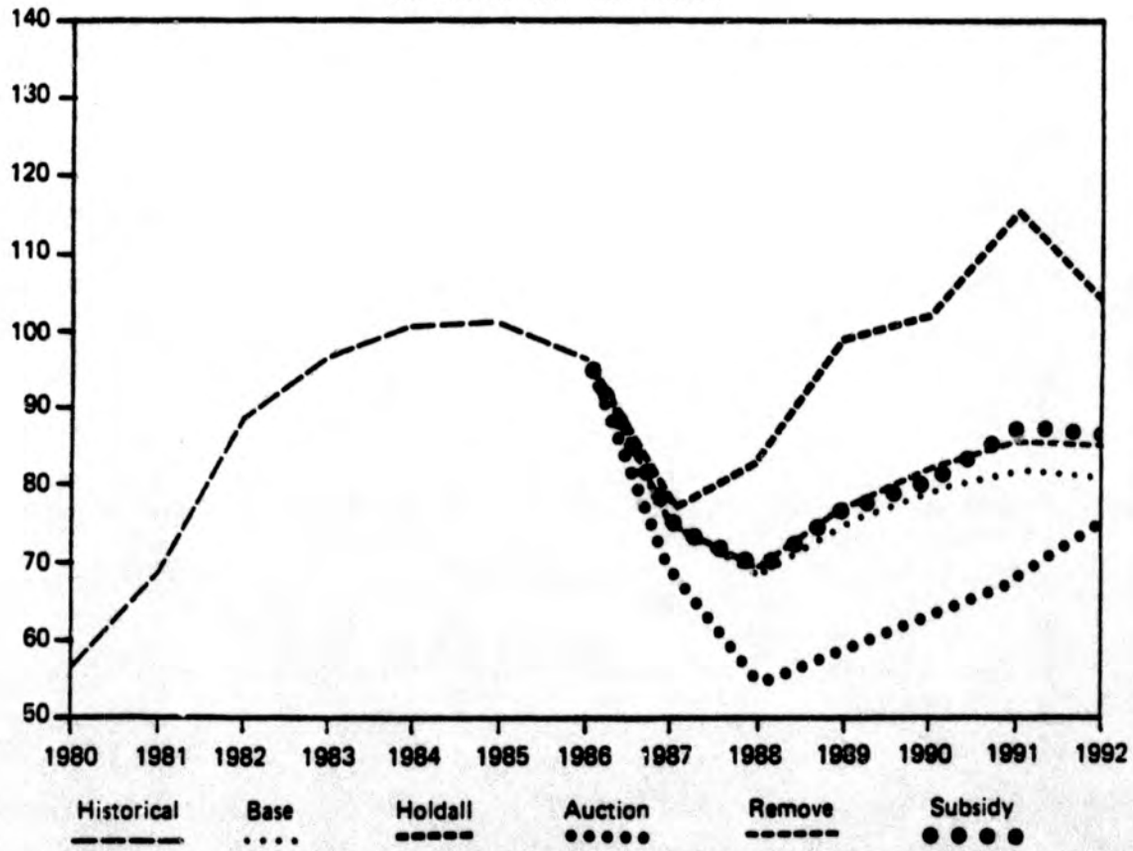


Figure 4.3 Nominal Prices, Anchorage Single-Family Houses
Under Three Cases, 1980-1992
(In Thousands of Dollars)

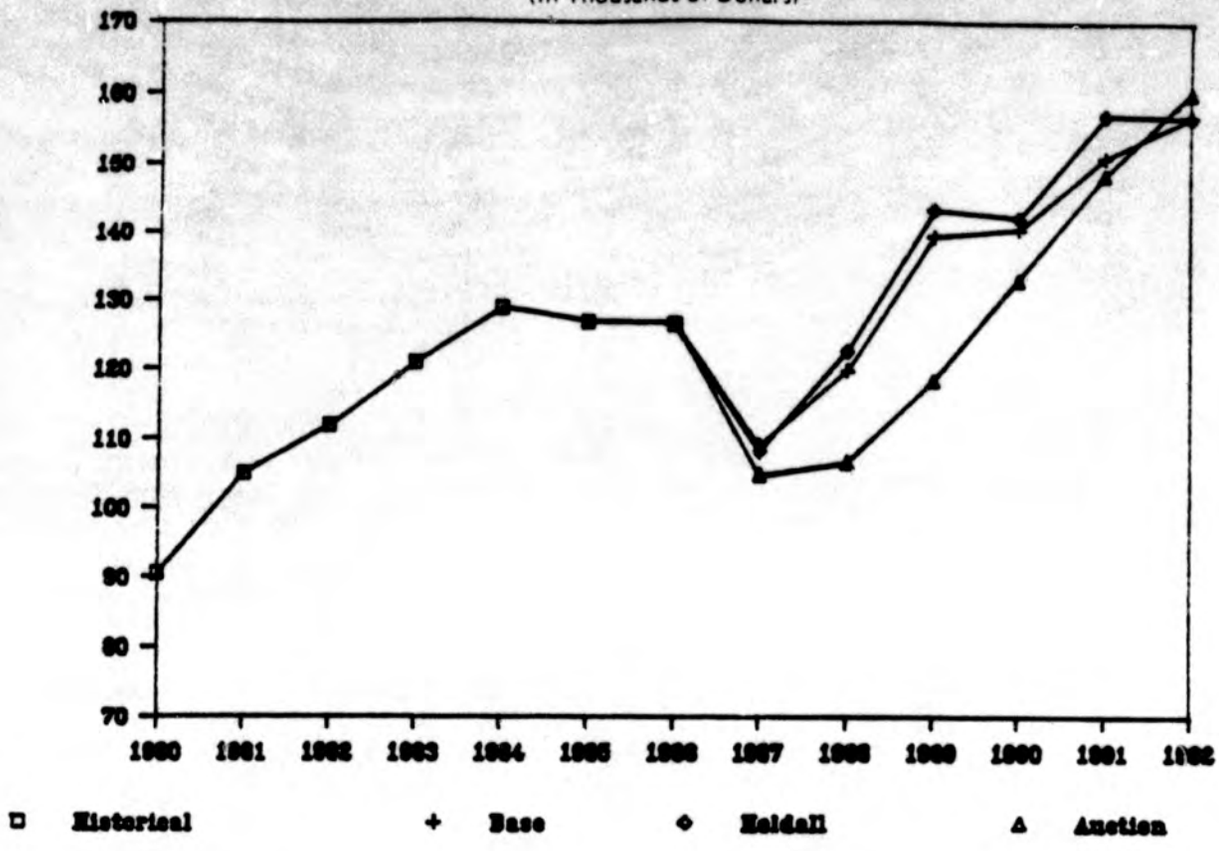
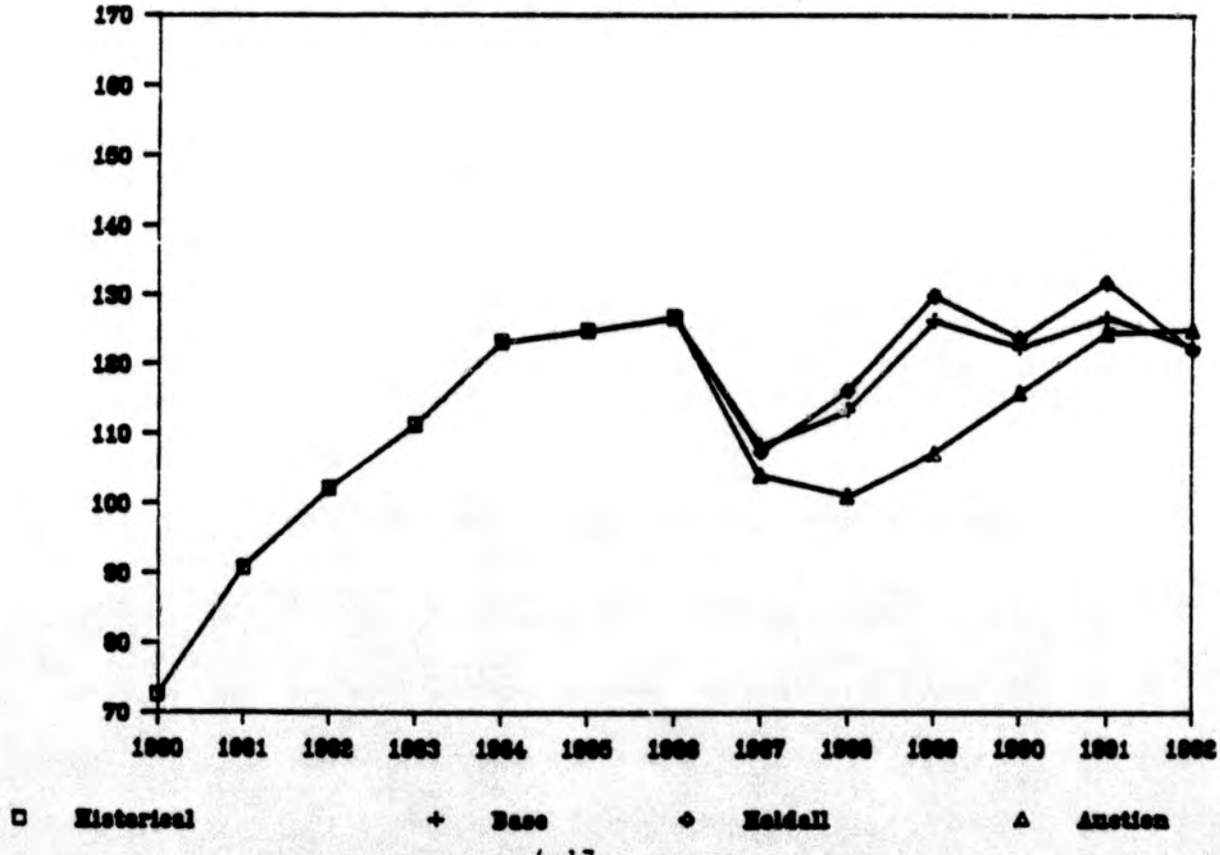


Figure 4.4 Real Prices, Anchorage Single-Family Houses
Under Three Cases, 1980-1992
(In Thousands of 1986 Dollars)



Prices of single-family houses would also be pushed down in the late 1980s by faster sales of foreclosed houses, though not as much as condominium prices; house prices would also rebound more quickly. Under this case average nominal house prices would be around $104 thousand in 1987 and would change little in 1988--but by 1990 they would reach their nominal 1985 levels. Real prices (in 1986 dollars) of houses would hit bottom in 1988 and increase about 23 percent by 1992. So in the short run (through 1989) auctioning houses would depress prices, but clearing that inventory quickly would make house prices slightly higher than they would be under the base case by 1992.

Hold-All Case Prices: This case assumes that lenders simply hold onto (or even, at the extreme, demolish) all their stock of foreclosed condominiums, selling none between 1988 and 1992, and reduce sales of single-family houses through the period. Keeping all foreclosed condominiums off the market would have a dramatic effect on both nominal and real prices: prices would bottom out sooner, fall much less, and recover faster. Nominal prices under this case would reach a low of around $78 thousand in 1987, rebound to their 1985 levels by 1989, and continue to well above their historic highs by 1992. Real prices would increase 35 percent between 1987 and 1992.

The effect of holding more single-family houses off the market would be relatively small; prices would increase slightly faster than under the base case in the next few years, but would be about the same by 1992. We assume that the Anchorage market could readily absorb more than 400 houses from the inventory of foreclosures each year, because the supply of single-family houses--unlike the supply of condominiums--will not exceed the projected demand in the next five years.

Subsidize Case: Subsidizing mortgage interest rates would increase prices of condominiums just slightly over base case levels; for instance, in 1989 nominal average prices of Anchorage condominiums would be about $85 thousand as compared with $83 thousand in the base case--or about two percent higher.

Remove Condominiums and Limit Liability Cases: The results of taking some condominiums out of the inventory of foreclosures or limiting liability of sellers are not shown in Figures 4.1 through 4.4; those measures would have little effect on prices as projected under the base case.

Policy Effects on Inventory of Foreclosures

The thousands of defaults and foreclosures in Anchorage and other areas of Alaska in 1986 and 1987 have been the most visible signs of distress in the housing market. Figures 4.5 through 4.8 show the effects of various policies on the inventory of foreclosures in the hands of lenders and insurers over the next five years in Anchorage. Projecting future defaults and foreclosures is particularly difficult and risky--so please keep in mind that what

is significant in these figures is not the precise numbers but rather the relative ways that different policies would affect foreclosures.

Base Case Inventories: Under this case--which assumes moderate rates of sale of condominiums and houses--the inventory of foreclosed condominiums would build until it reaches about 2,400 in 1989 and then begin to fall, but still stand at around 1,000 by 1992. The inventory of foreclosed single-family houses would peak at just under 2,000 in 1988 and then decline briskly--so that the inventory would disappear by the end of 1991.

Auction Case Inventories: In this case lenders try to reduce their inventories quickly by selling condominiums and houses much faster than under the base case. But the short-run effect of such rapid sales would be to increase rather than to decrease inventories--because auctioning off so many units would increase defaults, as we noted above. After 1988, however, such large sales would bring the inventories down much faster than under the base case. So in 1988 the inventory of condominiums would be at around 2,800 (as compared with 2,200 in the base case) but in 1989 would begin dropping sharply so that there would be no inventory of foreclosed condominiums by 1992--as compared with an inventory of 1,000 under the base case.

The inventory of foreclosed single-family houses would also be higher in this case in 1988 (more than 2,000) than under the base case, but the difference is not large--and the inventory would disappear by 1990, a year sooner than under the base case. Selling houses at a faster rate does not have as marked an effect on defaults and foreclosures as does selling condominiums rapidly--because, as we noted before, we believe the Anchorage market can more easily absorb houses than condominiums.

Hold-All Case Inventories: Keeping all foreclosed condominiums and a large share of foreclosed houses off the market would reduce defaults in 1988, but the inventory of foreclosures would become extremely large if none or few of them were re-sold. By 1992 there would be about 3,300 condominiums and almost as many houses still in the inventory of foreclosures.

Limit Liability Case Inventories: This case combines a moderate rate of foreclosure sales with limiting mortgage liability of sellers with negative equity to the market value of their properties. The figures show that this combination would reduce inventories of both condominiums and single-family houses far below their base case levels: in 1988 the inventory of condominiums would be only 60 percent as large as under the base case and by 1992 it would be roughly one-third as large. The inventory of houses would be only 30 percent as large in 1988 as under the base case, and would have almost disappeared by 1989.

Figure 4.5 Inventory of Foreclosed Anchorage Condominiums, Under Six Cases, 1987-1992
(In Thousands)

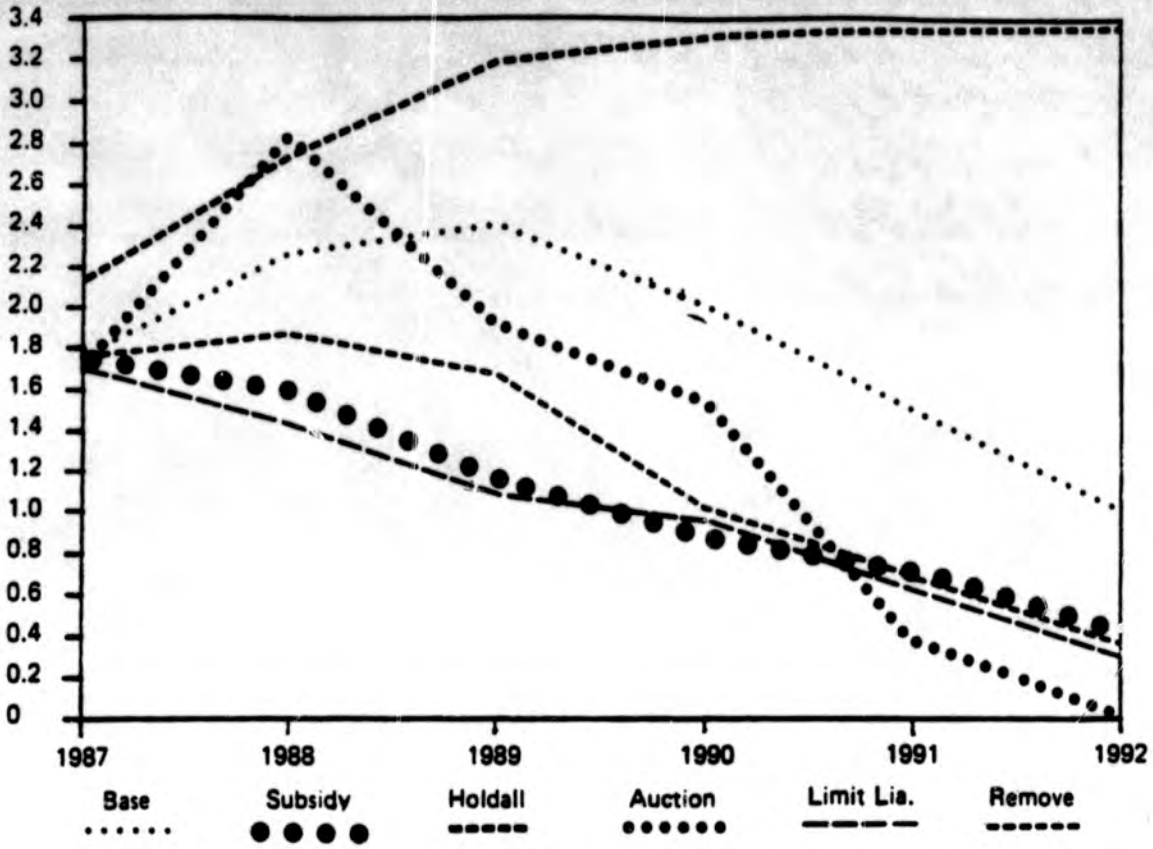


Figure 4.6 Inventory of Foreclosed Condominiums, Under Six Cases, 1988 and 1992
(In Thousands)

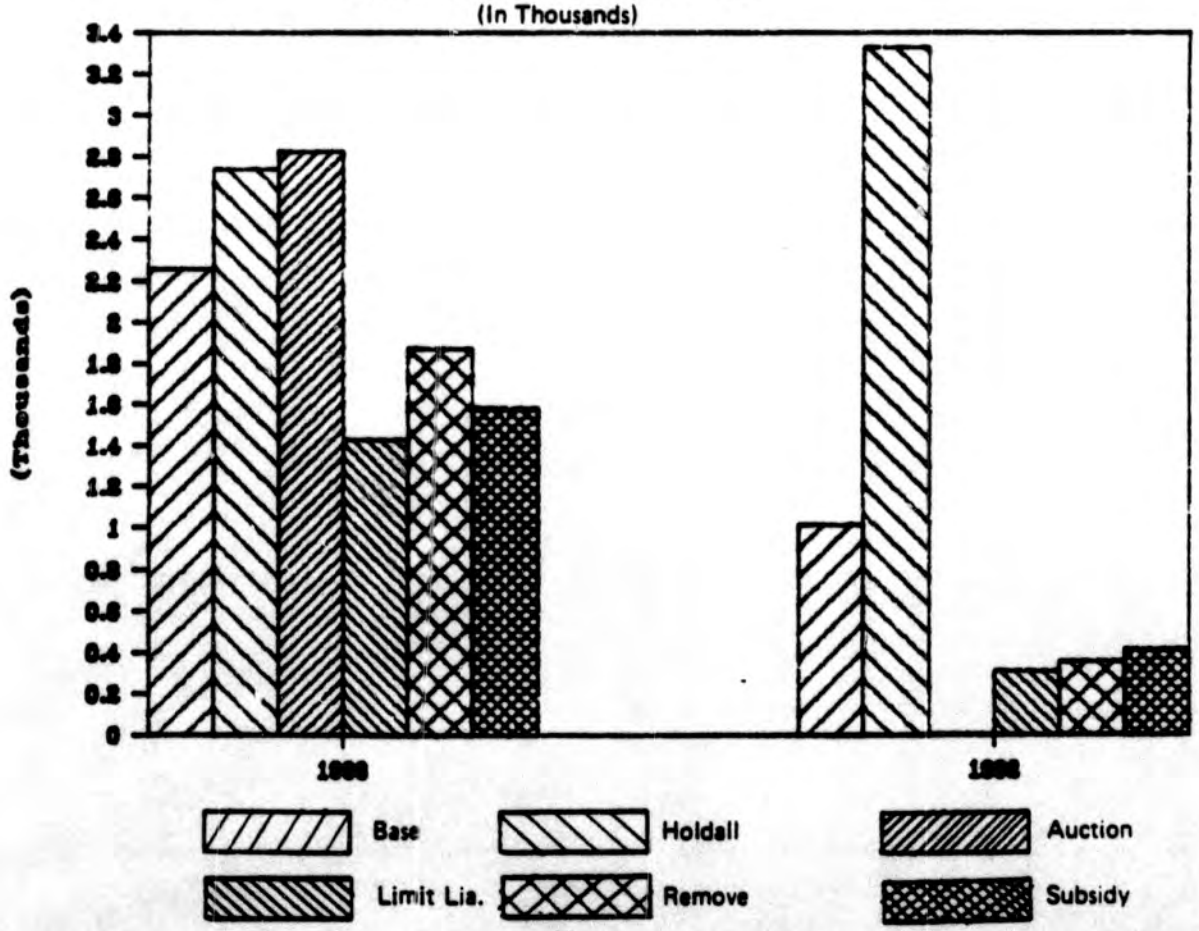


Figure 4.7 Inventory of Foreclosed Anchorage Single-Family Houses Under Four Cases, 1987-1992

(In Thousands)

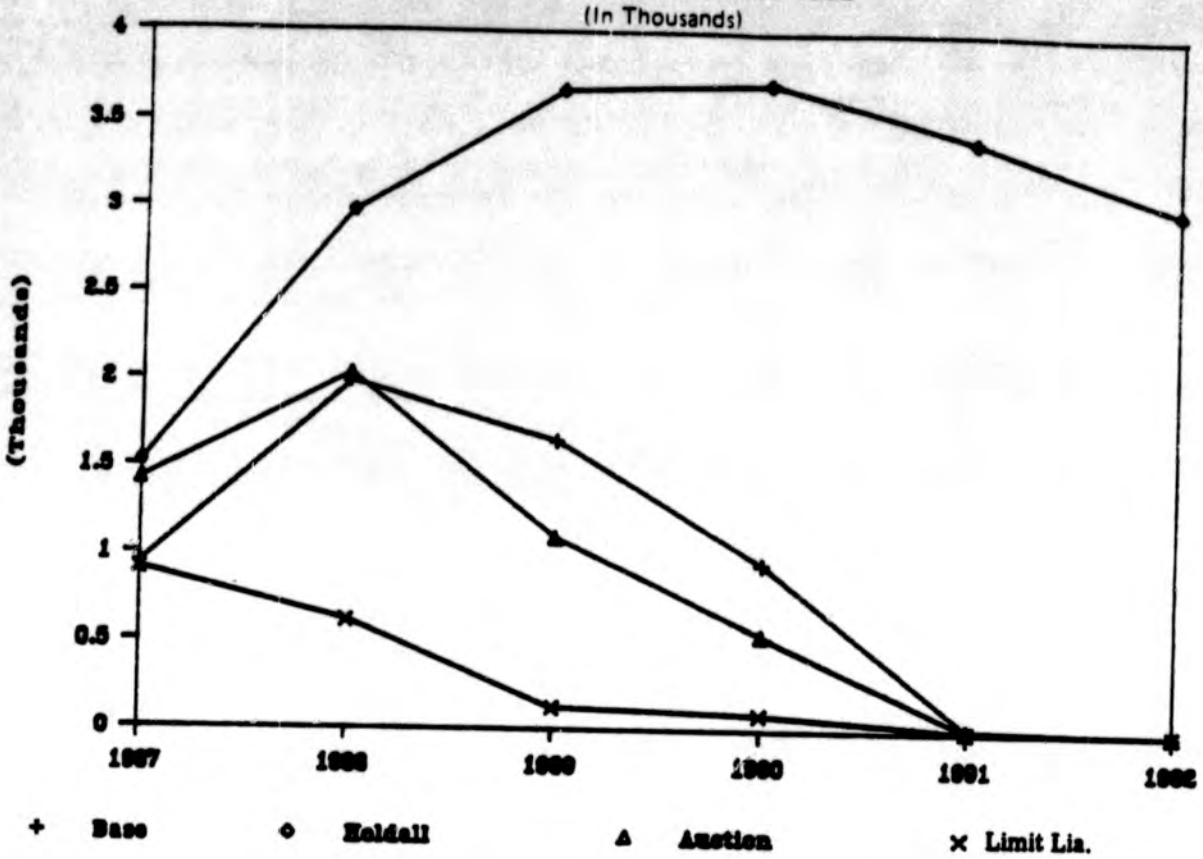
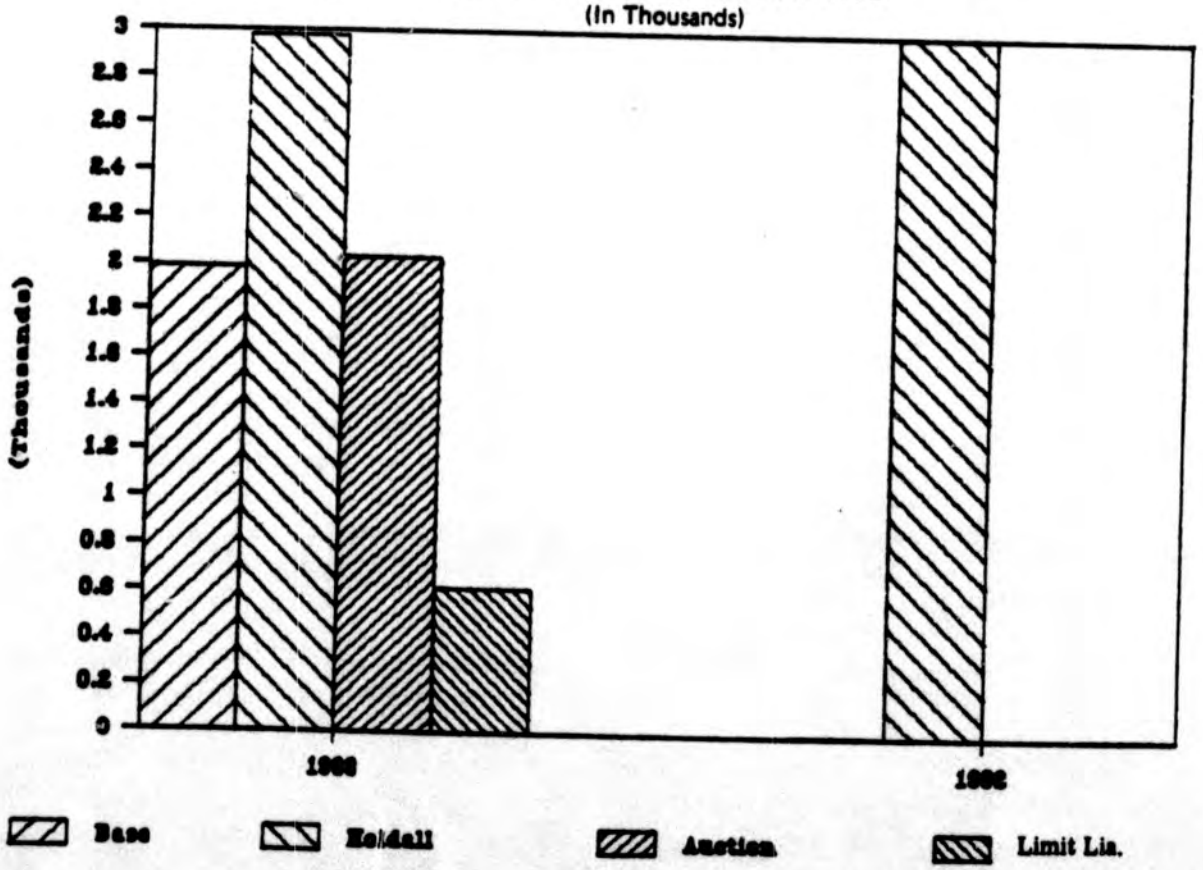


Figure 4.8 Inventory of Foreclosed Anchorage Single-Family Houses Under Four Cases, 1988 and 1992

(In Thousands)



Remove Case Inventories: Removing 1,200 condominiums from the foreclosed inventory would of course reduce that inventory--so that by 1992 it would be about one-third the size projected under the base case. Taking condominiums out of the foreclosed inventory would have no effect on the inventory of foreclosed single-family houses.

Subsidy Case: By increasing demand, subsidizing interest rates for condominiums would have the effect of reducing defaults and therefore the inventory of foreclosures. Figures 4.5 and 4.6 show that the inventory of foreclosed condominiums would be substantially smaller under the subsidy than the base case; for example, in 1988 the inventory would be 30 percent smaller under the subsidy than under the base case and in 1992 60 percent smaller.

Policy Effects on Private Sales

How are sales of foreclosed units under the various policy options likely to affect private owners trying to sell their condominiums and houses in Anchorage in the next few years? Figures 4.9 and 4.10 show historical and projected total sales (both private sales and foreclosure sales) of condominiums and houses in Anchorage under the base, hold-all and auction cases; figure 4.9 also shows projections under the subsidy case. Keep in mind that these projected total sales assume that specific numbers of condominiums and houses are sold each year--so they do not represent projections of likely housing demand, but rather show how prominent a role sales of foreclosed units will play in the market in the next several years. Sales would of course be highest under the auction case, because that case assumes fast sales of foreclosed houses and condominiums.

Figures 4.11 and 4.12 show how the projected total sales of condominiums and single-family houses would be divided between institutional and private sellers under the base case, auction, and hold-all cases in 1988 and 1992; Figure 4.11 also shows subsidy case projections.

Base Case Sales: Total condominium sales under this case would be between 350 and 700 annually through 1992. Few private owners (at best, fewer than 100 in any year) would sell their condominiums through 1992: sales by institutional sellers are projected to dominate the market throughout the period. For owners of single-family houses, the picture would be brighter: of total projected annual sales of between 1,700 and more than 2,000 houses, private owners would have about half the market through 1990 and virtually all by 1992, when the stock of foreclosed houses would be exhausted.

Hold-All Case Sales: If lenders kept most foreclosed condominiums off the market in the balance of 1987 and all off the

Figure 4.9 Historical and Projected Total Sales of Anchorage Condominiums, Under Four Cases, 1980-1992

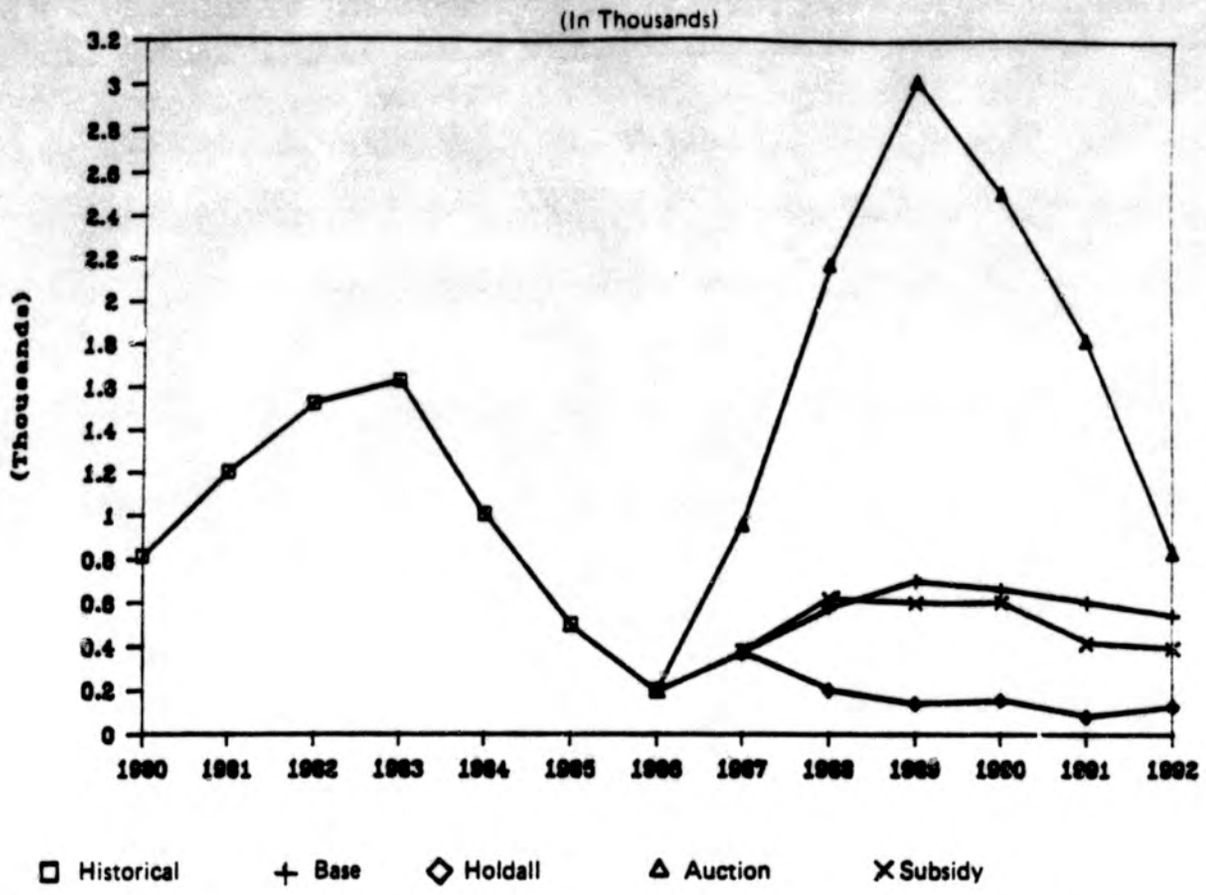


Figure 4.10 Historical and Projected Sales of Anchorage Single-Family Houses Under Three Cases, 1980-1992

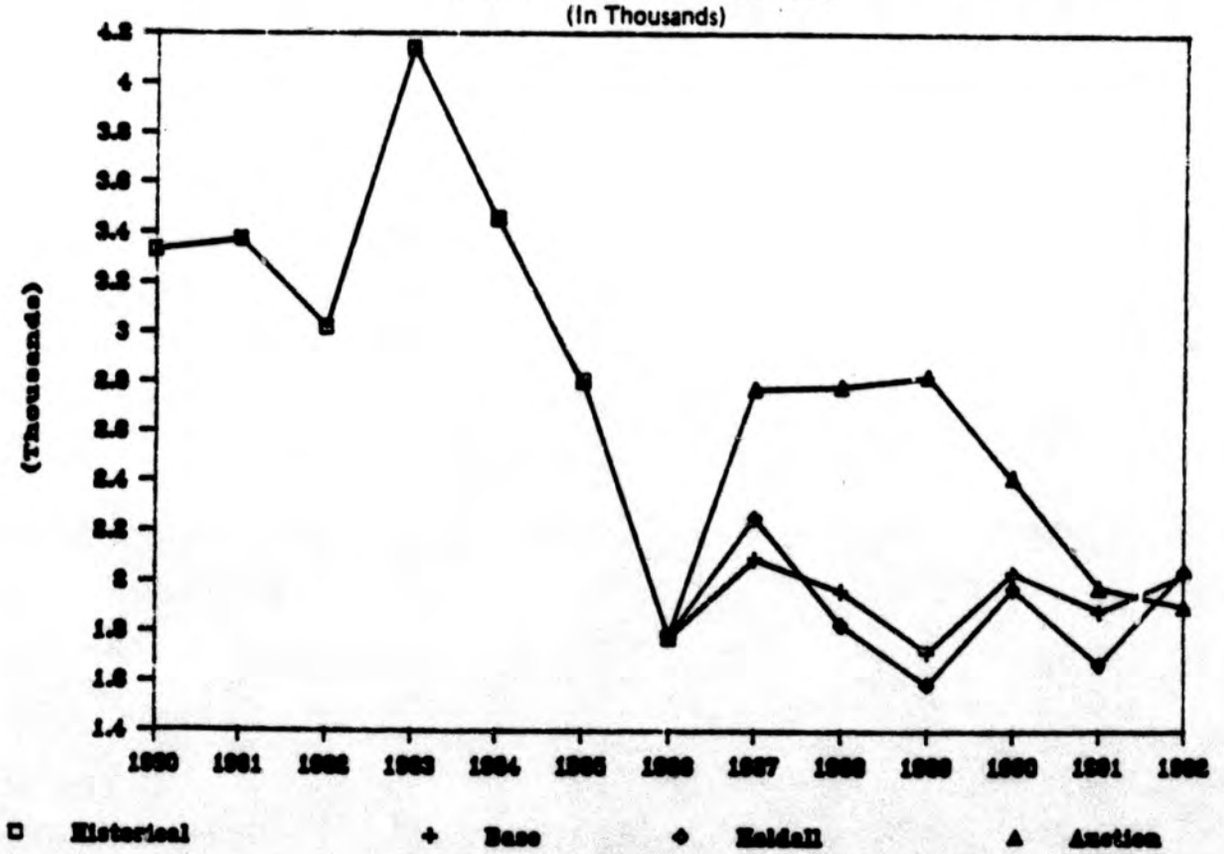


Figure 4.11 Projected Private and Institutional Sales, Anchorage Condominiums Under Four Cases, 1988 and 1992

(In Thousands)

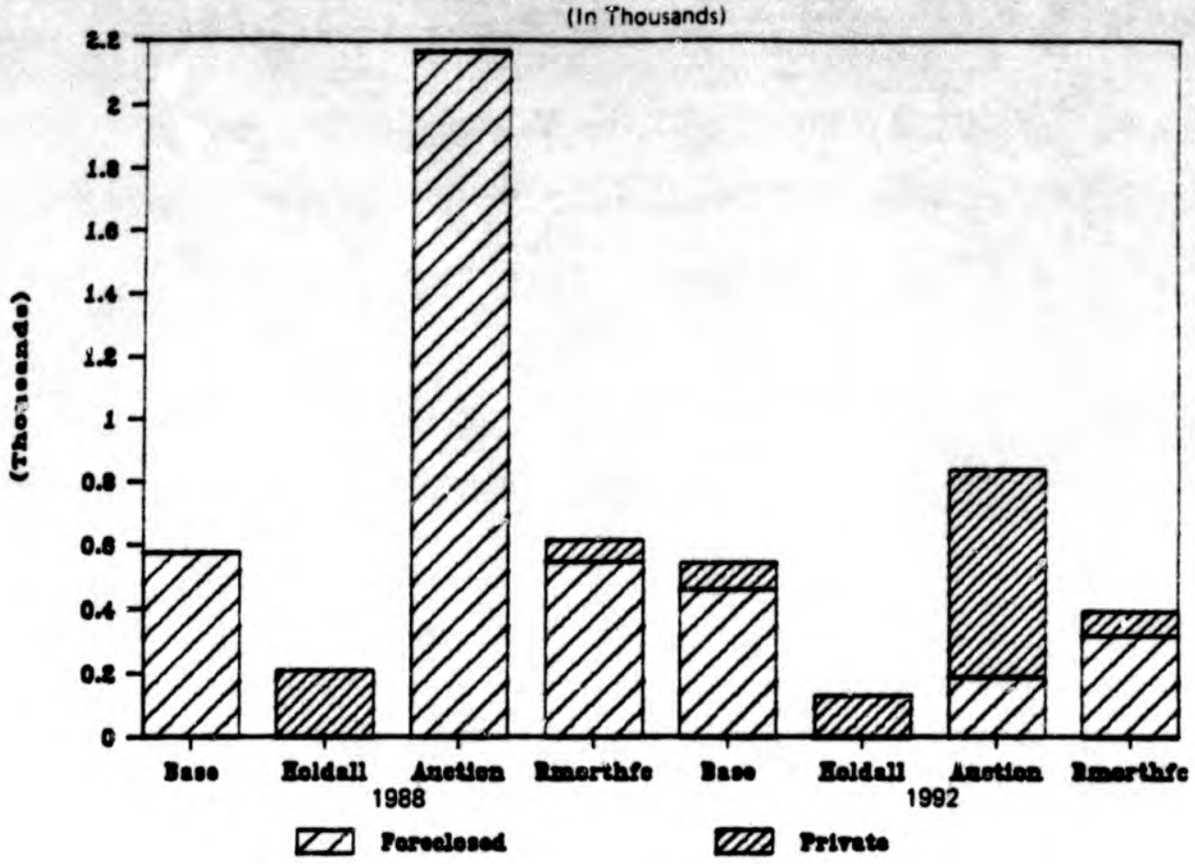
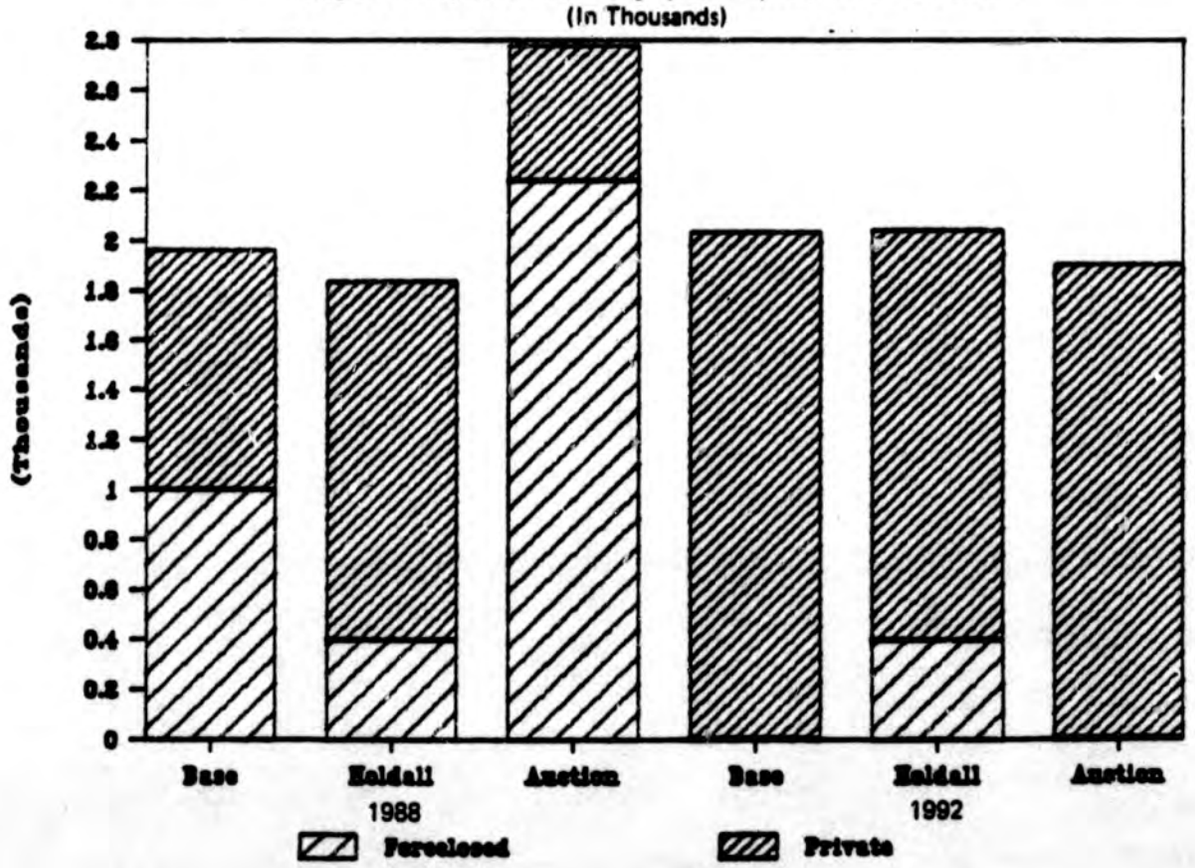


Figure 4.12 Projected Private and Institutional Sales, Anchorage Single-Family Houses, Under Three Cases, 1988 and 1992

(In Thousands)



market from 1988 through 1992, leaving the field open for private owners, private sales in the late 1980s would be substantially higher than if they were competing with institutional sellers--but still very low as compared with sales in the first half of the 1980s. Private owners would sell a projected 500 total units in 1987 and 1988 and roughly from 100 to 150 per year through 1992. By contrast, in the base case, private sellers would sell only a handful of condominiums in the whole five-year period.

Total sales of single-family houses are projected to be lower under this case than under the base case--because less than half as many foreclosed houses are sold--but private sellers have a bigger share of the market: at least 75 percent of sales in each year through 1992.

Auction Case Sales: Total sales under this case would be higher than under the base case, because lenders would be putting more units on the market--but private sellers of condominiums would be largely squeezed out of the market until 1992, when the inventory of foreclosed condominiums would be gone. Likewise, private owners would be able to sell few houses until 1990, when they would regain about half the market; by 1992 private sellers would have the whole market.

Notice that such very large hypothetical auction sales would put more condominiums on the market than were actually sold in Anchorage during the boom years of the early 1980s; as we noted in the section on prices, such large sales of condominiums could only be made at much lower prices.

Subsidy Case: Private sales of condominiums in Anchorage would be substantially higher under the subsidy than under the base case; between 1987 and 1992, cumulative private sales under the base case would be just 180 as compared with about 550 under the subsidy case. Figure 4.11 shows that in 1988 roughly 65 condominiums would be sold by private owners as compared with virtually none in the base case; by 1992 the number of private sales of condominiums would be about the same under the two cases.

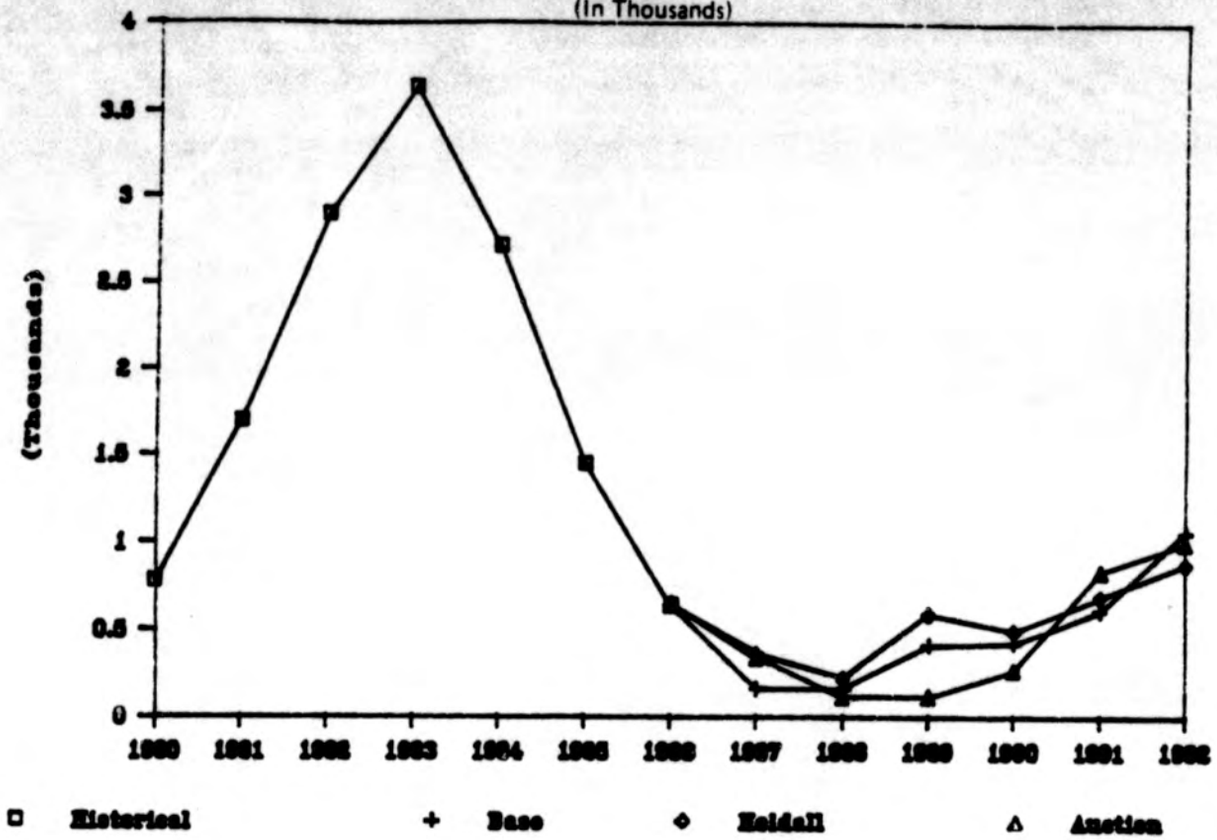
Limit Liability and Remove Case Sales: Limiting mortgage liability of sellers with negative equity and taking some condominiums out of the inventory of foreclosures would have relatively little effect on private sales of condominiums or single-family houses through 1992.

Policy Effects on Construction

We project that under any of the policy options, there will be very little construction of condominiums in Anchorage through 1992. This is true because under any of the options we examine, the existing supply of condominiums will meet expected demand. If the

Figure 4.13 Historical and Projected Building Permits, Anchorage Single-Family Houses, Under Three Cases, 1980-1992

(In Thousands)



economy grows faster than we anticipate, demand would be higher. Figure 4.13 shows historical numbers of building permits issued and projected numbers of permits for single-family houses in the Anchorage area under the various cases.

Base Case Construction: Under this case about 165 permits for new single-family houses would be issued in 1987 and about the same number in 1988. Numbers of permits would pick up sharply to around 400 in 1989 and build steadily to about 1,000 in 1992. By comparison, in the peak construction year of 1983, more than 3,500 new houses were built in Anchorage and in 1984 about 2,700.

Hold-All Case Construction: Under this policy, with fewer foreclosed units coming onto the market, total construction of new houses from 1987 through 1989 would be substantially higher than in the base case--with in the neighborhood of 1,200 new houses built over that three-year period--about 40 percent more than in the base case. But numbers of new units would still be small when compared with even 1985 totals, when more than 1,400 houses were built in one year.

Auction Case Construction: This policy would slightly reduce the number of new houses built from 1988 through 1990, because larger numbers of foreclosed houses would be on the market in those years. But after that, foreclosures sales would be smaller and more houses would be built.

Limit Liability and Remove Case Construction: Taking some condominiums out of the stock of foreclosures would have no effect on numbers of new single-family houses built throughout the period, and limiting mortgage liability of sellers with negative equity would have only a slight effect.

Policy Effects on Equity

Throughout this report we've talked about the problem of homeowners with negative equity--homeowners owing more on their properties than their market value. Figures 4.14 and 4.15 show the projected effects of the various policy cases on equity of condominium and house owners. We also include figures on historical levels of equity. (These are nominal equity figures--meaning they have not been adjusted for the effects of future inflation.)

Base Case Equity: In this case, the average equity of condominium owners in Anchorage would hit bottom in 1987 and 1988, when the average owner would owe $20 thousand more than his condominium was worth. Rising prices would begin increasing equity by 1989, but the average equity would not be positive until 1991. For owners of single-family houses the outlook is better: average equity of homeowners would hit a low in 1987, when homeowners on

Figure 4.14 Historical and Projected Average Equity of Anchorage Condominium Owners, Under Three Cases, 1980-1992
(In Thousands of Dollars)

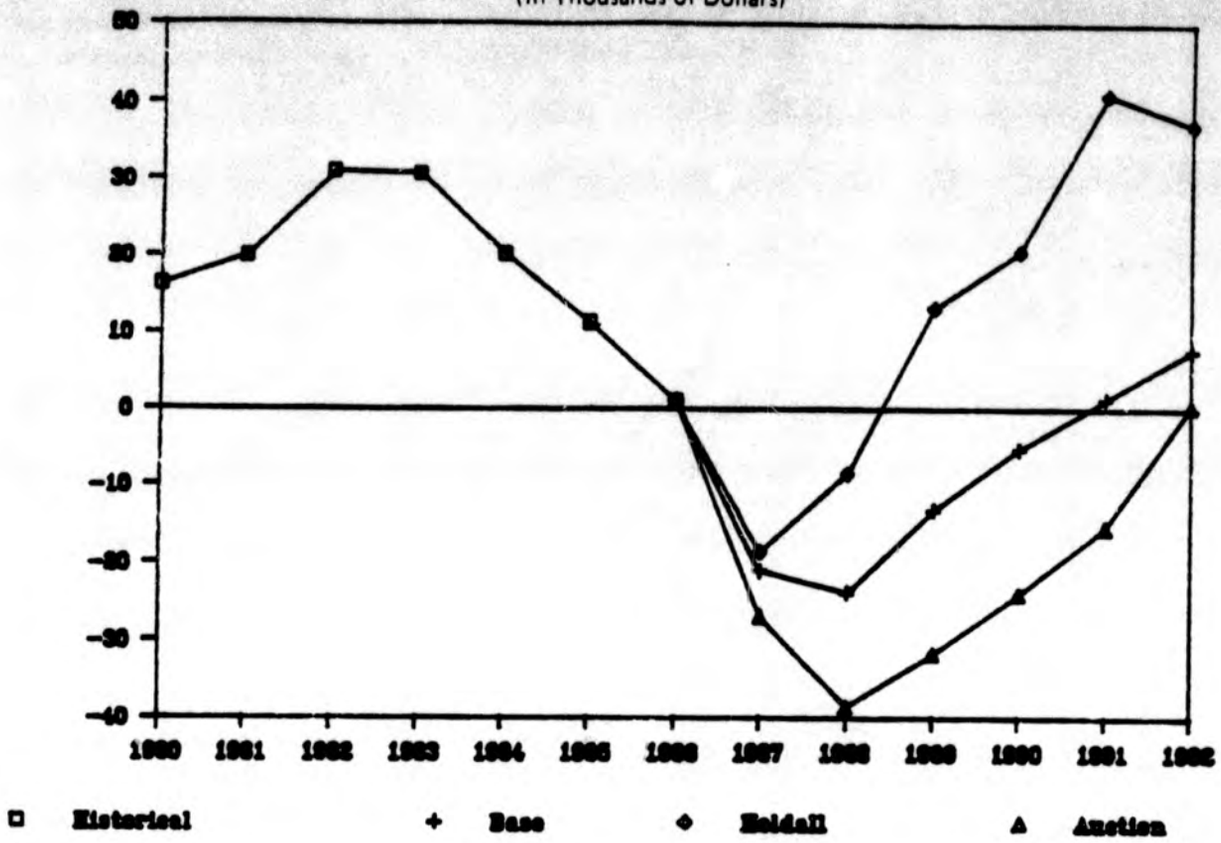
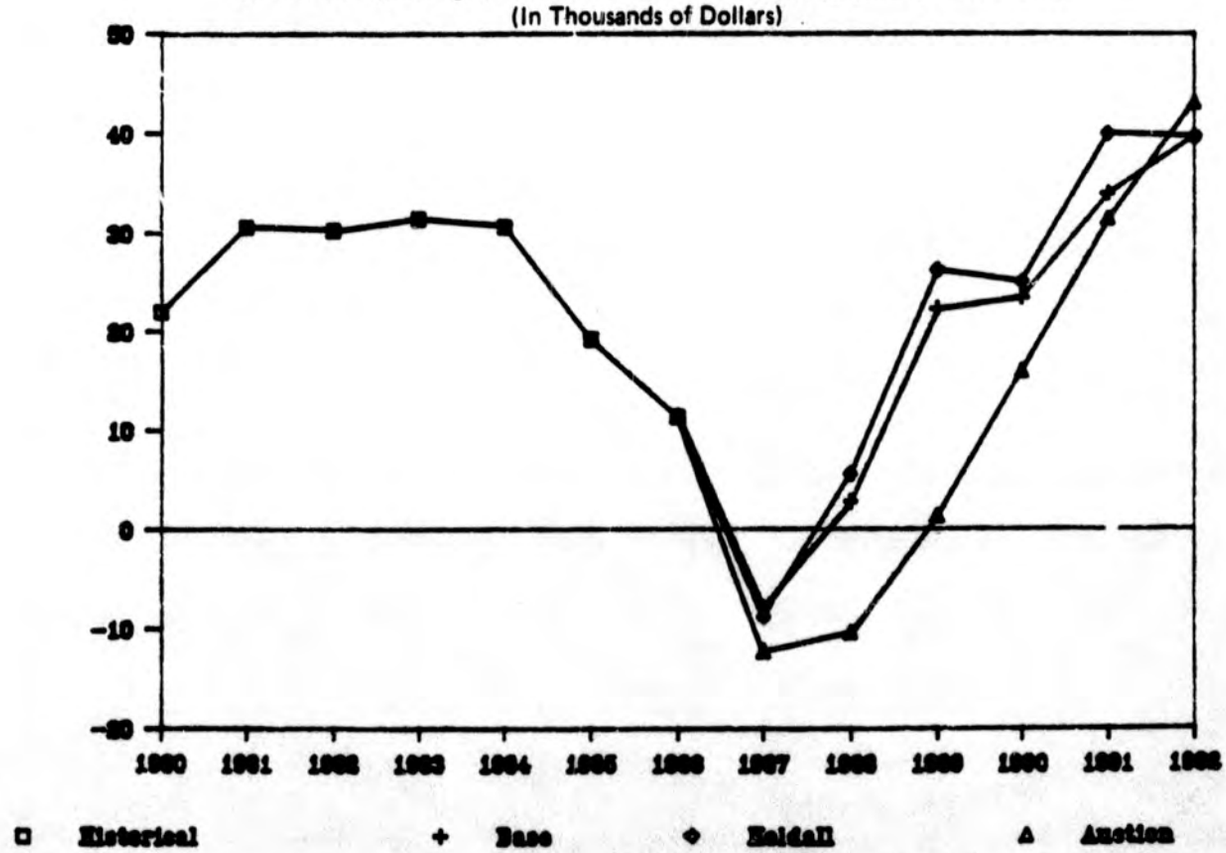


Figure 4.15 Historical and Projected Average Equity of Owners of Anchorage Single-Family Houses Under Three Cases, 1980-1992
(In Thousands of Dollars)



average would owe $7,000 more than their properties were worth. But in this case equity would begin improving in 1988, and would have reached more than $20,000 by 1989 and nearly $40,000 by 1992.

Auction Case Equity: Auctioning houses and condominiums off rapidly has a clear effect on equity of house owners and condominium owners alike, although the effect is larger on condominium owners: such sales would push equity much further into negative territory in the late 1980s. Average equity of condominium owners would drop to minus $38,000 in 1988; it would rebound very gradually, but would just be around zero by 1992. Homeowners would fare better: average equity of single-family houses would drop to around minus $12,000 in 1987, stay at roughly that level in 1988, and become just barely positive in 1989. After that it would rebound briskly, to reach around $40,000 by 1992.

Hold-All Case Equity: Under this policy condominium owners would see their average equity bottom out at minus $18 thousand in 1987 and be a positive $13 thousand by 1989--climbing upward to around $35 to $40 thousand by the early 1990s. This policy would improve equity of owners of single-family houses just slightly over what it is projected to be in the base case.

Limit Liability Case Equity: Allowing sellers to take market prices for their homes, even if their mortgages were larger, would help improve average equity, particularly for condominium owners, but the differences under this policy and under the base case are not large.

Subsidy Case: Subsidizing interest rates for condominiums would improve average equity of condominium owners slightly over base case levels; by 1992 average equity under the subsidy case would be roughly $13 thousand as compared with $8 thousand under the base case.

Remove Case Equity: Taking some condominiums out of the foreclosed inventory in the late 1980s would help improve average equity of all condominium owners somewhat but not a great deal over projected base case levels. It would have no effect on equity of those who own houses.

Policy Effects on Rental Rates

We project that none of the policy options we assess here would have significantly different effects on rental rates in Anchorage over the next few years. What will have a substantial effect--and what will likely keep real rents below their 1986 levels throughout the period--is the fact that the existing supply of multi-family housing will probably exceed the projected demand through 1992.

Figure 4.16 Projected Anchorage Real Rent Index
1987-1992
(1986 = 100)

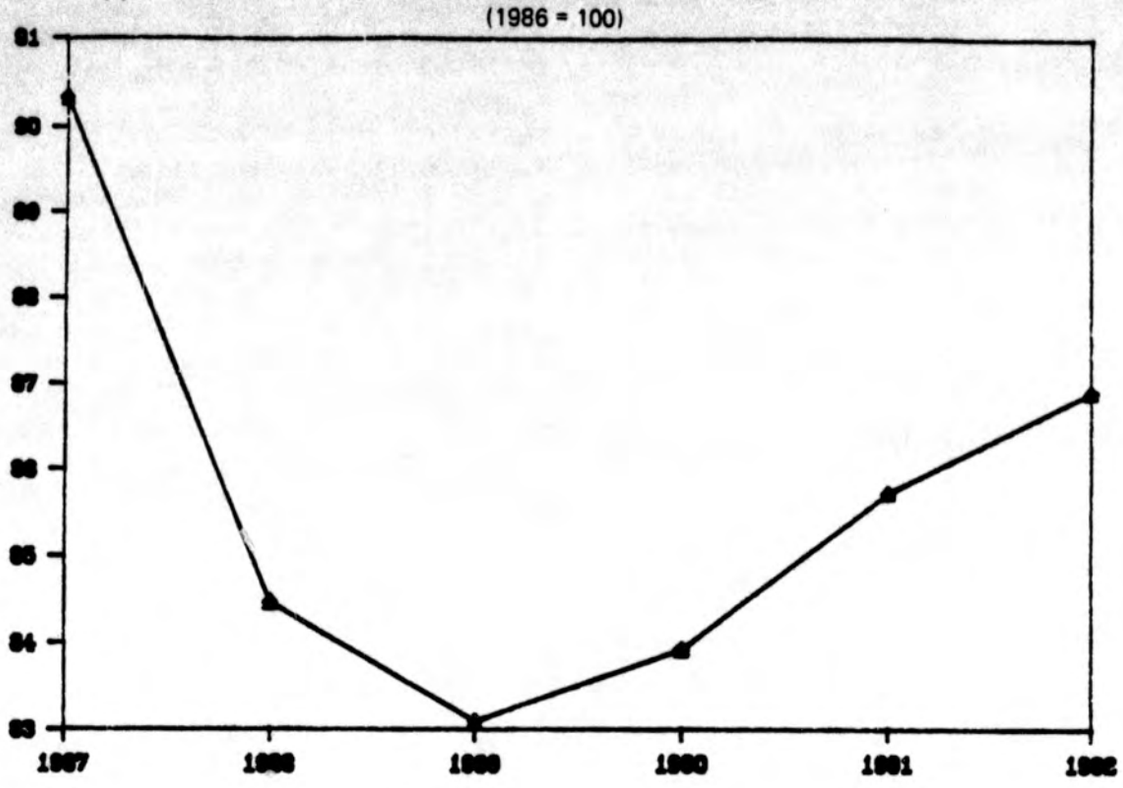


Figure 4.16 shows a projected real rent index through 1992. This is an index that measures real rents in Anchorage--rents adjusted for inflation--with 1986 rents as a base. Under any of the policies we examined, rents would bottom out at about 83 percent of the 1986 level in 1989 and then begin a very slow rise--but by 1992 they would still be (once adjusted for inflation) just 87 percent of their 1986 levels. If the economy grows faster than we project under our base case in Chapter II, rents would rise faster.

Summary of Policy Effects

Overall what our housing market model tells us is straightforward: if lenders sold large numbers of foreclosed condominiums very quickly over the next few years, prices would drop substantially, defaults would remain high, foreclosures would continue to beset the market, equity of the average condominium owner would be pushed further into negative territory, and prices would be slow to recover.

The same general findings also apply to rapid sales of foreclosed houses, but house prices and equity would not be depressed nearly so much as would condominium prices and equity--because the demand for houses in Anchorage is greater. And house prices would recover and exceed their historic highs much more quickly than would condominium prices.

How much difference might different policies for re-sale of foreclosed properties make in average prices over the next several years? Our model projects the extreme cases for condominiums--selling none and selling all quickly. We project that 1988 average prices for a standard condominium, for instance, could go as low as $58 thousand or as high as $87 thousand--a difference of 50 percent. Condominium prices in 1988 under a more moderate rate of sale (our base case) could be 20 percent higher than under the case where condominiums are auctioned rapidly. Again, the dollar values we refer to are less important than relative price levels.

The potential range of house prices under the various cases is much smaller; for example, 1988 prices under the case where houses are sold most quickly could be about 15 percent below prices in the case where houses are sold much more slowly. Still, 15 percent is a significant difference.

But what about the longer-term effects of getting rid of the inventory of foreclosures quickly? Might prices in the 1990s rebound faster if the inventory of foreclosures were cleared faster? Our model runs indicate that very fast sales of foreclosed condominiums would depress prices well into the 1990s; real

prices--prices adjusted for inflation--in 1992 would still be about 5 percent below projected base case prices. At the other extreme, keeping all foreclosed condominiums off the market would boost real prices by 35 percent between 1987 and 1992.

For single-family houses the story is different. Rapid clearing of foreclosed properties would depress prices in the late 1980s, but by 1992 prices would be as high or higher than they would have been if the houses had been sold more slowly. House prices would recover faster because the demand for single-family houses over the next several years will exceed the existing stock--unlike the case with condominiums.

Quick sales of large numbers of condominiums would also substantially increase defaults in the short run--increasing rather than decreasing the inventory of foreclosures. As we showed in Figure 4.6, auctioning thousands of condominiums could actually make the inventory of foreclosed condominiums bigger by the end of 1988 than it would be under any of the other options we examined. But by 1992 the inventory would have been eliminated by quick sales--while under the more moderate rate of sale assumed in the base case there might still be 1,000 foreclosed condominiums in 1992.

Subsidizing mortgage interest rates for condominiums would sharply reduce defaults, as would limiting mortgage liability of homeowners who are forced to sell and find that their houses are worth less than what they owe on them. As Figure 4.6 shows, the projected inventory of foreclosed condominiums would be much smaller in 1988 and 1992 under either the limit liability or the subsidy cases than under the base case.

Many homeowners in Anchorage today do owe more on their properties than they can be sold for. Our model projections show that quick sales of condominiums and houses--but particularly of condominiums--would push prices and therefore average equity of homeowners even lower. Under all the cases we examined, average equity of condominium owners in Anchorage would be negative in 1988--but the negative numbers could be nearly twice as large (minus $38 thousand as compared with minus $20 thousand) if lenders auctioned off condominiums rapidly. And prices and equity would be very slow to recover after large-scale auctions: equity would barely move out of negative territory by 1992. Average equity for those who own houses would not go nearly as low and would improve much faster after 1990--under all the options we examined, average equity among house owners could be as much as $40 thousand by 1992.

How will private property owners fare in the market place against the big institutional owners of foreclosed properties over the next few years? Under all policy options we examined except the case where all foreclosed condominiums are kept off the market,

private owners trying to sell condominiums in Anchorage through 1992 will find few opportunities: they will be hard-pressed to compete against the prices and the incentives the big lenders will be able to offer in a market with limited demand and an ample supply.

Private owners of single-family houses will fare better; under slow or moderate sales of foreclosed houses, private sellers would be able to capture half or more of the sales market in the late 1980s and more in the early 1990s.

We expect little construction of multi-family housing in Anchorage over the next five years--under any policy option--because we think the existing stock will meet the likely demand. Some new single-family houses will be built over the next few years, but not nearly as many as were built during the early 1980s. For example, the base case projects that in the neighborhood of 2,700 new single-family houses might be built in Anchorage between now and 1992--about the same number as were built in Anchorage in 1984 alone.

Another effect of the ample supply of multi-family housing will be to keep down rents in Anchorage over the next several years. Our real rent index--an index adjusted for inflation and keyed to 1986 rents--projects that real rents by 1992 will be about 10 percent below 1986 levels. Faster economic growth than we expect would push rents up faster.

Policy Considerations

We've seen that the thorniest problem for lenders and insurers is their inventory of foreclosed condominiums. The market for single-family houses has not been depressed as much, and we expect it to recover much faster. We know that Alaska lenders are not going to keep the condominiums they own off the market for years. We know that it costs lenders and insurers in the neighborhood of $20 a day in holding costs for each unit they own. We know it is not reasonable to propose a policy that leaves AHFC and other lenders sitting on hundreds of vacant properties so that other property owners can enjoy higher prices. We know that in Anchorage today some lenders want to get rid of foreclosed properties even if they have to take very substantial losses on re-sales. Lenders and insurers are offering prizes, reduced down payments, lower interest rates, and more to lure buyers.

Our policy case that looks at the effects of keeping all the foreclosed condominiums off the market is intended not as a policy proposal but as an illustration of the powerful effects foreclosure sales will have on the Anchorage market in the next few years. The case at the other extreme--in which we assume lenders auction off their thousands of properties at the cost of much lower prices--also

illustrates that power. That case not only shows that lenders have the power to push prices further down but that they could in the process bring even more foreclosures into their inventories.

In reality of course lenders don't just pick some fixed number of units to sell, without regard to market conditions. Demand ultimately determines how many properties lenders can sell, particularly if they attempt to maintain some price floor. The economic forecasts in Chapter II say that after mid-1988 the recession will likely end and an economic recovery begin. Figures 4.17 through 4.19 show how reducing the number of condominiums sold in the short run--from now through 1988--would change prices, equity, and inventories of foreclosed condominiums from base case levels. After 1988 numbers of units sold would be the same as under the base case. What these figures show is that this short-run change in selling policies (labeled the "sell fewer" case in the figures) would prop up prices and equity for the balance of the recession and that in the longer run inventories of foreclosed units would be at roughly the same level--because selling fewer units through 1988 would reduce defaults.

Lenders in a down market face many costs. Figures 4.20 through 4.22 compare some of those kinds of costs. The relationship between numbers of foreclosed condominiums sold and real average prices of standard condominiums in 1988 and 1989 is shown in Figures 4.20 and 4.21. With price and sales figures from the six policy cases analyzed earlier, we plotted the relationship between the two. As the figures show, high sales are linked with lower prices, low sales with higher prices, and moderate sales with prices between the extremes. At the extremes, prices vary by more than 50 percent and numbers of units sold by more than 2,000.

Figure 4.22 weighs estimated costs of holding a single foreclosed condominium against projected average price increases under the base and the auction cases. We assume that the hypothetical condominium in this figure was taken under foreclosure at the start of 1987, so that holding costs accrued all year. The bottom line on each half of the figure represents holding costs, estimated at $7 thousand per year for each year the lender holds the unit. The top line is the average price for a standard condominium, with 1986 prices as a benchmark--so for example in 1987, the average condominium price under the base case was about $20 thousand below 1986 prices. The third line is the sum of the first two, and where the holding cost line and the third line cross is the point at which prices have risen enough to offset holding costs.

The figure shows a grim picture for the lenders. Under either case, 1987 prices are tens of thousands of dollars below 1986 prices--so lenders begin with a substantial loss. On top of that loss are holding costs estimated at $7 thousand per year for this single condominium. Prices are slow to recover in either case: in

Figure 4.17 Real Prices, Anchorage Condominiums
Under Two Cases, 1988 and 1992
(In Thousands of 1986 Dollars)

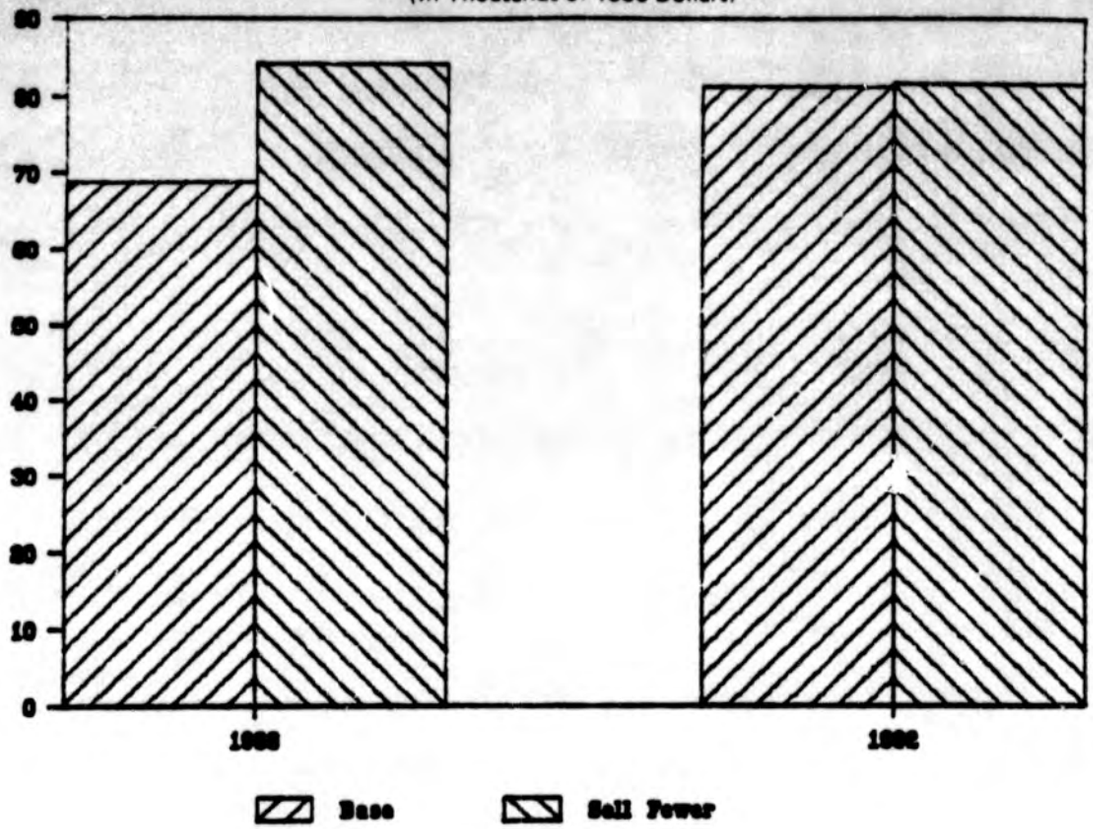


Figure 4.18 Average Equity, Anchorage Condominiums,
Under Two Cases, 1988 and 1992
(In Thousands of Dollars)

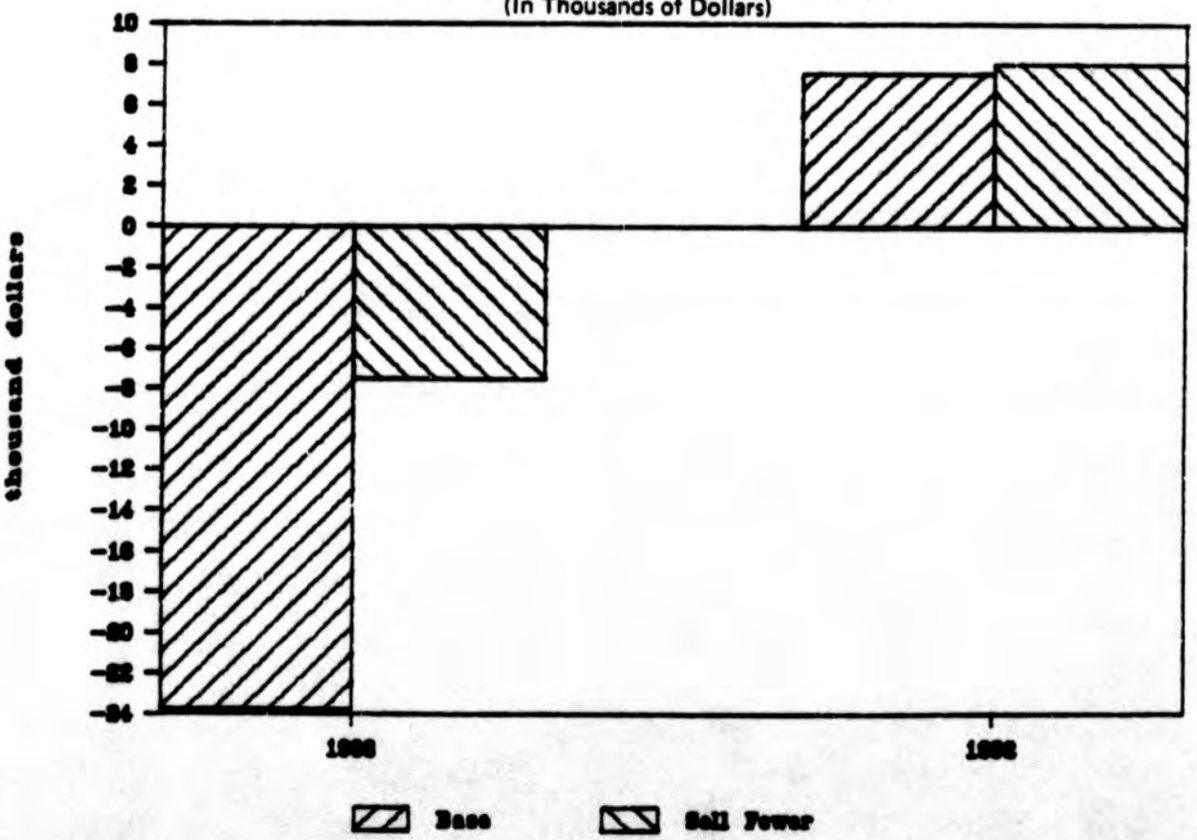
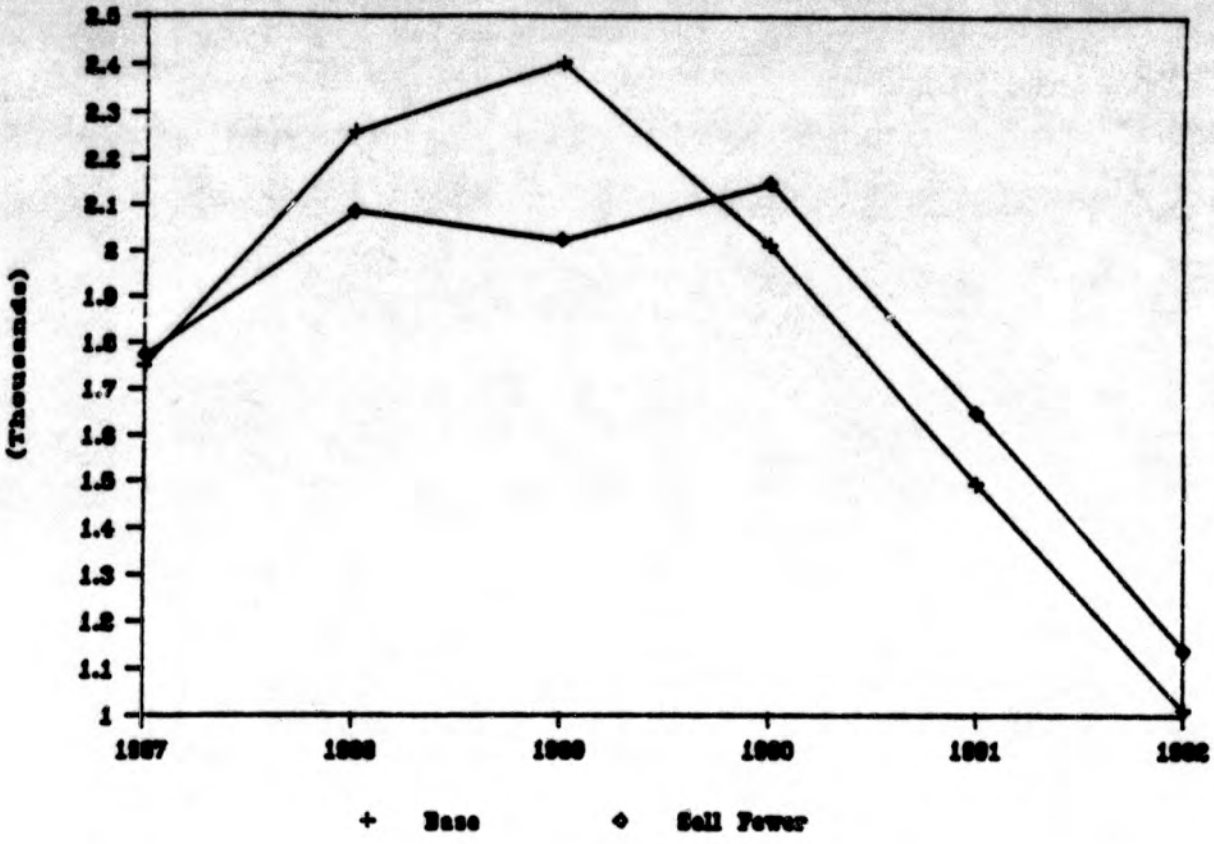


Figure 4.19 Inventory of Foreclosed Anchorage Condominiums
Under Two Cases, 1987-1992



the base case prices exceed 1986 levels by 1991 and under the auction case prices just regain their 1986 level by 1992. Holding costs increase $7 thousand every year the condominium goes unsold. Prices rise enough to offset holding costs by 1991 under the base case and by 1992 under the auction case.

In either case lenders face significant losses--but those losses are even larger under the auction case, because prices are more depressed. For example, a lender could see losses (as measured by combined price declines and holding costs) in the neighborhood of $50 thousand on this hypothetical condominium in 1988 under the auction case, as compared with losses of about $28 thousand under the base case. The figure tells us that lenders are in a tough spot in any case, but that their losses can be made even worse if they auction large numbers of condominiums.

Another policy option that we assessed with the model was simply demolishing a portion of the inventory of foreclosed condominiums. We assessed the effects of taking 1,200 condominiums out of the inventory over a three-year period, and found that removing that many units from the stock would of course reduce the inventory faster and would modestly improve prices and other measures of market stability. At the extreme, the effects of demolishing all foreclosed condominiums would be the same as we projected in the case where all condominiums are kept off the market through 1992.

Demolishing condominiums would be very costly in a number of ways, and we are not advocating it. But all options in a depressed housing market are costly, including costs of holding onto condominiums that may be very difficult to sell at any price--and which, if sold at very low prices, could create a vicious circle of more foreclosures by putting more owners at risk of default. We are advocating that lenders carefully consider the overall costs and benefits of any policy they undertake.

Another measure we looked at for reducing defaults and increasing demand was limiting mortgage liability of homeowners who are forced to sell at prices below their outstanding mortgages, or who would like to take advantage of lower prices to move into better houses but are constrained by negative equity on their current houses. We found that limiting mortgage liability for those with negative equity would sharply reduce the future number of defaults. However, our limit liability case represents the extreme: it reports how defaults could be reduced if lenders' limited mortgage liability of all would-be sellers with negative equity to the market values of their properties. In reality, lenders would not offer such blanket limits on liability--they would establish critieria for determining when and how to limit mortgage liability. In the <u>General Policy Options</u> section we discussed some of the possible ways lenders could limit mortgage liability, and the costs and benefits of those methods.

Figure 4.20 Relationship Between Real Prices and Sales of Foreclosed Condominiums, 1988
(In Thousands of 1986 Dollars and Thousands of Units)

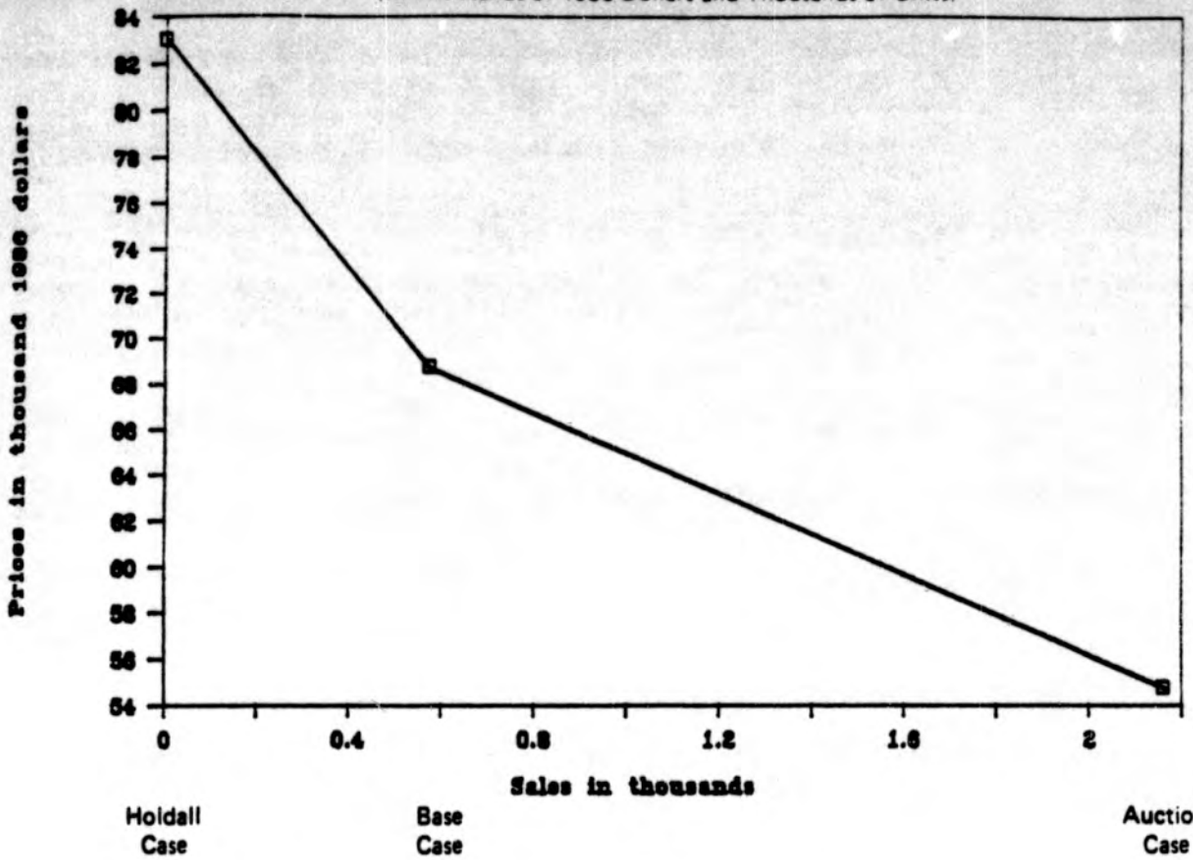


Figure 4.21 Relationship Between Real Prices and Sales of Foreclosed Condominiums, 1989
(In Thousands of 1986 Dollars and Thousands of Units)

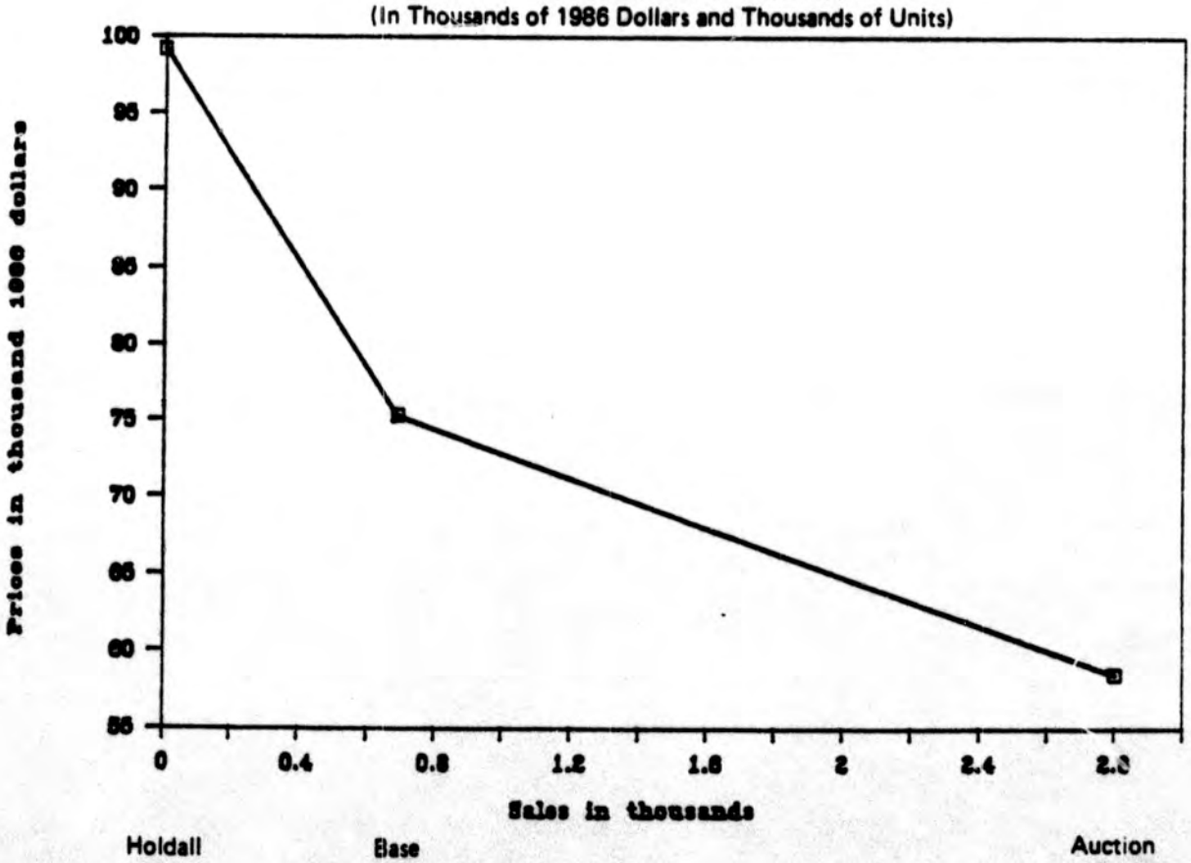
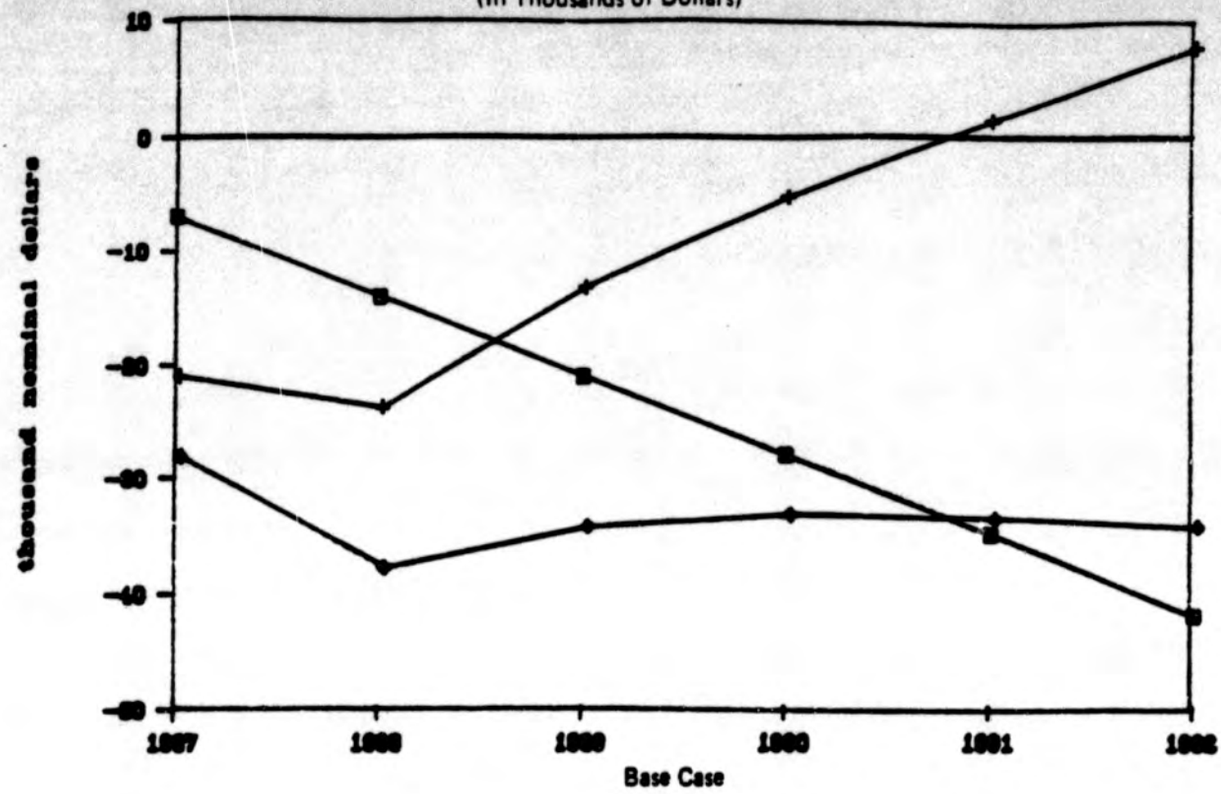
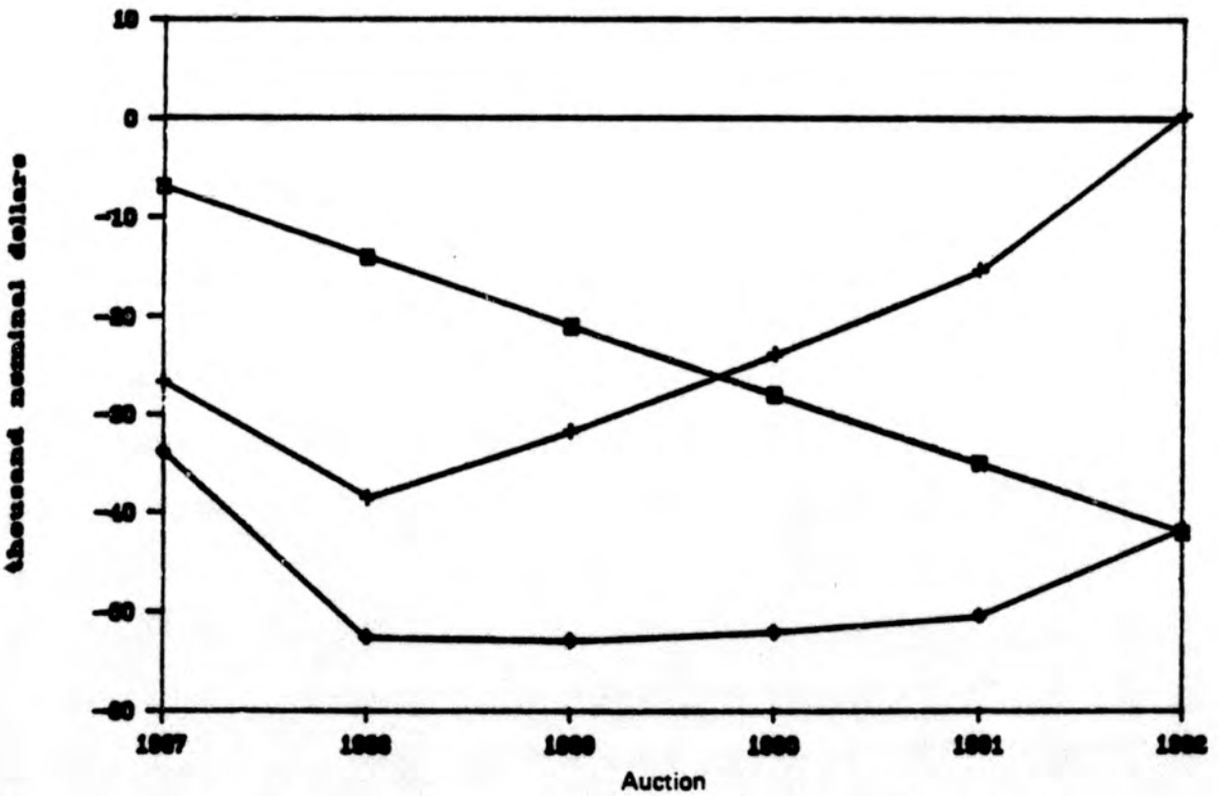


Figure 4.22 Relative Price Changes and Holding Costs
for One Condominium, Under Two Cases
(In Thousands of Dollars)





□ Holding Costs + Price Changes ◇ Net Benefits

Our policy analyses also showed that subsidizing mortgage interest rates on condominiums could help that market in several ways: it would help improve prices and average equity, it would help private owners sell more condominiums (although sales by institutional owners would still dominate the market), and it would help reduce defaults. Subsidizing interest rates would of course be an additional cost to lenders; lenders would need to weigh the benefits of such subsidies against the costs.

Faster or Slower Economic Growth

All our policy analyses assume the moderate rate of economic growth projected in the base case of Chapter II. The economy may grow more or less than we expect in the next few years. Such faster or slower economic growth would of course also affect the housing market. Figures 4.23 though 4.26 show how some aspects of the Anchorage house market would be affected if the economy grew at the rates projected under the high and the low cases in Chapter II.

Real prices--prices in 1986 dollars--for Anchorage condominiums and single-family houses under the low, base, and high cases through 1992 are shown in Figures 4.23 and 4.24. (These cases assume the same rate of sales of foreclosed houses and condominiums as in the base case; only rates of economic activity are different.) Real average condominium prices could vary by as much as 25 percent between the high and the low cases in 1989 and remain nearly 20 percent apart by 1992.

Real average prices for single family houses would also vary under the three cases, but not so dramatically as would condominium prices. For instance, the difference between prices in the high and low case would be greatest in 1991, but the difference would be less than 10 percent. The very slow economic growth projected under the low case would be harder on condominium owners than on house owners.

Figure 4.25 shows another measure of housing market activity under the three case: projected numbers of building permits for new single-family houses. The figure compares the cumulative projected number of building permits from 1987 through 1992 under the high, medium, and low cases. Projected permits under the high case would be in the neighborhood of 3,400, under the base case roughly 2,800 and under the low case just over 2,000. Looked at another way, the number of building permits for new houses in Anchorage could be about 70 percent larger under the high case than under the low.

Still another measure of housing market activity is sales; Figure 4.26 shows cumulative projected private and foreclosure sales from 1987 through 1992 under the high, medium, and low cases. The number of foreclosure sales depends on how many homeowners default

Figure 4.23 Real Prices, Anchorage Condominiums, Under Three Cases
(In Thousands of 1986 Dollars)

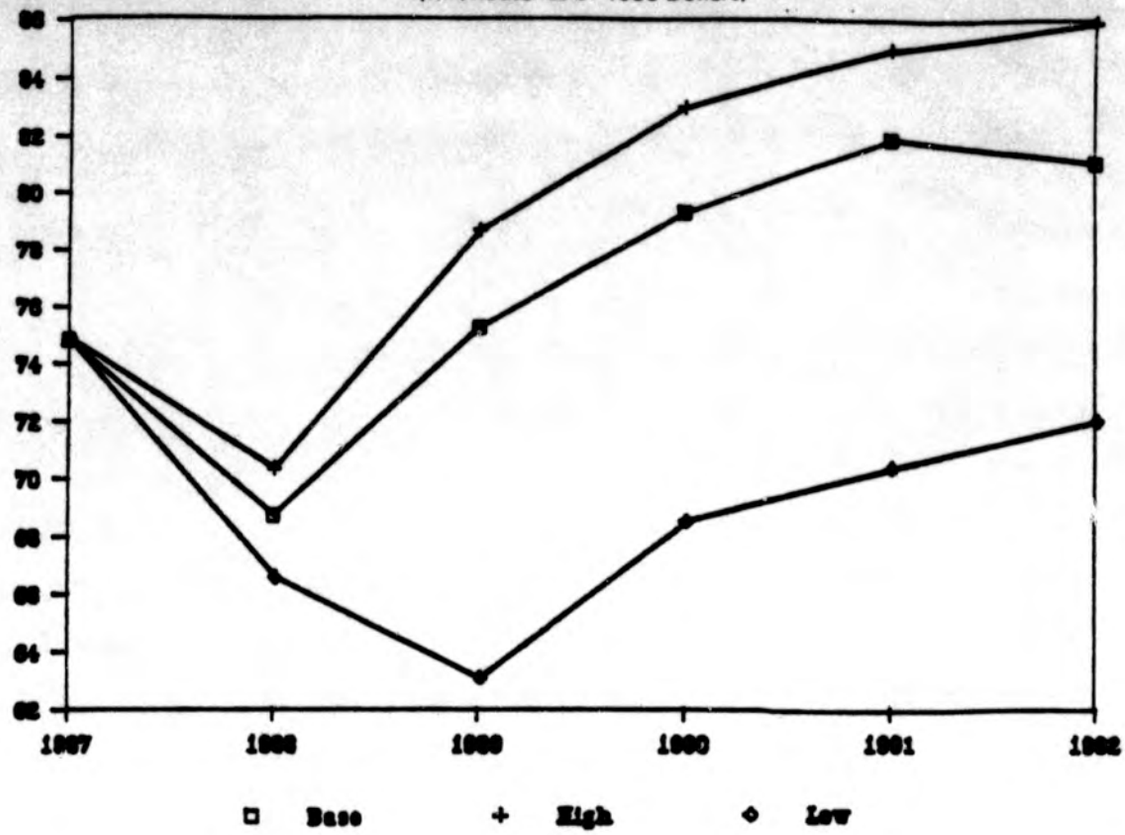


Figure 4.24 Real Prices, Anchorage Single-Family Houses, Under Three Cases
(In Thousands of 1986 Dollars)

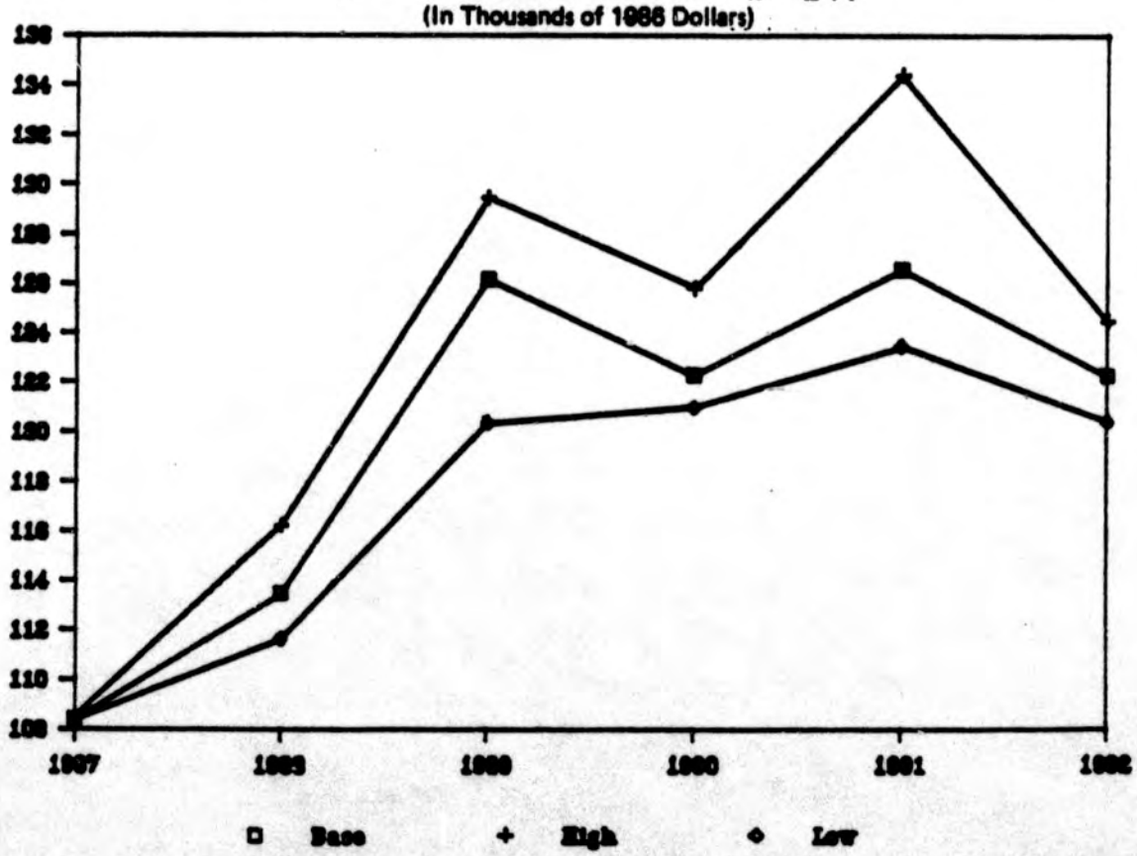


Figure 4.25 Projected Cumulative Building Permits for Anchorage Single-Family Houses, Under Three Cases
(In Thousands)

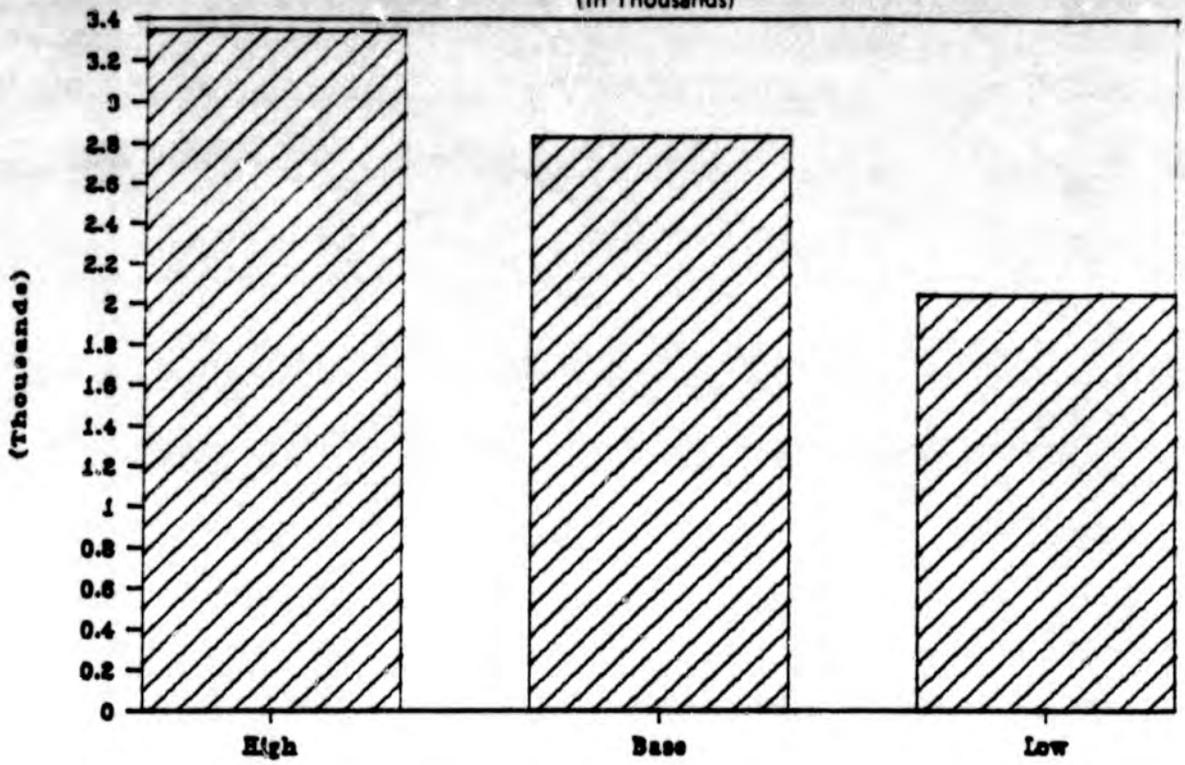
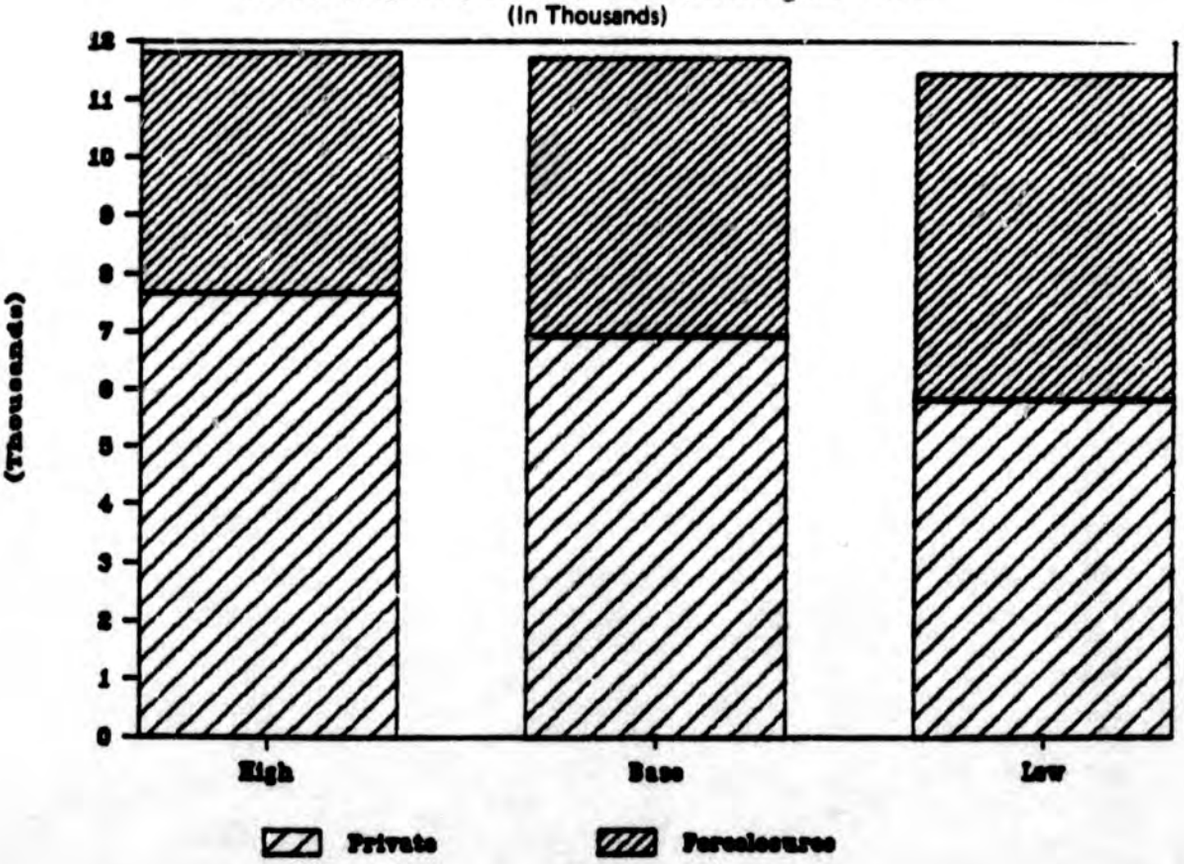


Figure 4.26 Projected Private and Foreclosure Sales of Anchorage Single-Family Houses, Under Three Cases
(In Thousands)



on their mortgages; the high case projects fewer foreclosure sales because under better economic conditions fewer homeowners would default. In all the cases foreclosure sales are projected to make up a significant share of total sales, but under the poorer economic conditions in the low case they would make up more than half of total house sales from 1987 through 1992. Better economic conditions would improve the sales market for private sellers--private owners would be able to sell about 30 percent more houses under the high than under the low case.

Other indications of how the housing market would respond if the economy grows faster than we expect can be found in earlier ISER reports that assessed the effects of AHFC programs during the housing market boom of the early 1980s. (The Effects of Changes in the Alaska Housing Finance Corporation Mortgage Programs, Interim and Final Reports, 1986.)

STATE OF ALASKA

STEVE COWPER, GOVERNOR

DEPARTMENT OF REVENUE

OFFICE OF THE COMMISSIONER

P.O. BOX S
JUNEAU, ALASKA 99811-0400
PHONE: (907) 465-2300

February 19, 1988

The Honorable Max F. Gruenberg, Jr.
Chairman, Joint Committee on Economic Recovery
Alaska State Legislature
P.O. Box V
Juneau, AK 99811

Dear Representative Gruenberg:

At the meeting of the Joint Economic Recovery Committee Thursday February 18, you asked whether I believed the legislature should consider social responsibilities as opposed to only considering what to do about the contraction that has occurred in the Alaska economy.

My answer was that I thought of the word "economic" as encompassing both the financial issues and the social and political issues.

I realize that may have been a confusing answer. Perhaps this will make it more clear.

State spending was the driving force behind the recent "oil boom." If we had spent at lower levels, and had much more moderate growth, then the adjustment would have been much easier. Hundreds of condos would not have been built, and would not stand empty today.

As pointed out by Erickson, and other economists, letting the real estate decline (or market correction) settle out will result in lower costs, and a quick growth rate because of that.

If the state intervenes, we will bias normal investment decisions, and make private dollars less productive than they otherwise would be. Economic recovery will be slowed, and the uncertainty and hardship will be prolonged. (Of course, if we could return spending to the per capita level of a few years ago, and keep it there, we will still be in fat city. But we can not - although we can squander our limited revenue).

Therefore, I think the most socially, politically responsible, and useful, thing we can do is to let the market correct itself.

04-02LH

Intervening is not social responsibility. At best, it is tinkering. At worst, it will waste what money we have and create an enormous sense of unfairness. I am not suggesting we let anyone starve, or freeze in the dark. I am suggesting we foster a private economy.

Sincerely,

Hugh Malone
Commissioner of Revenue

HM:mll
88-46

cc: Members, Joint Committee on Economic Recovery

A. overviews

Comment Draft 2/18/88

Comments should be addressed to: Gregg Erickson, senior economist, Division of Policy, P.O. Box AD, Juneau, AK 99811-0164 phone (907) 465-3568

The Recession, The Real Estate Crash, and Alaska's Economic Prospects

Introduction

Many Alaskans have been surprised by the severity of the current recession, and the speed with which it engulfed the state's economy. The collapse of the real estate market has been a shock, particularly in Anchorage. As long as anyone there can remember, investment in Anchorage real estate has been about as sure a thing as one could hope to find in this uncertain world. Granted, there have been ups and downs, but Anchorage real estate always held its value when the economy was doing poorly. When the economy was expanding -- during the Korean War, again after statehood, after the $900 million North Slope lease sale in 1969, during the pipeline boom, and in the biggest boom of all in the early 1980s -- an investor could achieve extraordinary returns. In the intervals when the economy was stagnant, a real estate investor in Anchorage felt protected. "You never sold a piece of property for less than you paid for it," recalls John Rader, Anchorage lawyer and investor whose experience in Anchorage dates to the early 1950s. "It was almost a religious statement."

The benefits of real estate appreciation weren't just restricted to the very rich. Anyone wealthy enough to buy a home was able to play the game. The more a family borrowed to buy a home and the less of their own cash they used in the purchase, the faster their home equity would compound. Over the years, ordinary folks and major investors alike came to believe that there some rules of investing were better ignored. In Alaska, it always paid to be highly leveraged. In Alaska, the more an individual borrowed, the more an individual stood to make. And in Anchorage, one would never need to sell a piece of real estate for less than one paid for it.

No single event swept away this folklore, but it vanished nonetheless. In January 1986 Anchorage taxable real estate had an assessed value of $13.9 billion, up 38 percent from two years earlier. In January 1988 municipal assessors estimated it at $8.3 billion, down 41 percent in two years. Because a half billion in new construction was added to the tax rolls over the '86-'88

period, the average property in Anchorage took an even bigger beating.

This kind of collapse would spell trauma in any community, but because of Anchorage's demographics, growth pattern, and the policies of an activist state government, the distress has touched an especially large number of households. Anchorage's population is relatively young, and the town has been growing fast. In any other state most of the young families that dominate Anchorage's demographics would still be renting; a crash in real estate values would then be to their advantage since it would mean falling rents. In Alaska, though, the state has actively encouraged home ownership by providing mortgage credit at subsidized rates. The booming market made it look foolish not to participate, and in Anchorage about 29,000 households now owe about $2.5 billion on subsidized residential mortgages.

According to Anchorage real estate broker Brooke Marston, these subsidized mortgages are now virtually all "underwater," e.g., the principal owed on the mortgage exceeds the market value of the home. The average family's equity in its home is one of its major repositories of savings. In Alaska, for most urban households, the value of that asset has been erased or become a net liability. The probability is that many now have negative net worth.

The purpose of this analysis is to examine these painful events in the broader context of Alaska's overall economic performance, addressing five questions: What caused the recession? When will it end? What sort of recovery can we expect? How will the real estate crash affect the recovery? And what are the economic policy options for state government?

The Inevitable Recession

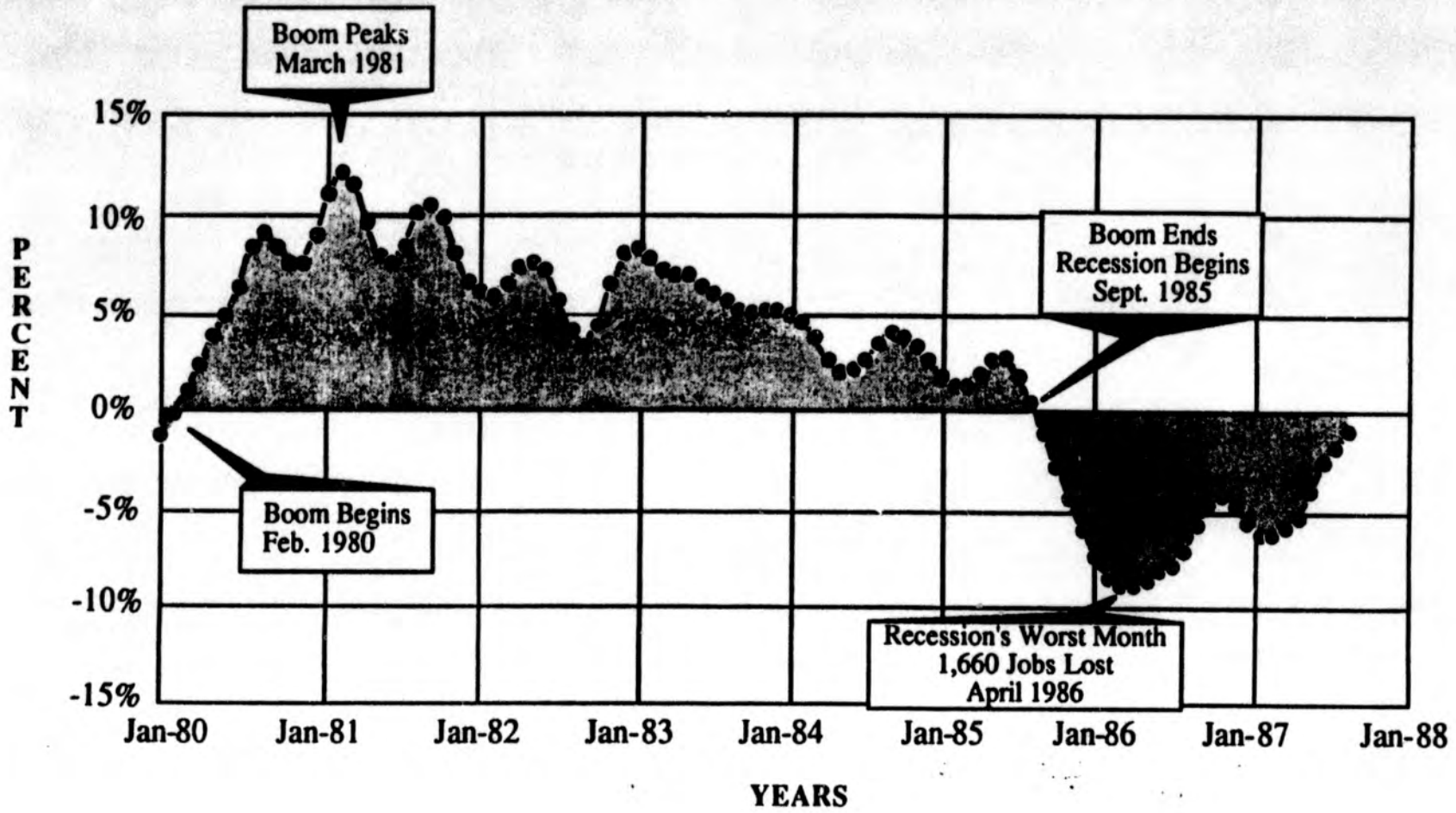
Alaska's recession had its roots in the extraordinary boom that began in early 1980s. ***When the state government doubled its real per capita spending between 1980-81, a recession became virtually inevitable***. Using the rate of job creation and job loss (shown in Figure 1) as his yardstick, Scott Goldsmith, economics professor at the University of Alaska's Institute of Social and Economic Research, measures the peak of the boom in early 1981, when jobs were being added at the phenomenal 12 percent annual rate.[1] The rate tapered off slowly after that, but since growth was still occurring the economy continued to get bigger. The economy stopped growing in September 1985, which is the date ISER's Goldsmith identifies as the beginning of the recession. The first phase of the recession was exceptionally sharp, but it was also short: the economy hit bottom in April 1986, just 6 months after the recession started; at that point

[1] Economists who keep track of the business cycle on a national basis generally define a recession as two consecutive quarters of falling gross national product. Because figures for gross *regional* product are more difficult to determine, regional economists generally use falling employment as their measure. Economists recognize that there is much more to the evaluation of economic performance than is told by either GNP or employment.

Figure 1

Rates of Growth and Decline in Alaska Employment

Seasonally Adjusted Annual Rate



Source: Scott Goldsmith, ISER

Office of the Governor
Division of Policy
2/8/88

jobs were being lost at an 8.5 percent annual rate. Thereafter things improved, with the data from late 1987 showing jobs being lost at a 1 percent annual rate.[2]

The Alaska recession has not been typical. Regional recessions usually result from regional specialization, as in the manufacture of airplanes or the production of corn, combined with declining worldwide demand for the specialized product or service. The Seattle area specialized in large commercial jet transport aircraft. When demand for that product ebbed in the 1960s, Seattle lost 70,000 jobs in the space of a year. In the mid-1980s declining agricultural prices triggered a regional recession encompassing much of the Midwest. Here is the way the Scott Goldsmith, of the University of Alaska's Institute of Social and Economic Research (ISER) put it:

> It is critically important to recognize that we brought this recession on ourselves, and that it was not primarily the result of weakness in the markets for the goods and services which Alaska sells to the rest of the world. This fact distinguishes our recession from those that have occurred in other regional economies.

The dramatic growth in state spending in the first years of this decade guaranteed that there would be an explosion of demand, and that private capital and labor would mobilize to meet that demand. Since much of this demand was from new public and private investment, demand was especially strong in the area of investment goods -- especially construction services and housing. Just to keep up with the growth in population and business required a Herculean effort. Few communities ever find themselves needing to add housing at a rate that would double the number of units in seven years. Since much of the growth was itself the result of new investment, there was a feedback loop. Economists call it an investment accelerator -- the expansion called forth investment which in turn accelerated the expansion. Unfortunately, the process also works in reverse. When growth stopped (notice we didn't say " reversed"), the Herculean effort would no longer be needed. And once a downturn was started, the feedback loop would cause it to feed on itself, to accelerate.

The only thing that could have prevented an eventual demand collapse was for state spending to keep growing. This would have required state revenue to keep growing. Some thought this a likely future, but it wasn't. When state spending stopped going up, the balloon would be punctured and the Alaska economy would deflate. The only questions remaining were when the recession would occur and how severe it would be.

This logic leads to an important conclusion. ***The oil price collapse was not an important cause of the recession.*** The oil price slide started in December 1985, three months *after* the recession began and two

[2] Some economists are less sanguine in their interpretation of the employment data, but most conclude that the recession, if not yet over, is in its final stages.

years *after* job losses started in the Alaska construction industry. Real (inflation adjusted) state spending stayed constant at $6,800 per capita in FY 1983 and 1984, then increased to $7,400 in FY 1985. The construction recession began in December 1984 (mid-FY 1985), notwithstanding the spending increase. With the beginning of FY 1986 spending fell to $5,400 per capita.[3]

The FY 86 spending cut hurried along the recession which started three months later and made it more intense, but didn't cause it. The cause was that in 1981 the state of Alaska increased its spending at growth rates it could not reasonably hope to sustain, and adopted policies that encouraged private investment in housing, where the needs were only a temporary response to the inflated spending. ***When state spending stopped growing, a recession resulted from falling demand for investment goods.*** The collapse had its most severe consequences in construction and housing, precisely those areas where the state had the most success in its efforts to stimulate the economy.

The recession did not take Alaska's economists by surprise. Ten years ago, in March 1978, economist David Reaume and Goldsmith independently analyzed the effects of state spending growth expected with the beginning of Prudhoe oil production. Their analyses were contained in separate papers delivered to the annual meeting of the Western Economic Association. Both authors used the concept of "sustainable" spending (Reaume called it "sustainable revenue"). Both papers concluded that spending growth above the sustainable level would culminate in a self-inflicted regional recession.

Over the following decade this central conclusion was refined and reiterated by virtually every Alaska economist who wrote or spoke on the subject. Sometimes the conclusions were cloaked in mathematics or couched in eco-speak, but the warning was clear from the beginning. Here is how Dr. Reaume, phrased it ten years ago:

> [I]ndependence from non-renewable resource revenue can be achieved ...if real state spending grows by no more than 2.5 percent per year...and if short term budget surpluses are carefully invested. A parallel conclusion is that ...the state faces a financial crisis by 1990 if it does not immediately restrict spending.

Despite the warnings, between fiscal 1979 and 1985, real (inflation adjusted) state spending rose at a compounded annual rate of 13.9 percent.[4]

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[3] The average U.S. state spends about $1,700 per capita. All figures are unrestricted general funds expressed in constant 1987 dollars.

[4] The annual real per capita growth rate over the whole fiscal 1979-88 period was 3.7 percent.

Recovery

If the economists are right, the end of Alaska's recession is imminent and doesn't depend on outside events like a rise in the price of zinc or corn or a change in the demand for Boeing airplanes. Alaska's recession will end when the decline in state spending ends and the excess capacity in areas like construction has, in the words of ISER director Lee Gorsuch, "been fully wrung out." Since most economists believe that both have already happened or are due soon, most also believe the job losses will end soon as well.

Precisely when will the recession end? Some economists believe it may already be over. A simple-minded extrapolation of Goldsmith's data (Figure 1) would suggest that employment actually started to grow between December and January. Chuck Caldwell, the state's chief labor economist, thinks this is possible: "I'm not going to make any predictions now, but when [the final seasonally adjusted numbers are in] we may well see that the economy started growing again around the first of the year." A Dittman Research Corporation survey of Railbelt business owners and managers conducted in January 1988 seems to provide some confirming evidence. Twenty-one percent of those responding said they planned to increase the number of employees in 1988, while only 12 percent said they planned to cut. Goldsmith himself predicts that the recession will end in the second half of 1988, a view shared by Reaume.

The pace of the recovery thereafter will be affected by any structural changes that occur in the Alaska economy, by changes in state spending, and by demand for Alaska's exports -- energy, fisheries products, wood products, visitor services, and defense services. The outlook for the state's export industries is generally favorable. Virtually all international economic experts foresee a protracted period -- perhaps 15 years -- during which foreigners will find U.S. dollars cheaper than at any time in recent history. For Alaska the change will mean growth. Consider tourism. The weakening dollar has reduced the cost in Japanese yen of an Alaska vacation, making it more affordable to the Japanese tourist. Moreover, Americans tourists will also be more likely to come to Alaska since the dollar cost of visiting foreign destinations, Alaska's competitors for tourist spending, will have increased. The same altered incentive structure will increase demand for Alaska minerals, wood and fisheries products.

In fishing, development of an on-shore bottomfish processing industry, discussed for years, has finally shown up this winter as real growth in employment. With one mine preparing for production and others well along in development, this time it appears that metal mining has finally started to grow. Federal spending is under pressure everywhere, but new military deployments to Alaska and increased federal park and wilderness management responsibilities in the state may mean an increasing overall federal presence in the economy. Petroleum employment is growing now,

reflecting the extraordinary profits available from further investments in already producing fields. The oil companies and state forecasters expect long-term increases in the real price of Alaska oil, but even if this doesn't materialize, labor required to produce existing fields will increase due to technical factors common to all declining fields even as production declines. The consensus among Alaska economists is that demand for the goods and services Alaska produces will grow, and that this growth will add new jobs to the Alaska economy at a rate of 1 percent or so annually, starting in 1988 or 1989 at the latest.

Recession's Dividends

Scholars of economic development have noted that the great economic "leaps" recorded in history often come as the result of a crisis of one sort or another. The crisis brought about a reordering of society that was key to releasing suppressed opportunities and efficiencies. Alaska's recession isn't likely to spawn an economic miracle, but it is eroding two longtime barriers to Alaska's development -- high wages and inflated prices. Whatever one may feel about these changes -- and there are many who are hurt by them -- "[t]he bonus ...is an increase of competitiveness of our economy both in the production of basic commodities, and in the local production of support services," states Goldsmith.

The most immediate economic impact of falling real estate values is the boost it gives to the purchasing power of people that rent. Mike Breedlove, chief demographer for the Municipality of Anchorage, estimates that 31,000 Anchorage households live in rented quarters.[5] Assuming 2.4 persons per household, and if the average rental cost two years ago was $200 per month per person, the roughly 40 percent drop in rents has added an average $960 to the annual spendable incomes of these 75,000 people. This "renter's dividend" has thus increased Anchorage's spendable income by about $72 million, and has had about the same economic impact as would result from hiring 1,400 new state employees in Anchorage.[6]

The recession hasn't been all bad for businesses either. Anchorage has about 7.8 million square feet of net rentable office space, and 5.4 million square feet of retail space. Assuming that 70 percent percent of that space is renter occupied and that monthly costs have declined by $0.75 per square foot from their levels three years ago, the business renter dividend in Anchorage is over $80 million per year, the equivalent of another 1,600 additional jobs in the Anchorage economy.

Declining real wages have hurt household purchasing power, but they've provided business with a powerful competitive boost, and many have taken

[5] The figures do not include renters living on military bases.

[6] The calculation assumes an average annual salary of $35,000, and a personal income multiplier of 1.30.

advantage of it. Oil companies can now make money in fields like Kuparuk with wellhead prices as low as $3.50 per barrel, and Alaska petroleum construction contractors are starting to bid fabrication work away from competitors in Oregon or Korea. Space rental and labor are the biggest cost items in many service and support sector businesses, so declines in these costs are particularly important to holding on to the recent growth in these sectors. Alaska retailers have also been helped by declining transportation charges. According to Greg Carr, of Carr's Quality Centers, these factors together contributed to narrowing the differential between grocery costs in Alaska and Seattle, a differential which he believes is now only about 3 percent. This has also produced a "dividend" for all residents.

The full ramifications of these changes cannot be predicted, but they suggest structural resilience and adaptability in the Alaska economy. These are good attributes for any economy, and especially valuable traits in a period of economic uncertainty.

The Real Estate Crash

The economists haven't completely ignored the $8 billion or so in Alaska real estate values lost over the past two years.[7] ISER economists recently studied the Anchorage housing market for the Alaska Housing Finance Corporation; they said to expect further declines in values, especially in Anchorage. Nevertheless, there is wide agreement among Alaska economists: ***The real estate crash will tend to stimulate economic growth in Alaska.***

The reason is jobs. A bankrupt real estate investor has minimal impact on employment, but a bankrupt hardware store may signify a real loss in jobs. The real estate crash makes it hard for real estate investors, but it makes it easier on hardware store by lowering its costs. This mean the store is more competitive, which means more business and more jobs, so the real estate crash means employment is likely to grow. What if the investor also owns the hardware store? No problem -- the investor sells the business to cover his losses. The new owner pays more attention to the business, and with lower occupancy costs becomes more competitive. Because it means more jobs, the real estate crash is good for the Alaska economy, however difficult it may be for individuals.

Given this view, economists tend to be skeptical of schemes to rescue the economy by spending public money on real estate. Indeed, they express considerable skepticism about any *economic* justification for trying to prop up the real estate market. Part of this skepticism arises from growing doubts

[7] The loss in Anchorage private real property values has already been $5 billion; making allowances for the losses elsewhere in the state, the likelihood of further losses, and losses of "going concern" values, $8 to $10 billion is a reasonable guess for the toll the recession has taken on the value of Alaska assets. Outside investors, mortgage insurance companies, and the federal deposit insurers have absorbed a major part of this, however.

concerning state government's institutional suitability for managing economic change in general. "It seems very clear to me now that politics and the kind of hard objective decision-making needed...will never be reconciled," writes Dr. Reaume, formerly chief economist in the state Department of Commerce and Economic Development and formerly a leading advocate of aggressive government action to achieve development. Professor Hayden Green's skepticism is more concrete: "Some of the same people who recommended we spend ourselves into this nightmare are now telling us that they can get us out by using the same concoction that made us sick as medicine to heal us...."

The Dissenters

One expert who disagrees with this generally upbeat view of the economy is Scott Hawkins, formerly chief economist with Alaska Pacific Bank and now executive director of the Anchorage Economic Development Corporation. He believes that the real estate collapse and repercussions in the banking sector have "given Alaska a bad name" among outside banks that had been providing loans for Alaska development or were thinking of coming in. "It will be ten years before some of those [institutions] consider coming back to Alaska," Hawkins predicts. He argues that the resulting lack of capital is likely to cause retarded development.

Some economists are concerned that mergers will increase the share of the state's banking business controlled by the two or three largest institutions, possibly causing reduced competition in credit markets. Nevertheless economists apart from Hawkins discount "capital shortage" as a significant drag on development. Less money is flowing to the state now than two years ago, just as Hawkins suggests, and outside banks that thought they saw opportunities here, now probably see the issue differently. But it is important not to confuse cause and effect. Less money is being invested in Alaska because there are fewer opportunities for profitable investment, not the other way around. It is a situation that is not likely to change for several years, at least as far as the kind of lending that outside banks did during the boom. Their loans went largely to build shopping malls, offices, and homes, all of which are now in oversupply in urban Alaska. Meanwhile, deposits in Alaska banks have declined by less than 3 percent during the recession. Opportunities to make profitable loans, on the other hand, have declined much more significantly. The result is that ***Alaska bankers are scrambling to find creditworthy loan customers.*** "If someone with a serious business proposition comes through my door, I can assure you that person will have no difficulty in getting what he needs," said one Anchorage banker. Juneau economist and business consultant Eric McDowell agrees: "If I had a money-making idea that required capital, I could get it in an instant. The problem is that there aren't that many opportunities out there right

now."

Hayden Green, professor of real estate at the University of Alaska at Anchorage, is the other notable dissenter from the consensus view, though not on the capital shortage issue. Green argues that the collapse in property values will cause Alaskans to feel less wealthy, and this will cause them to reduce their consumption of goods and services, including goods and services provided by other Alaskans. Declining demand will mean more layoffs, thus propagating and prolonging the recession.

In eco-speak this is a "wealth effect." It will have some impact, but economists don't generally expect it to be significant. Goldsmith notes that the stock market crash wiped out $1 trillion in wealth overnight and has had little apparent effect on consumption. In interviews with Anchorage retailers, Seattle consultant Dr. Bill Mundy found that "stores...that sell non-discretionary items (such as groceries) indicate that sales [in the first half of 1987] are just about the same as a year ago or off some, but not dramatically as one might expect." Mundy also notes that employment in stores selling general merchandise didn't decrease at all from March 1986 to March 1987, and that food store employment actually increased. According to Professor Lee Huskey, co-author of ISER's recent study of the housing market, if people do respond with reduced consumption, items foregone will be heavily weighted toward items with low "Alaskan" content such as Hawaiian vacations and Cadillacs. "The effect will be very marginal."

What about the arguments that a state funded entity, a so-called vulture fund, is needed to buy up distressed properties and keep them off the market? The "Phoenix Fund" proposed by Hawkins would be designed to prevent...

> an unnecessary acceleration of small business bankruptcies [and] the additional failure of Alaska financial institutions, which would set off another cycle of falling real estate values, rising foreclosures, business bankruptcies, job losses, population outflow, etc.

The fund would be run by Hawkins' Anchorage Economic Development Corporation.

Fundamental to this line of thinking is the assumption that Alaska economic development will be hurt by falling property values. Economists, as noted earlier, simply don't buy this idea because they think falling property values will on balance increase jobs. "The real estate collapse is tough on those who invested in property," says McDowell, "but for the economy at large it is of little consequence." According to Reaume, "the current real estate situation may have major positive ramifications on the economy. A 'buy out,' on the other hand, could induce mistakes in the future. It's a bad idea." Department of Revenue economist Al Zangri is specific:

> " [a] state program to reduce excess capacity in commercial real estate...will

> ... drive business, employment, aggregate demand, and aggregate income lower than they would be in the absence of such a program. Furthermore, this will create an additional source of uncertainty in the economy as other interest groups exert pressure on the system to fashion their own 'bail out' program. This will further prolong the adjustment period and delay the process of economic recovery."

Connie Yoshimura, an Anchorage real estate broker, points out the shakey technical assumption underlying the vulture/Phoenix fund idea -- that purchasing distressed properties will stabilize the market for holders of other properties. The Anchorage market has seen a "distinct flight to quality." She argues that the demand for mid- and high quality property is largely independent of the demand for the low quality properties that constitute virtually all the distressed assets. According to Yoshimura, removing those assets by demolition might make sense as an urban renewal strategy, but will have no effect on prices or demand for anything except the the very lowest quality properties, most of which are already in foreclosure. Professor Green expresses similar concerns.

Loss of Confidence

Despite economists belief that the direct economic effects of the real estate crash will be positive, the regional recession in Alaska is at least partly beyond the range of economic experience. It is a reason for caution.

An event this encompassing could conceivably have non-economic effects that could feed back into the economic system in unanticipated ways. Anchorage real estate broker Chris Stephens has suggested that most severe effect of the market crash could be the loss of entrepreneurial talent. Most economists scoff at this idea. "Heck," ISER's Lee Huskey remarks, "lower costs are going to make it *more* likely entrepreneurs will succeed."

Arlon Tussing, a Seattle economist and frequent visitor, thinks the odds are good that the loss of confidence won't last very long or extend very deep into the fabric of Alaska society. So far, the evidence seems to favor this view. Anchorage's municipal demographer Michael Breedlove estimates that 59 percent of the households lost in Anchorage since 1985 have been male headed, non-family households, a category that accounts for only 18 percent of total households. Moreover, 80 percent of the population loss has been in 20-30 age group, and two-thirds of the loss is accounted for by males. These numbers don't suggest a broad-based exodus.

But what about the attitudes and intentions of those who remain? Population movements tend to lag changes in the economy, so a collapse of confidence could have already happened, with the resulting wave of out-migration only now beginning. As far as attitudes are concerned, the answers given by Dittman's Railbelt respondents don't reflect any sense of crisis: 44 percent say the economy will get better over the next two years,

compared with 16 percent who see things getting worse.

What about the 18 percent of Dittman's respondents who reported they were "very likely" or "quite likely" to leave Alaska within two years? For some observers the number was "shocking." Gregg Williams, the state's chief demographer, doesn't see it that way. "Every year, in good times and bad, about 15 percent of the people in Alaska leave. The [poll] results are about what I'd have expected." According to Dr. Williams, the number of people coming to Alaska is much more variable than the number leaving, and much more sensitive to economic conditions. Unfortunately, surveys of people already in Alaska, whether the results are "shocking" or "expected," tell nothing about the intentions of those not yet here. The guessing among experts like Breedlove and Williams is that population isn't in for any collapse in Anchorage, and certainly not in the balance of the state.

Alaska's Policy Options

Many of the experts who are saying there is no economic justification for using public money to prop up the real estate market are also owners of homes and other real estate. A few of them suggest that there may be some *moral* justification for state government involvement. "After all," one asked rhetorically, "doesn't everyone agree that the state government was responsible for getting us into this?" But even those who see a moral basis for state intervention sense that whatever state government's guilt, indemnification of those who have taken losses would be beyond its means. And proposals to assist only a segment of the market, say the commercial real estate market, are hard to take seriously when so many others have also been hurt. Indemnifying all Alaskans hurt by the real estate collapse would simply cost more than the state could afford.

Besides, excess capacity in investment goods and services (like construction) has dissipated, and it seems likely that the state will arrest the decline in public spending. If this happens, the recovery will occur regardless of what else the state does or does not do. That doesn't mean that prompt, informed government action would not save a lot of pain. Unfortunately, what the government should do, apart from not trying to corner the real estate market, is not nearly so clear. It would make sense to allow people to carry their negative equity along with them to a different house. Whether the public and private bureaucracies involved are able to handle these transactions remains to be seen. It doesn't make sense to have a moratorium on foreclosures. The rights of condominium associations may need to be strengthened. The policies and role of the state's lending agencies -- especially AHFC, need review. Millett Keller, an Anchorage business consultant, suggests that the real estate collapse provides Alaska communities with "opportunities to accomplish ... public sector projects at bargain rates," including acquisition of property for parks, greenbelts and rights-of-way for

future transportation facilities, assuming government can avoid carelessly mixing in subsidies and economic recovery. That may be an optimistic assumption, but Commerce and Economic Development Commissioner Tony Smith was surely on target when he testified that "we can't spend ourselves out of this one, we have to manage ourselves out of it."

Borrowed Time

With management -- and a little luck -- the real estate crash will do no lasting damage to Alaska's economy. Years hence Alaskans may look back at the recession and post-recession period as a time of renewal and opportunity. If so, it will probably be because Alaskans learned the lessons that this self-inflicted recession had to teach.

On this point, however, the returns are still to be counted. Alaska did cut its spending in FY 1985-88, but not enough to erase the fundamental imbalance that Drs. Goldsmith and Reaume first described ten years ago. In a speech early this year Goldsmith described the imbalance as a problem

> which always takes a back seat to concerns which are more immediate or pressing, but it is the most pervasive issue we will face in the next decade. *In the long run the economy is still living on borrowed time.* We continue to artificially stimulate the economy by selling off the assets of the state -- our petroleum wealth. How we adjust to a sustainable level of government will affect us all as surely as this recession. [emphasis added]

Unless Alaska controls its public spending, the state will be buying a ticket to a rerun of its present recession. Showtime will be within the decade, and probably sooner.

Another old imbalance also remains. Alaska has developed a mature economy, but parts of rural Alaska have increasingly been left behind. Disparities in income, employment, educational success, health, and a host of other measures all are all widening. Some economists say that this is the kind of problem that economics shouldn't have much say in solving, but all agree that the growing disparities are already a drag on economic development *throughout* Alaska, and that these disparities will become an even greater burden in the future. Economic solutions that might work seem unacceptable on other grounds, and solutions acceptable on other grounds clearly don't work economically. It is a tough issue that won't be ignored.

Alaska's economist emeritus George Rogers wrote in 1962 of how many Alaskans subscribe to the view that economic forecasting "should be a projection of present hopes, that prediction should bolster self assurance. Forecasting in this view is only valid if it agrees with a popularly held dream of the future and makes its realization appear likely."

Today, economists' believe that the real estate collapse will not produce dangerous consequences for the economy as a whole. This view runs counter not to a popular hope, but to a popular fear. A lesson from the recession and

real estate crash may be that hopes and fears, like dreams, are better servants when they are firmly founded on a hardheaded respect for history.

Reference Notes (Incomplete)

If not otherwise cited, quotations are from personal conversations with the author.

Taxable Anchorage real estate values are from Phil Webber, municipal assessor's office, Municipality of Anchorage. Data on the number of Anchorage AHFC mortgages are from AHFC. State spending data are Division of Policy figures.

Goldsmith's seasonally adjusted employment figures have not been published, but are available from him or the author. Goldsmiths statement on the cause of the recession is from "Remarks to the Alaska Policy Forum," January 7, 1988.

The papers presented ten years ago to the Western Economic Association are "Fiscal Planning and the Long-run Growth Pattern of Resource Based Open Economies," by Goldsmith, and "Alaska Financial Planning and the Permanent Fund," by Reaume, both dated March 1978.

For more on Caldwell's and his Department of Labor research staff's view on the end of the recession, see Edward Eboch, "Alaska's Employment Scene," *Alaska Economic Trends* January 1988. Reaume's recovery estimate is found in his article, "One More Year of Employment Decline," *Alaska Construction and Oil Report*, January 1988. He thinks despite the expected upturn in late 1988, average employment figures for the year will be down. Goldsimth predictions are found in his Alaska Policy Forum remarks. Also see *"Can State Spending Speed Alaska's Economic Recovery*, December 8, 1988, by Goldsmith and Gorsuch.research memorandum prepared for Governor Cow

The Dittman survey data is found in *Railbelt Economic Assessment Survey*, January 1988, by Dittman Research Corp. The Anchorage demographic information is from the *1987 Anchorage Population Profile*, December 1987, prepared by Breedlove, *et al*, in the Community Planning Department, Municipality of Anchorage. It is an extraordinarily useful document.

Figures on total available office space figures are from Norman Rokeberg, Jack White Realty. Retail spce figures are from Alaska Valuation Services, Fred Ferrara, president, as provided by Connie Yoshimura in testimony to the trustees of the Alaska Permanent Fund, February 10, 1988.

The Greg Carr quotation is from an Associated Press story datelined Fairbanks, December 2, 1987.

MEMORANDUM

State of Alaska

TO: See Distribution

DATE: March 7, 1988

FILE NO:

TELEPHONE NO:

THRU:

SUBJECT: Comments on Various Economic Recovery Proposals

FROM: J. Anthony Smith
Commissioner
Department of Commerce and
Economic Development

Due to the number of issues being discussed relative to legislative suggestions for possible actions to address our economic troubles, we are providing the following comments on a number of various issues/bills.

1. SB 392 & HB 402 -- AIDEA -- These bills address the issue of bank participation with AIDEA and the current statutory withholding of such participation because of the "2% rule." The Governor's bill, HB 402, also addresses a number of other issues which the Board of AIDEA has identified as limitations on AIDEA's ability to be responsive to the current economic conditions. The Department of Commerce and Economic Development supports both of these bills, and strongly supports passage of the entire package of proposals contained in HB 402.

2. SB 471 -- AIDEA Loan Guarantees and Refinancing -- Both of these issues have been the subject of considerable discussion among the board members of AIDEA. There is not at this time a consensus of opinion on the board on the relative merits or structure of either proposal. All members of the board are most concerned about preserving AIDEA's current bonding ability and ratings. Hence, close scrutiny must be utilized when incorporating any new financial service into AIDEA's powers.

   The Department of Commerce and Economic Development is conceptually supportive of both proposals. With respect to the guarantee program, we believe it is most appropriate to fund the reserve for such a program by new appropriation to AIDEA. For consideration, we suggest that a portion of the current unappropriated portfolio of DCED's Division of Investments be appropriated to fund a reserve for the insurance program. The funded reserve will be the only asset offered to insure against losses, e.g., neither AIDEA nor the state

pledge any additional assets or responsibility. There will be losses in the program irrespective of the quality of the underwriting standards, but these losses will appear at least a year or two in the future. We also recommend that there be a 1-to-4 ratio of reserves to program commitment at the start with the Board of AIDEA having the flexibility to adjust reserves to reflect actual experience. This means that there needs to be an appropriation of loans which will generate $25 million if we are to do $100 million in guarantees for the program to have the impact desired. We recommend a $100 million program at the start.

3. HB 422 -- Payment for Purchases by Various Public Entities -- DCED supports this expansion of current law.

4. HB 429 -- Optional Exemption from Property Taxes on Vacated Land -- The Department is supportive of this concept and would suggest elimination of the limitation of its applications by removing the 30-year-old requirement on improvements currently included in the bill. So long as this proposal does not directly affect the revenues of the state, and is optimal for local governments, it should be considered.

5. HB 430 - 431 -- Neighborhood Business Development Programs and Appropriation -- The Department is conceptually supportive of these bills. We understand the difficulties associated with balancing the state's budget and do not represent that this is an essential $3 million item. Hence, a threshold question is identifying a source of funding.

   In addition to HB 429, 430, and 431, it is our perception that an appropriate public sector response to the supply/demand problem is public acquisition of developments for purposes of parks, neighborhood upgrade and to eliminate obsolete or nonconforming properties. Thus, special appropriations to entities such as the Heritage Land Bank and local governments would allow local governments and the state to take advantage of present price levels to improve the quality of life while beneficially impacting the supply/demand problem.

6. HB 432 -- AHFC Trades -- We are conceptually supportive of this bill; although by this time the Labor and Commerce Committee is fully cognizant of the limitations on AHFC's ability to unilaterally achieve the ends sought in this bill. The approach currently undertaken by the Labor and Commerce Committee seems to reasonably address this issue.

   There are other changes in AHFC which would allow the agency to manage its revenues to be part of the solution rather than part of the problem. For example, AS 18.56.098 needs to be altered so that the interest rate formula is more flexible. Some recommended changes are:

Financial Provisions Changes - Currently, many AHFC financial provisions are "hard-wired." For instance, the interest rate formula as specified in AS 18.56.098 permits no flexibility in interest rate calculation, even though at times adding some flexibility could significantly help the market at little or no additional cost to AHFC.

One way to add some flexibility would be to develop a mechanism whereby the maximum amount of assistance that AHFC can provide for any individual loan is set, but the specific way in which it was applied would be flexible. Another possible change would be to permit more flexibility in the amount of assistance if the whole market was in bad shape. For instance, if the delinquency rate in a particular market exceeded, say, 10%. Additional assistance would have to be targeted at certain groups to achieve specified outcomes, or very quickly AHFC could use up its available resources.

For instance, assume AHFC wanted to target the condo market, either for trade ups to mid-high range condos, or to encourage the purchase of some of the many low end condos. Many of the current condo loans were based on a loan amount of $75-80,000, with an interest rate of 10-12%. Consider the following figures:

Loan Amount	Interest Rate	Payment
$ 80,000	10%	$702
125,000	6%	749
50,000	6%	300

In one case, a borrower can buy much more "house" for approximately the same payment, whereas in the other case, a borrower could buy a $50,000 condo (which was likely originally an $80,000 condo) for a payment of less than half of the original. Properly targeted this could help stabilize price and reduce the inventory of foreclosed properties. It is our belief that the "equity underwater" problem could be stabilized in targeted projects by offering financing opportunities for full prices sales.

Other changes would deal with AHFC's role in disposing of its real estate portfolio. For instance, if current plans are successful, AHFC could well own entire condo projects. These projects could eventually be sold as condos, but they might also be sold as apartment buildings. If AHFC were able to manage the building (via a contract) and perhaps provide financing to the ultimate buyer, the total loss might be much less. Possibly other types of nonowner-occupied financings to help in disposal of foreclosed properties should be added.

More flexibility would be most helpful in workout situations. HOAP will be sufficient for a great number of troubled borrowers, others will need far more assistance. AHFC, in conjunction with the applicable insurance companies, should be able to provide assistance to these borrowers in a variety of ways -- much lower interest rate, deferral of principal payments, etc. To hold down the ultimate cost of the program and to provide more assistance than is needed, AHFC should be able to design various approaches to recapturing some of this assistance if the property ever appreciates in value beyond its original loan amount.

We have discussed with various individuals the thought of establishing a subsidiary corporation of AHFC which would be granted broader powers to address critical issues in Alaska's current housing market. Such a subsidiary may be charged with acquisitions and/or eminent domain powers to achieve public purposes. Further, it could facilitate the consolidation of condominium owners to allow for the conversion of other condominium projects to other uses, including apartment complexes and public sector housing. We believe all such ideas should be explored in detail and are appropriate items to try to adopt this legislative session.

Lastly, AHFC should be given broader investment powers so that it could participate in acquisitions such as Hollywood Vista and Willow Park when it makes economic sense for the agency.

7. HB 433 -- Moratoriums on Judicial and Nonjudicial Foreclosures -- This is intended as a parochial attempt to preserve for Alaskans a greater opportunity to preserve their residence at the expense of lenders, a good portion of whom are nonresident. Similiar legislation was adopted in two mid-western states as responses to the farm crisis. Their experience should be studied in detail before passage of this legislation.

While the approach has appeal on its surface, it appears to also generate considerable technical questions, especially with respect to bonded indebtedness of various Alaska debt issuers. Further, as probably the largest financier of Alaska real estate, various state entities, including the retirement funds, may be injured by this approach. We are also concerned about the potential ramifications if "outside" lenders respond to passage of this legislation by further restricting access of Alaskans to secondary money markets.

We are also confused by the language which suggests that a nonjudicial foreclosure entitles the mortgagor to a right of redemption. This appears to be antithetical to the main purpose of nonjudicial foreclosures.

8. SCR xx -- Loan Approval Withheld for New Construction -- The Department has been asked to comment on a draft of this resolution. We do not agree with this approach. We do agree that financing agencies must be sensitive to the oversupply of several categories of real estate and should coordinate their financing policies to assure that they do not inadvertently exacerbate a serious problem. We also believe that the inventory of some classes of property may require additional construction to meet a growing demand in the near term. It would be much more appropriate, from our perspective, to allow market forces and coordinated state policy development, such as through the Alaska Housing Marketing Council, to address the concerns expressed in this draft resolution. For example, there are market segments which would be severely paralyzed by a generalized moratorium. It is more appropriate to add private sector representatives to the Housing Market Council.

We feel any response of this nature should be in the manner in which municipalities issue building permits and carry out inspections. As Chairman of AHFC, it seems indisputable that many of AHFC's problem projects were not inspected.

Other

Bridge Bank and Hallwood Trust - we conceptually support these, as well as other initiatives to have assets held by the FDIC or banks managed to minimize the adverse impact on the economy. There needs to be consideration given to both the management difficulties and the carrying costs which will be incurred. In addition, we need to recognize that any state guarantee or stand-by letter of credit could most likely be used.

There are three possible options at this time. Any one, or a combination of these, may work. They are the Anchorage Economic Development Corp., the Sealaska REIT group, and the Hallwood Trust. Should the state choose to participate in one of these structures, it should be prepared to contribute cash as well as properties. Cash flows to fund such an entity will not likely, in the short run, be sufficient to meet expenses. Hence, initial capitalization will be important to help assure success -- understanding that success includes the avoidance of increases of property liquidations.

Distribution

Garrey Peska, Chief of Staff, Office of the Governor
Bob Evans, Lesislative Liaison, Office of the Governor
The Honorable Jan Faiks
The Honorable Max Gruenberg
The Honorable David Donley
Gregg Erickson, Office of Management & Budget,

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Peat Marwick

Joseph E. Heintz
Managing Partner

Peat Marwick Main & Co.
601 West 5th Avenue, Suite 700
Anchorage, AK 99501-2258

January 8, 1988

Governor Steve Cowper
State of Alaska
Pouch A
Juneau, Alaska 99811

Dear Governor Cowper:

During the past several weeks an Economic Recovery Task Force has been meeting to discuss the status of the Anchorage economy and proposed solutions. The attached listing of members of the Task Force indicates the breadth and depth of the community participation. The Task Force was initiated by the Anchorage Chamber of Commerce and the Task Force recommendations will be submitted to the Chamber of Commerce Board of Directors at its meeting on January 15, 1988. However, the Task Force wanted to submit to you its findings and recommendations at the earliest possible date, whether or not they are approved by the Chamber Board of Directors.

The findings of the Task Force were passed unanimously by the Task Force members. I must add that not every member agreed with every specific recommendation. However, there was no exception to the finding that the economy in Anchorage is depressed and there is no immediate indication there will be an economic rebound. While there is tremendous support for letting the market forces guide the economy, there is the strong belief that appropriate government intervention can assist without further aggrevating the functioning of the economy.

The Task Force members recommend you adopt the recommendations as your own, and the members pledge their support for you in implementing any of the recommended programs. We look forward to working with you as we navigate through these troubled waters.

Very truly yours,

Signed

Joseph E. Heintz

ECONOMIC RECOVERY TASK FORCE

The task force recommendations are based upon a general consensus that Anchorage is suffering from an economic recession and, while the economic decline may be slowing, there is no immediate turnaround in sight. In fact, the recession may result in the loss of another 10,000 to 15,000 people from Anchorage during 1988, further disrupting many of the basic sectors of the local economy.

The task force concluded that the economic recession is not limited to a specific interest group. For example, it isn't only the banks that are suffering from the economic decline. Virtually every homeowner in the Municipality of Anchorage has lost at least 30 percent of the value of their residential property and further declines can be anticipated. In fact, most homeowners in the Municipality of Anchorage are now probably "under water" with respect to their mortgage, i.e., the mortgage balance exceeds the fair market value of the residential property.

The recommendations of the task force are not intended to be a subsidy. Rather, for the most part they are a restructuring of existing programs, recognizing the changed economic circumstnaces. They reflect a use of State money for the citizens of the state. And, in general, they result in a benefit throughout the state, not just in any one area of the state.

The recommendations of the task force are meant to be specific, action oriented programs that can be implemented with a minimum of delay. They are not intended to be an all inclusive answer to the economic woes of the state of Alaska but rather are intended to be specific steps that can reverse the economic decline.

AHFC

The Homeowners' Assistance Program (HOAP) proposed by AHFC is a significant and positive first step. We compliment AHFC for its willingness to identify a problem and work out a solution. However, we do not believe the HOAP program will provide significant enough relief to alleviate the problem. We believe AHFC should adopt an additional program which includes the following components:

* Reduces rates for all AHFC home mortgages. The reduction should result in a rate reduction to all home owners of 2%, and should come out of AHFC's $1.5 billion in equity.

* The reduction of interest rates should not be added back to the homeowner's loan at the end of the program.

* The reduction should be for a period of 12 to 24 months.

We believe the proposed program will provide relief to the homeowners so that they can maintain or begin to accrue some equity in their property. We believe that the interest rate relief will free funds to be spent for general stimulation of the economy. And, finally, reducing interest rates for all homeowners is not arbitrary and does not single out any one individual.

Real Estate Market

The real estate market in Anchorage, both commercial and residential, is characterized by a significant imbalance of supply and demand. The excessive supply cannot be reasonably absorbed in the near or mid-term (say next five years) and will have the ongoing effect of depressing real estate prices. The impact is not limited to real estate speculators but is pervasive to most citizens in that most have major investments in real estate. So as personal and business income decline, the ability to continue to function is jeopardized by the debt service with the resulting effect in foreclosures, bankruptcies, etc.

We believe the imbalance in supply and demand can be partially adjusted by reducing the supply of real estate. Specifically, we would recommend the following:

* For residential property:

  ** Remove sub-standard housing from the market and destroy the properties. Convert other property to low income housing so there is no additional cost to the low income person.

  ** Ship mobile homes that have been vacated out of the state.

  ** Convert existing condo or similar units to University of Alaska student housing.

* For commercial property:

  ** Create a vehicle to take commercial property out of the market. Perhaps establishing an entity similar

to an REIT which would acquire FDIC-owned property and other obsolete property at a nominal price simply for the purpose of holding the property off the market.

** Consider use of the Permanent Fund as a "Vulture Fund" to finance the property acquisition in conjunction with Heritage Land Bank.

AIDEA

AIDEA should be instructed to adopt restructuring policies that provide a cushion to commercial borrowers. For example, these procedures should include interest rate reductions when loss of jobs would occur if the loan defaulted. AIDEA should be allowed to take an equity participation in consideration for restructuring the terms and conditions which result in the survival of a business.

AIDEA should modify its requirements so that banks can participate even if their loan delinquency rate exceeds two percent.

AIDEA should expand its lending activities to provide for a new guaranteed loan program modelled after the federal SBA program. The essentials of the program should include:

* Bank administered with AIDEA guarantee.

* Loans would be available to finance existing AIDEA debt; other debts could not be refinanced.

* $1,000,000 limit on loan.

* Funds could be used for new construction if the project had an economic benefit analysis.

The revisions to the AIDEA programs should result in the survival of the viable small businesses, thereby maintaining statewide employment and minimizing the effects of the current recession.

Employment Incentives Fund

The State should identify a portion (say $50 million) of the construction fund budget to be used as a venture capital fund. The fund should be used somewhat along the following guidelines:

* An applicant could apply for capital funds up to

$10 million. Matching funds would be available on a dollar-for-dollar basis. In other words, an applicant could receive $1 of State funds to the extent the applicant put in $1 of private sector funds.

* The private sector project would need to create new jobs for the state of Alaska to qualify. These new jobs would need to be permanent positions as a result of the project and not as a result of any capital construction.

* The criteria for qualifying may be that for each $1 million of State participation, five new positions must be created.

* The criteria might also include that the project results in new dollars coming into the state of Alaska and the economy. In other words, it will result in exporting local products or services.

The State and local municipalities have no specific program incentives to entice business. While this would be a onetime subsidy program, it would create new jobs throughout the state and provide a sustaining boost to the economy.

Public Forum

Town hall meetings should be held wherein members of the public are provided the opportunity to describe their economic and financial condition to state leaders (Governor, Commissioners, Legislators, AHFC, AIDEA, etc.).

QUALITY: Sells

Continued from Page B-1

condo market shouldn't distort other areas of the market, which are getting healthier. Take for example the upper-end residential marketplace, homes costing between $200,000 and $220,000. Presently, there are only 31 properties for sale in Anchorage in that range. In fact, residential inventory above $100,000 has declined 35 percent between 1986 and 1987, while at the same time sales declined only 10 percent. That amounts to a healthy absorption rate.

There is no doubt about it. The low-end of the market is suffering from poor quality housing and an oversupply, including condos, single-family and zero-lot-line homes. Unfortunately, no state bailout program or moratorium is going to change those two factors. The state, if it opts for a foreclosure moratorium, will do nothing more than create a brief time-out.

The poor quality and condition of the bottom of the real estate market is not going to be helped by state interference, whether it is in the condo market or the commercial real estate market. The issue is really one of quality.

A recent survey by Shorett & Riely demonstrated that better quality apartments have a 13 percent vacancy rate while lower quality have a 40 percent vacancy. Another survey just completed by Alaska Valuation demonstrates the same thing in retail mall space. Those strip malls with anchors have a substantially lower vacancy than those without. This points to the fact that better properties, those developed with foresight into the market, are going to survive while those in poor neighborhoods and not designed to meet the market might fail. Not all properties were created equal. When the market improves, new housing will be built that will make today's poor quality housing unsellable.

It also should be noted that this flight to quality is great for consumers. Although apartment owners may be complaining about low rents, tenants have been able to improve their quality of life substantially in the past two years.

The issue here is quality

connie yoshimura

The Anchorage real estate market has a black eye but it certainly shouldn't be pronounced out of the fight by any means. Rather, the condition of the market is more like a technical knockout. The black eye of course, is the condominium market. With an increasing amount of inventory due to foreclosures, the absorption of excess condos is going to need more than fancy sales promotion. There is the beginning of talk about conversions back to apartments, the razing of certain functionally and cosmetically obsolete units, the conversion of condos to low-income rental units, among other innovative ideas. All of these suggestions need to be considered very seriously because it is apparent that if we just leave the condo market to the buyers out there, An-

Daily News 2/13/88

chorage has 'a nine-year supply' of inventory.

However, the black eye of

See Page B-6, QUA

ALASKA PERMANENT FUND CORPORATION
VERBATIM MEETING MINUTES

February 10, 1988
Alaska Permanent Fund Corporation Offices
Juneau, Alaska

PRESENTATION BY CONNIE YOSHIMURA

YOSHIMURA: I guess I need to identify myself. I'm Connie Yoshimura. I'm an Anchorage real estate broker and, unfortunately, developer at this point in time, although I used to be proud of that fact. As far as any conflicts of interest are concerned for what it is that I have to say, I do want to divulge that I owe my mortgage to the Alaska Permanent Fund. But other than that, I am speaking as an individual and I'm not representing any other groups.

The reason that I am here is because I am concerned about the topic which was just discussed, which is the use of the Permanent Fund earnings or principal to shore up the real estate market in the railbelt energy communities, for which I am extremely opposed.

I have to tell you that I first became interested in the Permanent Fund because I served on a committee on the Permanent Fund who will be issuing a report next week having to do with Commonwealth North, and that was over two years ago. So I started attending these meetings. When I started attending these meetings I was very angry because I felt that the Permanent Fund should have a vehicle for investing in the State of Alaska and, in particular, real estate more than the extent to which they do with their home mortgages and through the banks in terms of deposits and securities on first deeds of trust that may involve some real estate. As I sat and listened to these presentations over the past two years, I became convinced that you should not be investing in real estate in the State of Alaska. I really had a complete reversal of my opinion as I began to become educated as a member of the public in terms of what your investment criteria was and as I looked at what your rates of return were in shopping centers and in apartment complexes outside the State of Alaska. Although politically I may have had some problem with it, I felt that you were absolutely on the correct investment track and that, with few exceptions, there was no opportunity for that type of investment within the State of Alaska. And if there wasn't

any opportunity for that type of investment in the State of Alaska two years ago, certainly there is not any opportunity for that today. So whether it is using the principal or using the undistributed earnings of the Permanent Fund, or coming in the back door vis-a-vis a pension plan and a vulture fund that's created in Seattle for the express purposes of buying real estate in the State of Alaska that's depressed for a long-term potential, I am adamantly opposed that the Permanent Fund do not participate in any way, shape and form with anything outside of what they're presently doing.

I'd like to take this opportunity to explain my position a little bit and I have some charts and graphs that I want to distribute to you. I want you to understand that I am a residential broker. I am not a commercial broker. But what I'm going to demonstrate to you residentially and in apartment complexes and briefly in malls, shows a distinct flight to quality that you're not going to get rid of, irregardless of who owns the distressed properties, because so many of the distressed properties that were built in Anchorage and Alaska in particular were so ill-conceived. For example, strip malls without anchors or properties or apartment complexes located on the east side of town or on the north side of town where there has been substantial loss of population because there's a flight to quality on the south side of town. So really, unless you're interested in getting into the urban renewal issue, which is what Anchorage is really all about at this point in time, since it has more supply than it has demand and you have properties that irregardless of whether or not they're one year old or thirty years old are functionally and cosmetically obsolete from the day they came out of the ground because they're ill-conceived by greedy developers, you don't have much of an opportunity to invest in commercial real estate in Anchorage, Alaska. And I think that I can prove and demonstrate this flight to quality, so to speak, throughout all segments of the market.

Well, the alternative to that is, if you don't want to buy distressed property, then you could take vulture funds and maybe you could buy quality property at distressed prices. But the quality properties are not for sale because the quality properties are the ones that have already had their loan modifications and their workouts already accomplished. You don't want to buy them for the amount of their loan balance and an owner, if he has loan modification and he's got a mortgage that now cashflows, is not particularly

interested in selling to you and making that difference up in cash out of pocket. So, unless you're interested in buying raw land, which we have plenty of since we've had a ten percent decline in population, there's not much opportunity, despite what the mayor may say or despite what the poll may say or despite what a vulture fund may say. There isn't any opportunity for investment that's going to give you the type of return that you presently have in real estate in other parts of the country.

Secondly, one of the problems that the commercial real estate market faces in Anchorage, Alaska is not simply an over-supply versus demand and a depressed local economy, but we've had massive changes in our tax laws which no longer make it beneficial for small investors to join in syndications and to purchase large commercial pieces of property in partnership form. Although Anchorage has not been overly syndicated, there are significant syndications both in raw land and in income-producing properties that have gone belly up in recent months because the partners no longer want to continue to pay into a partnership that has no immediate return and that has no tax benefit. One of the problems that we find in the commercial real estate market, from my own personal experience of owning a couple of hundred apartments, and unless those apartments cashflow today I have absolutely no tax break, which they were created for three and four years ago. I have no tax break whatsoever today for owning those apartments. So unless I can get a 10% return on them, or whatever, there is no reason for me to continue to own those properties. So it's not just the economy that's causing people to walk away from all of these commercial real estate investments, it's because they were overvalued because depreciation and interest write-off were added into them and made them an attractive investment vehicle, which the tax laws changed last year.

Briefly I have some information here which I would like to give to each one of you. One of the things that I would like to demonstrate to you is that the market is not nearly as bad as what you may think that it is in the better quality properties.

The first chart that I have is residential homes for sale by price range, and although you may not be particularly concerned with houses, you probably are concerned with jobs and you probably are concerned with the overall economy. I would like to point out that in the Anchorage area there has

been a substantial decline in all areas of residential properties after you reach the $100,000 price range. This is an incredible number, but you will see that between $200,000 and $220,000 there are only 31 homes for sale in the entire Municipality of Anchorage bowl, as of January 1988. That's an incredibly small number. Three or four years ago there would be 300 houses in that price range for sale. So we've had like a 90% decline in inventory in that price range. On the other hand, under $80,000 we've had a tremendous increase in the number of homes. And the first two numbers, under $80,000 and $80,000 to $100,000, are the only two categories that have increased, and that's due to the REO market. That's due primarily to the job loss and to the exit of the 20,000 people that's happened in Anchorage.

SCHAIBLE: When you're talking about residential homes, are you talking about stand-alone homes?

YOSHIMURA: Single family and zero-lot lines.

So you will see that indeed we don't need a building moratorium as Mr. Rose suggested in one of his position papers, except for what we probably do need are stricter zoning laws which will prevent the building of condominiums that are 600 square feet and that have no car storage and are two bedroom, because it's the lower price range that's facing the tremendous problem. And with 31 homes for sale between $200,000 and $220,000 and 41 between $220,000 and $240,000, there is not much of a problem in the marketplace. As a matter of fact, there is not enough inventory.

What really gives the Anchorage real estate market, in the broad picture, such a bad name is the condominium marketplace. As you can see, we have a vast number of condominiums and from January of 1987 to January 1988 the condominium market increased by over 50%. All of that can be attributed to the REO inventory that's held by the Alaska Housing Finance Corporation and MGIC. Your investments, as far as in single-family homes, because you do mostly high end mortgages, I would think that you are relatively safe and secure and could continue on in a program doing that without much problem.

Under residential inventory and sales, I've tracked 1986 versus 1987, and this is a very important chart, because what this demonstrates to you is, first of all, that inventory in general has declined 35% in the Anchorage area and sales activity has only declined 10%. Virtually on the

chart it looks like it's almost identical. So what you see here is that you have a healthy absorption, that inventory is declining and absorption is remaining virtually the same. So you don't have a problem, except under $100,000, in the Anchorage real estate market.

You do have a problem, however, in the condominium market and you have 1,800 units this year, 1,800 units last year. Approximately the same amount of sales. And the condominium market is really being addressed now on an institutional basis by all the institutional sellers. MGIC, for example, controls 56% of all of the repossessed condominiums in Anchorage. There is talk of bulldozing units. There is talk of turning properties back into rental properties. In other words, to solve the condominium market which generally is giving the entire real estate market a bad name in the railbelt communities, you are going to have to do more than give away fur coats and fancy trips to the Caribbean in order to sell property. I mean, they did all that and they generated 237 sales, but at that rate you still have a nine year supply of condominiums.

MALLOTT: Give away condos.

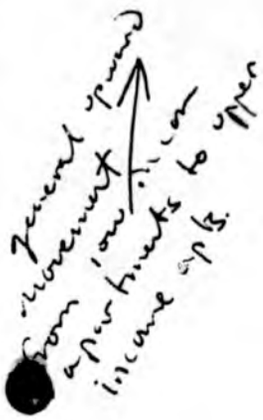
YOSHIMURA: You could give away condos. Well, you know, you've heard the story that the banker, if he did a good job, got one condo and if he did a bad job he got two for his bonus. I'm not exactly sure how that worked. For whatever bankers there are that are left in Anchorage.

In the condominium sales price, the most telling statistic is in December of 1986 the average condo was worth $113,000 in Anchorage and now in 1987 it's worth $50,000. That's a 44% decline and I used December to December as opposed to the weighted average statistic for the entire year to tell you that the condo market is still declining in Anchorage and needs serious attention.

The next two charts have to do with population and housing statistics, which shows you that in single-family, for example, how it breaks down into housing type. In the 5-plexes, there are 21,582 physical units -- doors -- and it doesn't matter if they're condos or apartments, and they represent 26% of the entire housing market. Then if you look at the next chart, you'll find that they have a vacancy of 25%, where single-family houses only have a vacancy of 5.9%. And, of course, we have mobile homes and there's

nothing you can do about those, despite what the trailer park owners say.

Getting a little bit into an area that you might be a little more interested in because you own apartment complexes in the lower 48, and demonstrating what I feel is the commercial flight to quality, there has been a 40% increase in low-cost apartment vacancies. Apartments in the lower price range, their vacancies have increased 40%, whereas mid-cost apartments have decreased 21% in their vacancy factor, and high-cost apartments have decreased 37%. High-cost, quality apartments in Anchorage only have a vacancy factor of about 13%, which is about 5% more than what we'd like it to be, but it's not a bad percentage to work with. The problem is that there has also been a decrease in rental income, so what is a high-quality apartment today may only get $550 a month rent, whereas two years ago it was probably getting $950 a month rent. Now the only person that's angry about that is the apartment owner, and I am an apartment owner and I own 200 apartments. However, I have 200 tenants that are absolutely delighted that my income has gone down.



So if you talk about the commercial real estate market being a political issue, it is a political issue. But you've got a much broader-based constituency for those people who are business owners and who now pay $1 a square foot as opposed to $2 a square foot. I lease 6,000 square feet in Anchorage for my business. My rate was supposed to be, according to my lease, $2.35. I now pay $1.71 a square foot. I am delighted by that. But in many instances what you have in the commercial real estate market is you have a very articulate, well-financed and very politically astute constituency as far as real estate developers and investors are concerned and you have sort of the silent majority. You have all the tenants who live in all of the apartments, all of the small business owners, and they're delighted that things have gone down, because they are able to live better in a better house, in a better apartment. They're able to go out and rent class A square feet instead of class C for either their shop or their office, and they're absolutely delighted by the turn of events.

I have to say that in all real estate markets what you have are winners and losers. In Anchorage you had a lot of real estate developers who didn't know what they were doing. The last chart probably demonstrates that, without naming any names. You have Anchorage retail inventory and vacancies by type of mall. This is a new study that has just been done

by Fred Ferrara, who is the president of Alaska Valuation Services. You have major malls, which include 5th Avenue and the Diamond Mall, and you have their vacancy factor. You have strip retail with anchor having a very small vacancy factor, and you have strip retail with no anchor. But everybody knows that you should never have strip retail with no anchor to begin with. It doesn't make much sense unless you're in a ski resort area in Nevada around Lake Tahoe or something like that where you've got small space and you have to deal with it and you can have a lot of little shops. But Anchorage doesn't have those types of demographics.

So, in my opinion, the people that are in trouble -- the good properties you are capable of doing a loan modification and a workout on. And the bad properties, the ones that are ill-conceived to begin with, like the strip retail with no anchor, you don't want those properties to begin with. Nobody wants them. If the owner couldn't make them work through a loan modification and they have to go back to the bank, and the bank fails as a result of having too many of those properties because they can't handle them either because they're functionally and cosmetically obsolete, and so then that bank goes belly up and a new bank comes in and they cherry-pick the loan portfolio and they don't want that piece of property anyway, and the FDIC ends up with it, why would anyone want to bail out the FDIC after four people can't make this property work and can't make this loan performing? It just doesn't make any sort of real estate sense, although it makes political sense.

MALONE: If I understand what you're saying, it is that, as far as you can tell, and from the information put together both apparently in the area of the retail type real estate and the residential real estate, the fact that these properties exist and they're not being used and maybe the FDIC or somebody else is holding onto them, is not depressing the real estate market because nobody is going to go in and buy them anyway.

YOSHIMURA: No one is going to go in and buy them anyway.

MALONE: They're not going to be able to beat down the prices of the higher quality properties because they're just not a marketable item today.

YOSHIMURA: They're not a marketable item today, and they're not a marketable item tomorrow. Because when we do start having

population and we do start having growth again, there will be real estate developers who have learned a lot of good lessons from all of this and they're going to go out and they're going to build better product to compete, unless Dave Rose's suggestion happens that there's a building moratorium, which I will fight to my dying day. But this bad product is going to remain bad product, because when the economy turns around and we have population and we have jobs again, there will be more opportunities for growth and those properties are just going to fall by the wayside because they were functionally obsolete properties to begin with. Whether they're new or not is immaterial. Yes, I agree with that.

MALONE: So, in other words, one of the big scares that people hold up saying, well, if this outfit or the FDIC or somebody else dives in and dumps everything on the market, they're just going to submerge the Anchorage real estate market. What they're probably going to do is find out there either aren't any buyers or, if there are buyers, they're going to be very low prices, but that the better quality properties -- the ones that people want -- are not going to be greatly affected by that one way or the other.

YOSHIMURA: The better quality properties are full. They have a low vacancy factor. You may not have the rental income that you'd like from those properties, but they're full. They don't have that bad a vacancy factor.

Anyway, those are my comments and I appreciate the opportunity to speak before you.

MALLOTT: Good. Thank you very much.

FORTUNE

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562-7653

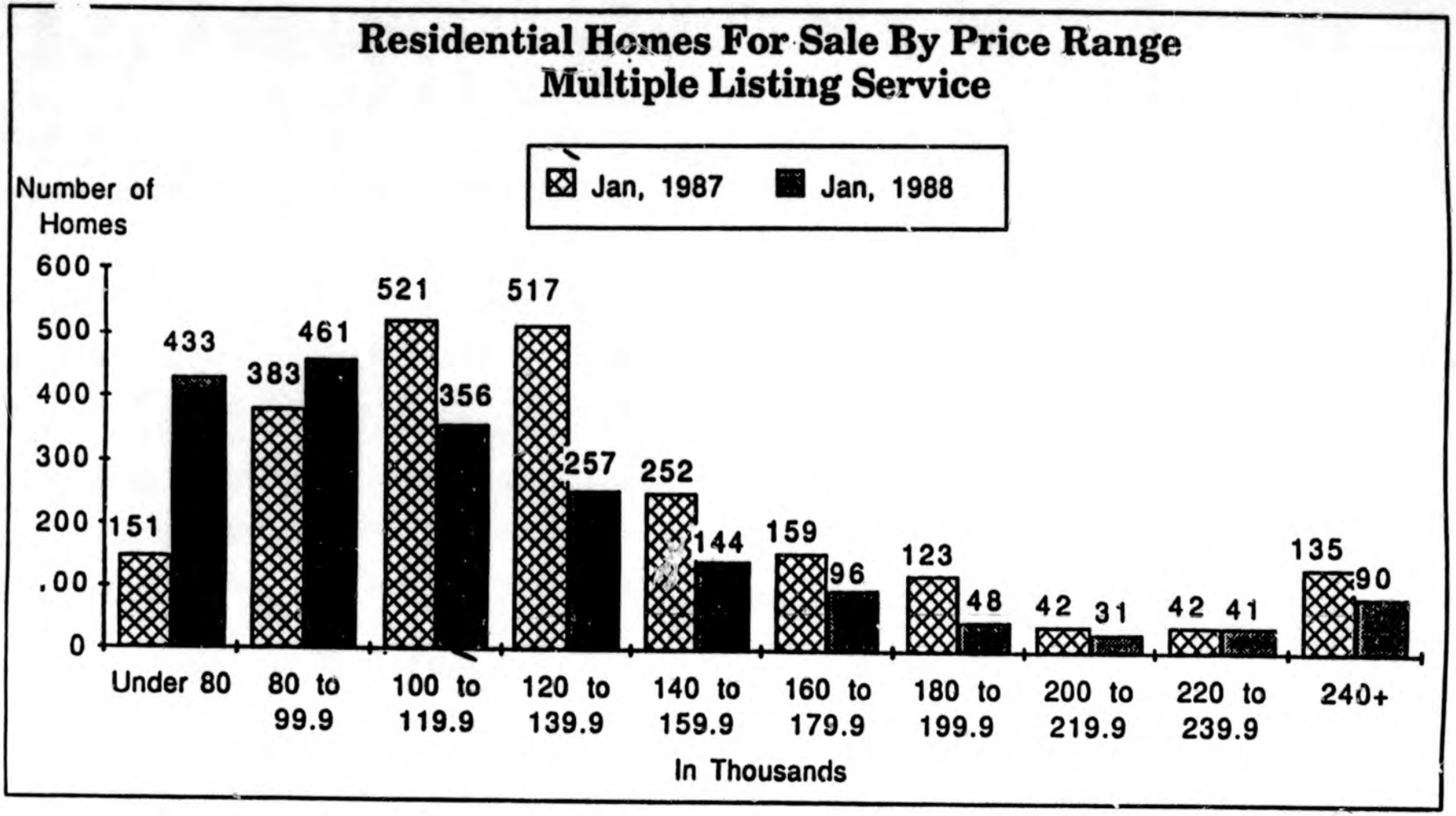


Chart Preparation: FORTUNE PROPERTIES, INC.

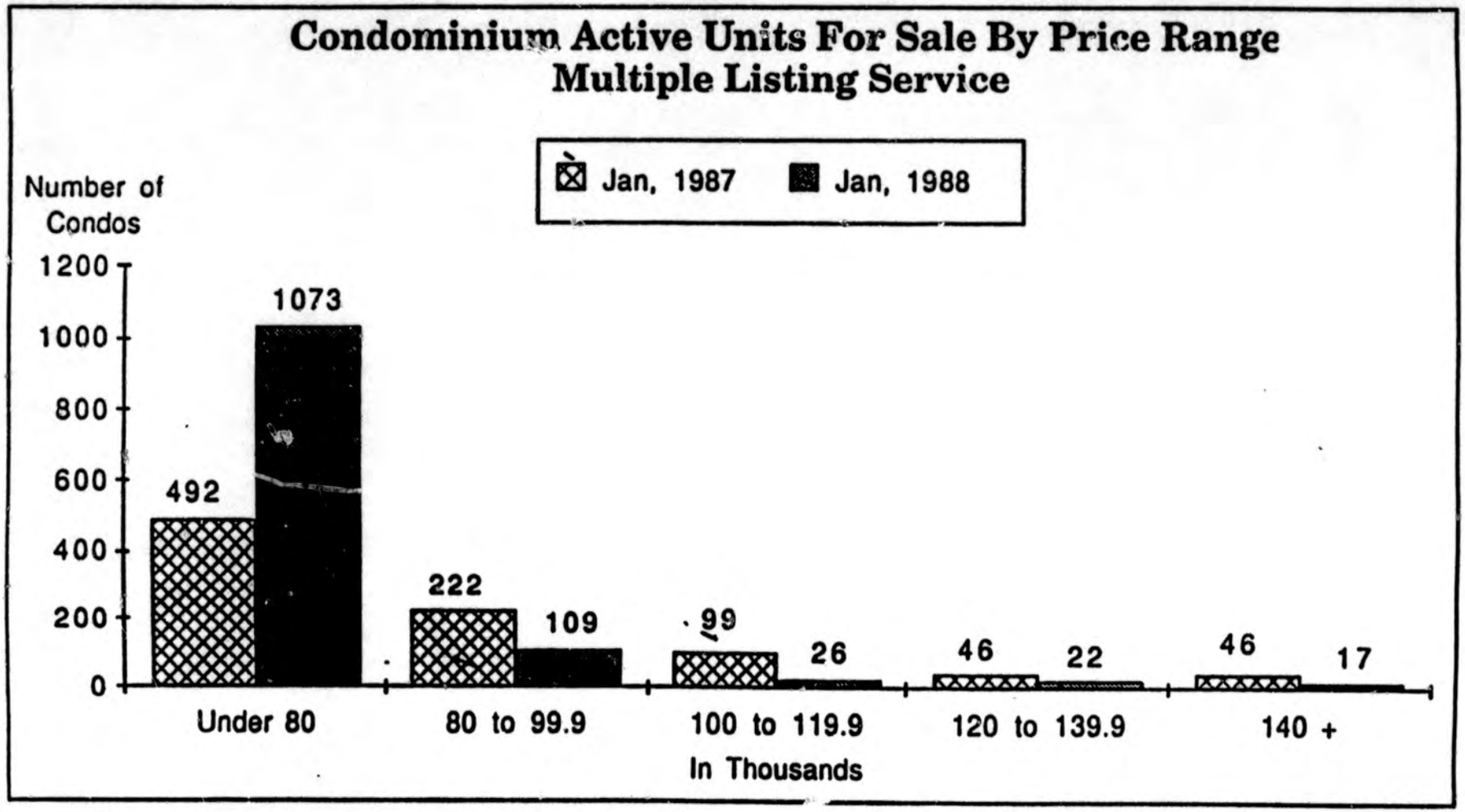
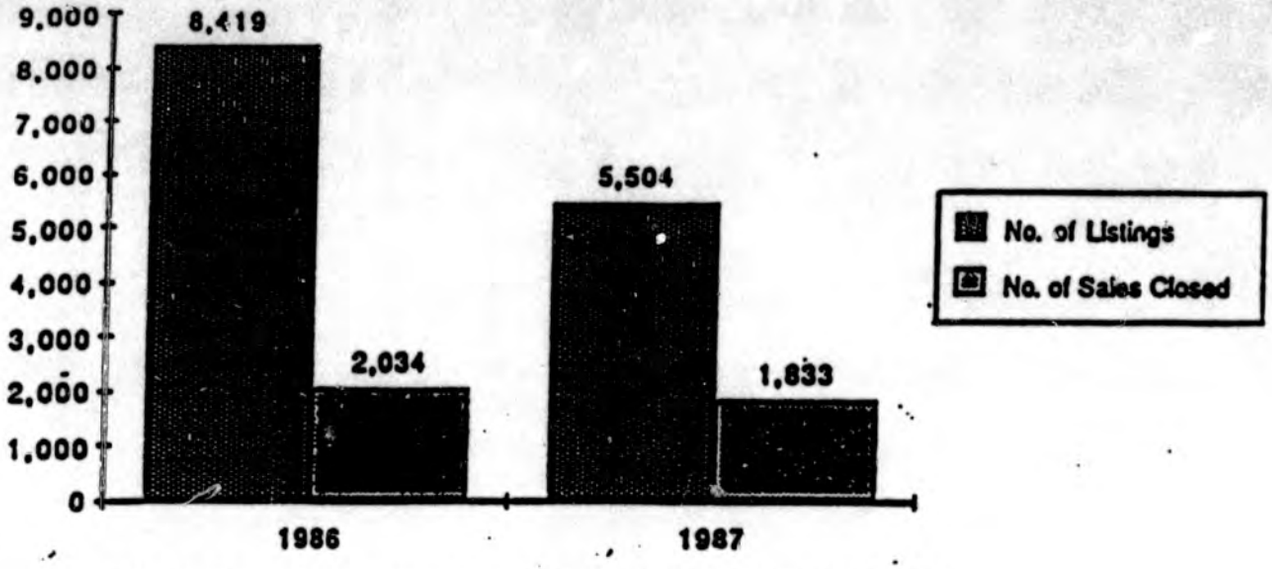


Chart preparation by: FORTUNE PROPERTIES

Residential Inventory and Sales
1986 vs. 1987



35% decline in inventory vs. only a 10% drop in sales units.

Source: Multiple Listing Statistical Year End 1987

COMMENTS:

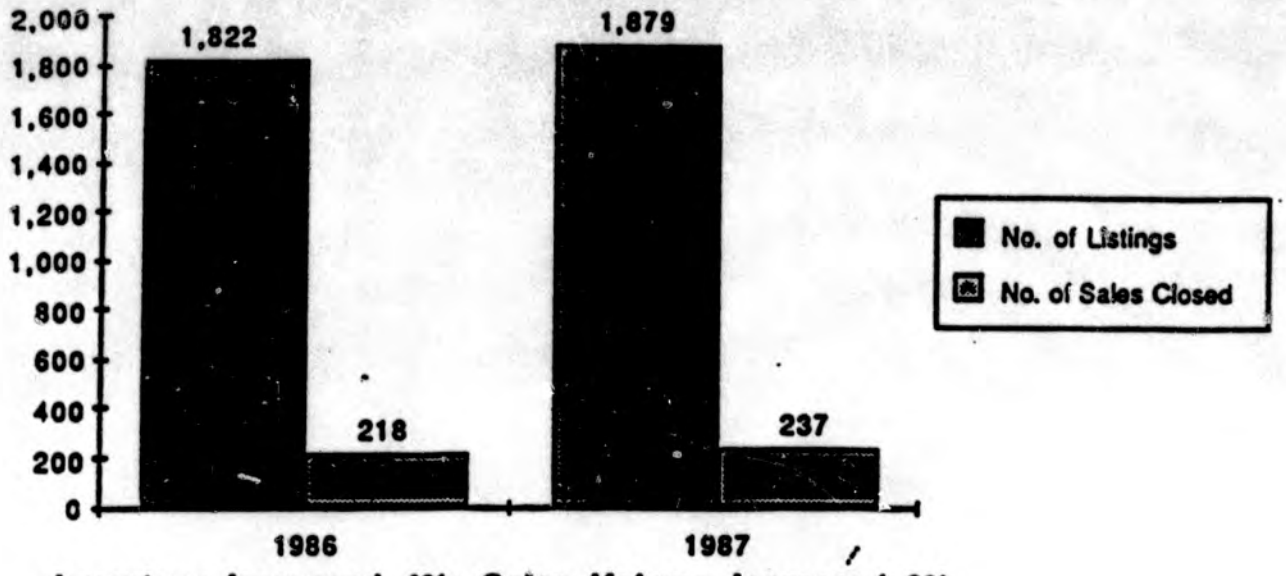
If there is any good news in the Anchorage real estate market, it is the fact that residential inventory (classified as single family and zero lot line properties) had a significant 35% drop in number of units available.

This figure is particularly significant in the fact that sales, measured by unit count, and not dollar value, declined by only 10%. This indicates a fairly healthy absorption of property in Anchorage.

There is no problem selling property in Anchorage according to these statistics. The only problem is in the value that is obtained for residential properties. This value, however, has indicated considerable stability and it is anticipated that little, if any, further decline will take place in value for single family and zero lot lines.

This market, if left alone, will continue its absorption. There is no recommended action for the single family and zero lot line market. Given all the economic circumstances of the times, it is functioning well.

Condominium Inventory and Sales
1986 vs. 1987



Inventory Increased 4%; Sales Volume Increased 9%

Source: Multiple Listing Service Year-End Statistics

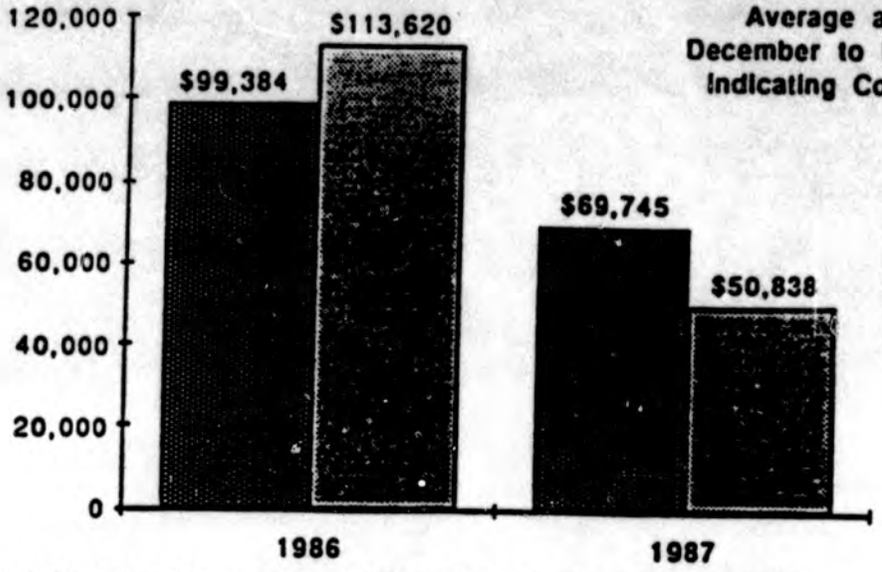
COMMENTS:

From the above chart, it is obvious that the condominium market is virtually stagnant. Neither inventory nor sales have increased or decreased a significant amount.

It is an interesting note, however, which is not on the graph that closed sales for the month of December 1987 was exactly double that of 1986, or 34 compared to 17. Doubling the number of closed condominium sales is admirable, which was accomplished primarily through the marketing efforts of MGIC, but it does not address the basic problem of oversupply. Other action must be considered.

At the current absorption rate, assuming no new inventory, there is a nine year supply of condos within the Municipality of Anchorage.

Condominium Sales Prices
1986 vs. 1987



Average annual price dropped 30%; December to December price dropped 44% indicating Condo market is still declining

Additional Information: 17 Condo Closed Sales in 1986; 34 Closed Condo Sales in 1987

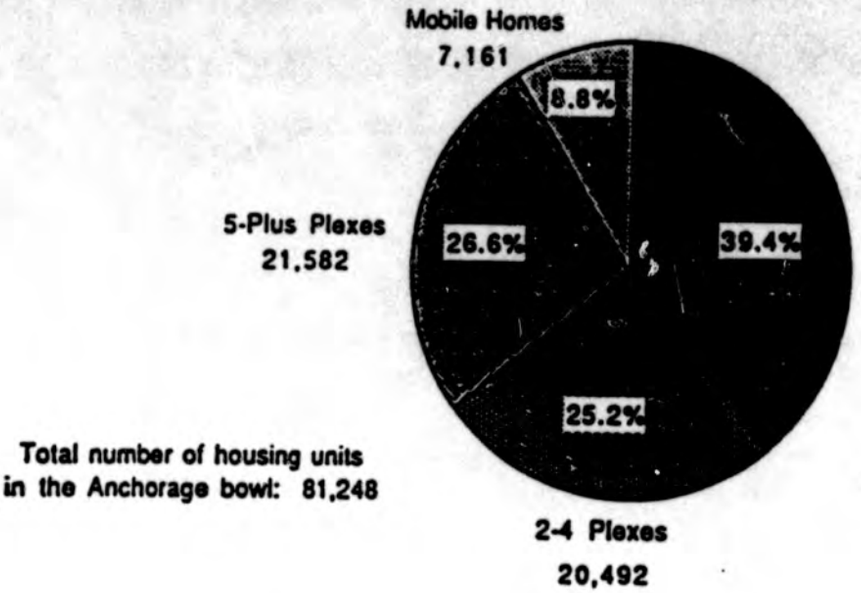
Source: Multiple Listing Service Year-End Statistics

COMMENTS:

By comparing December 1986 to December 1987, it is obvious that the condominium market is still in its downward spiral. The year end statistics show a drop of 30% in value from 1986. However, the December comparison shows that the drop is 44%. Since the December statistic is not averaged and is the most current, it is obvious that the present value is 44% of last year's value and not the 30%.

There is no reason to think with the oversupply that exists that all condominiums will not continue to decline in value unless steps are taken to take properties off the market, either through warehousing or rentals.

1987 Population and Housing Unit Statistics
Housing Unit Types



Total number of housing units in the Anchorage bowl: 81,248

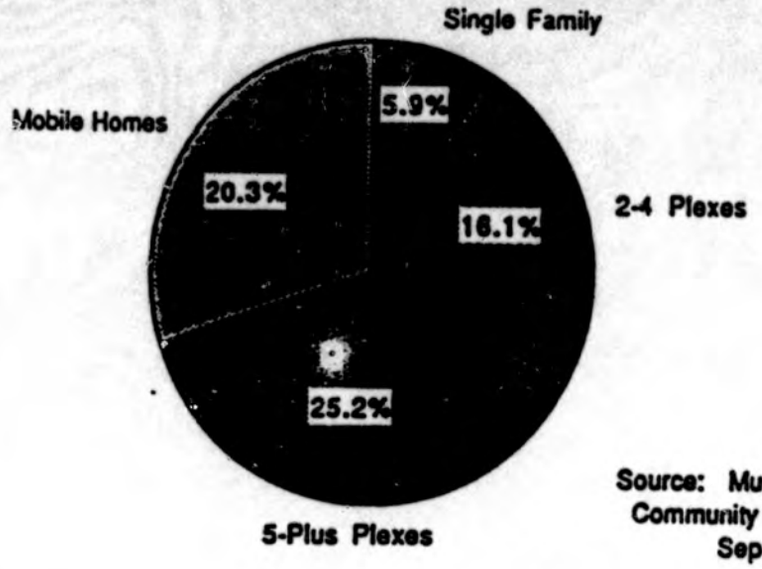
Source: Municipality of Anchorage
Community Planning Department
September, 1987

COMMENTS:

Nobody knows for sure how many condominiums there actually are in Anchorage, Alaska. The reason for this is that the Municipality of Anchorage counts housing units by physical building type. This means that condominiums fall within the 2-4 plex category, if they are in a building of that size or in the 5-plus category if located in a larger structure. The majority of condominiums fall within the 5-plus structures.

AHFC has over 7,000 condominium loans, the vast majority of which are in Anchorage. Condominiums could probably best be counted by taking a survey of investors because most condominiums were financed at the time of purchase.

1987 Population and Housing Unit Statistics
Census Vacancy Rates--Anchorage Bowl



Source: Municipality of Anchorage
Community Planning Department
September, 1987

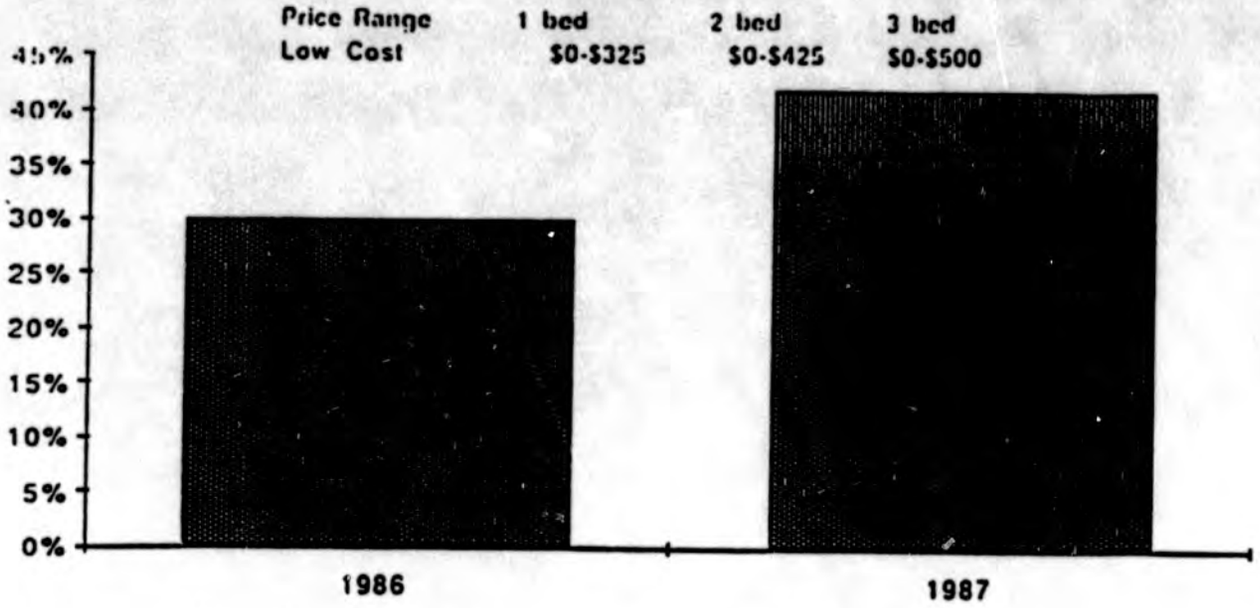
COMMENTS:

This pie-chart shows a 25% vacancy in the 5-plus categeory, which demonstrates that renters prefer to live in as low a density as possible.

This chart measures physically vacant properties which were inspected by the Municipality during the second quarter of 1987. As you can see, it indicates all product type.

The overall vacancy for the Anchorage bowl is 14.9% taking into consideration all product type. The chart breaks down this overall vacancy into percent of product type.

Fourth Quarter Low Cost Apartment Vacancy Rates
1986 vs. 1987



There has been a 40% increase in low cost apartment vacancies.

Source: Shorett and Riely Appraisers, Ken Kincaid

COMMENTS:

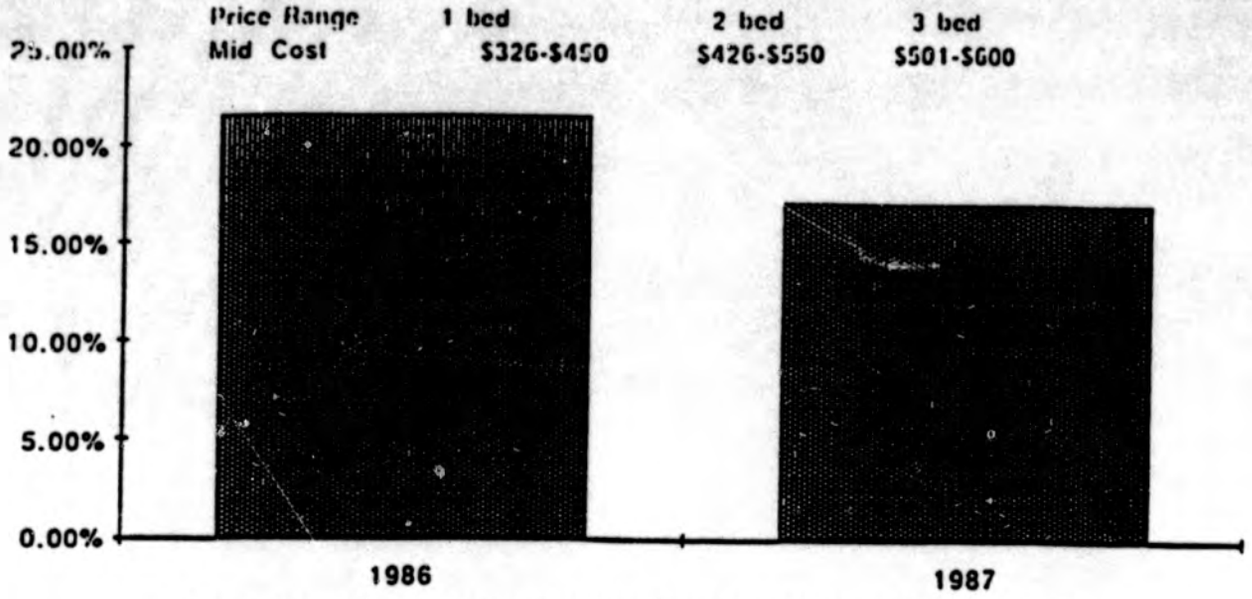
The most revealing statistic from the 5,000 unit survey completed by Shorett and Riely was the fact that there had been an increase of 40% in the vacancy of low cost apartments.

This substantiates a flight to quality that is being taken advantage of by savvy renters, as well as upgrading home buyers. There are certain areas of Anchorage which, without extensive urban renewal projects, are not going to be repopulated for many years. These areas include Mt. View, parts of Spenard, some pocket areas of the Eastside, as well as areas in Muldoon.

The apartment projects in these areas are functionally and cosmetically obsolete and with loss of rental income are in dire need of maintenance and repair which the owners cannot afford to make at this time. Many of these properties should probably be torn down. Even the newer four-plexes, etc., which were built in these areas suffer from higher vacancy factors.

There is a definite flight to the southside of Anchorage. Although Anchorage lost 10% of its population in the past two years, the southside of Anchorage, defined as being south of Tudor Road, has had an increase in population. In fact, the elementary schools on the southside of town, such as Rabbit Creek, O'Malley, Huffman, and Spring Hills are considered to be overcrowded, and there has been purchase of a new elementary school site off Huffman Road.

Fourth Quarter Mid Cost Apartment Vacancy Rates
1986 vs. 1987



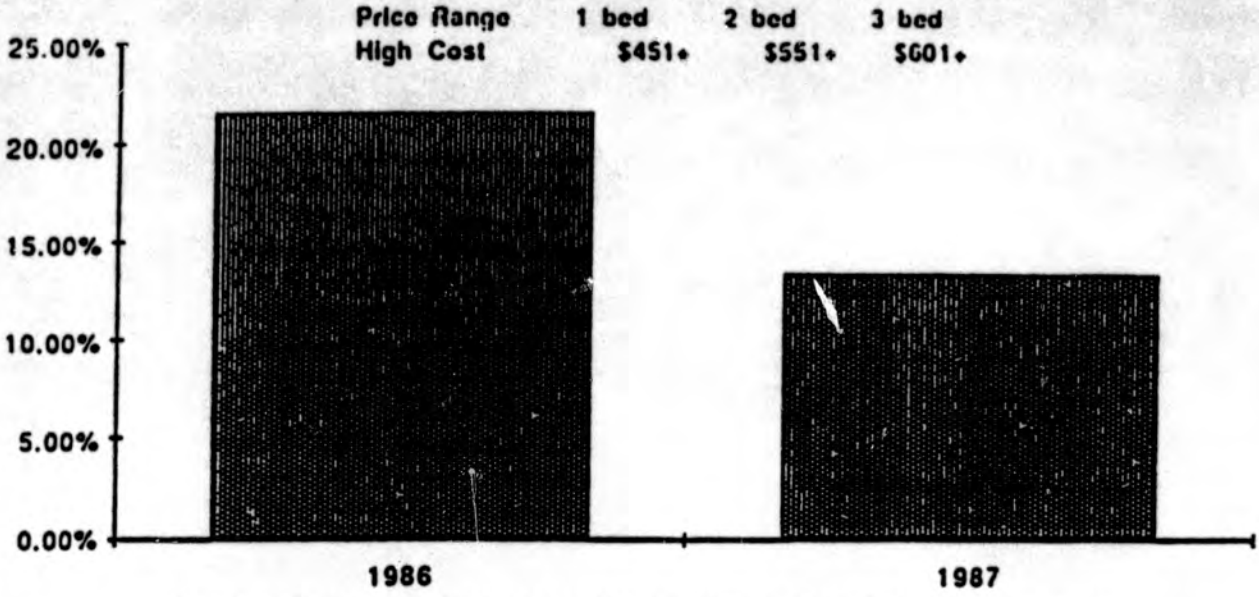
There has been a 21% decrease in mid cost apartment vacancies.

Source: Shorett & Riely, Real Estate Appraisers

COMMENTS:

Although there has been a substantial decrease in mid-cost apartment vacancies, it is important to note that these apartments were probably at one point in time considered high cost. In other words, just as vacancies have declined in this price range so as the rental rate. This is the flight to quality in rentals previously commented upon.

Fourth Quarter High Cost Apartment Vacancy Rates
1986 vs. 1987



There has been a 37% decrease in high cost apartment vacancies.

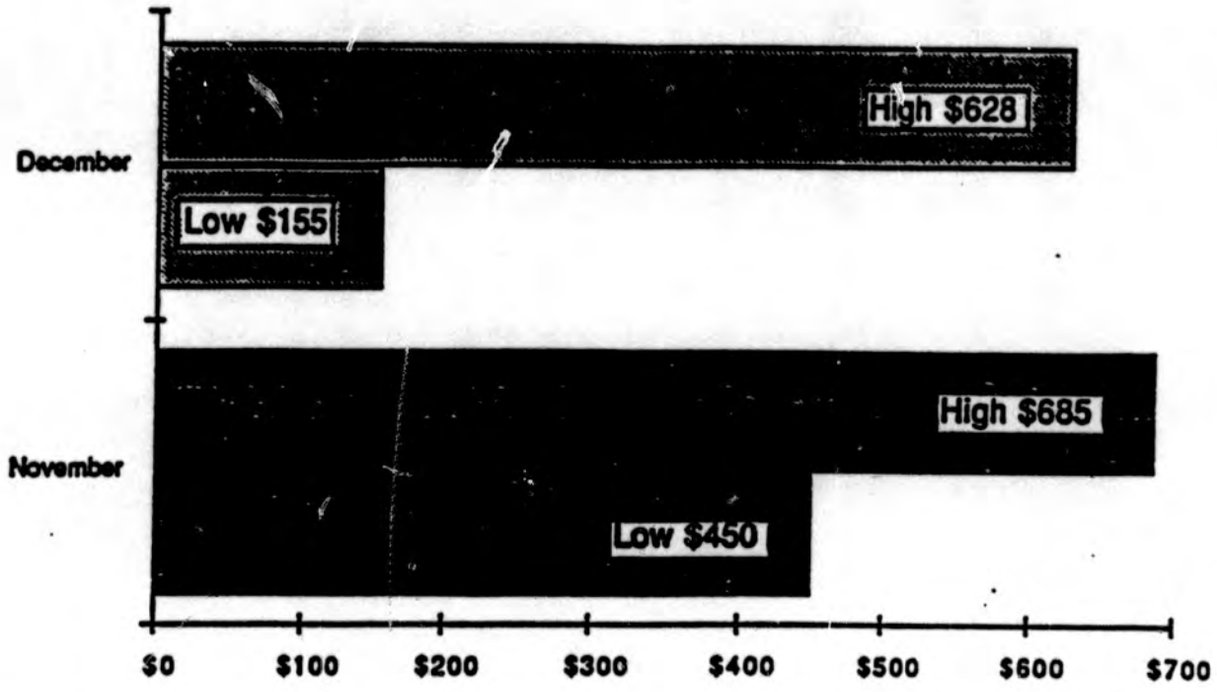
Source: Shorett & Riely, Real Estate Appraisers

COMMENTS:

The decrease in vacancies for pricey apartments is signification. Again, however, it must be pointed out that this decrease in vacancy is a result of only lower rents being charged for these apartments.

These charts point out, however, that the trend to quality is overwhelming and that there is probably no market force great enough to deter it except more population.

Analysis of Rental Rates for 2 Bedroom Condos
As Advertised in the Anchorage Daily News and Anchorage Times
November, 1987 vs. December, 1987



Information Provided by Kay E. Eliason

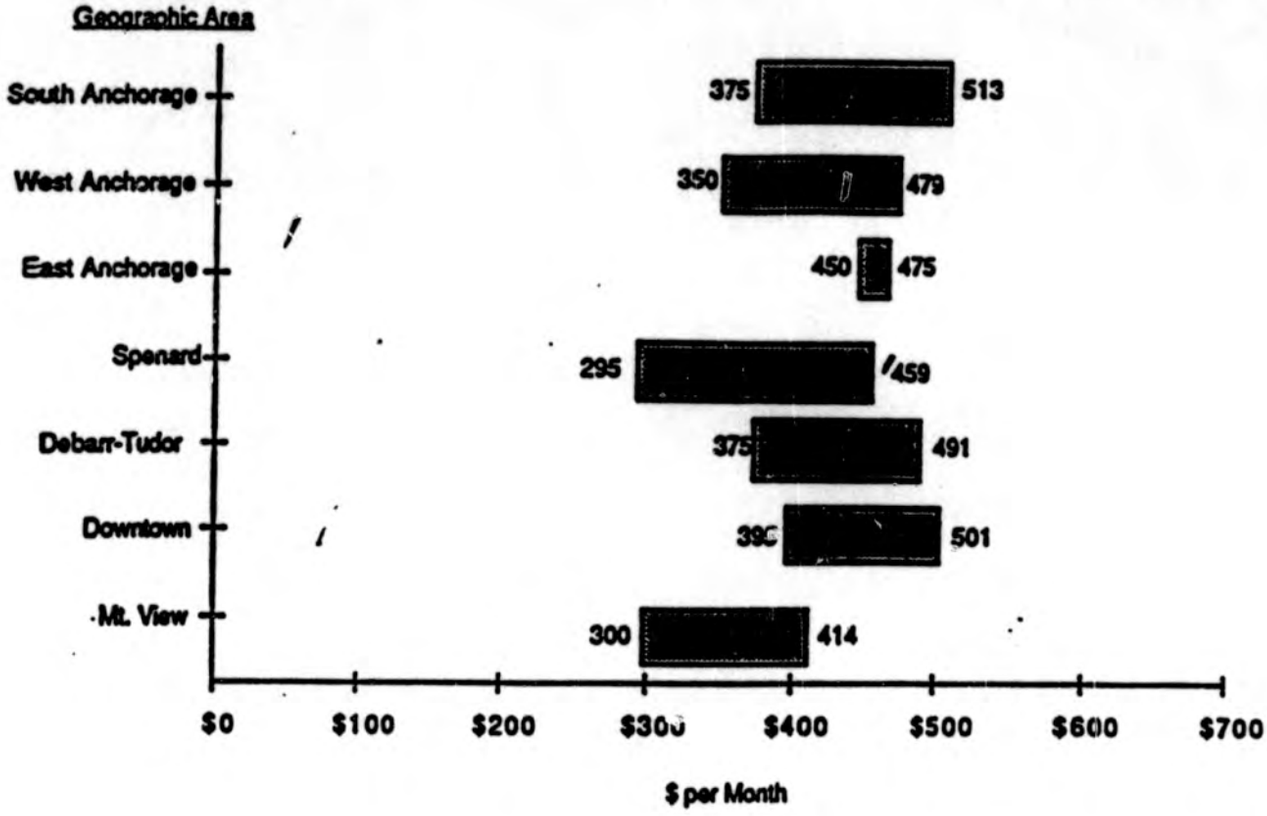
COMMENT:

This newspaper survey was done by a private consultant who used Sunday's Anchorage Times and News to do a comparison of rental rates...

This chart demonstrates from November to December that rental rates fell for two bedroom condos a significant amount. The high rate in November advertised in the paper was $685. In December that rate dropped to $628.

The number of ads for November was 39; for December 41.

Rental Rate Analysis
of Two-Bedroom Unfurnished Apartments
Acccording to Classified Advertising
Anchorage Daily News and Times Classified Ads
December 6, 1987



Information Provided by Kay E. Eliason

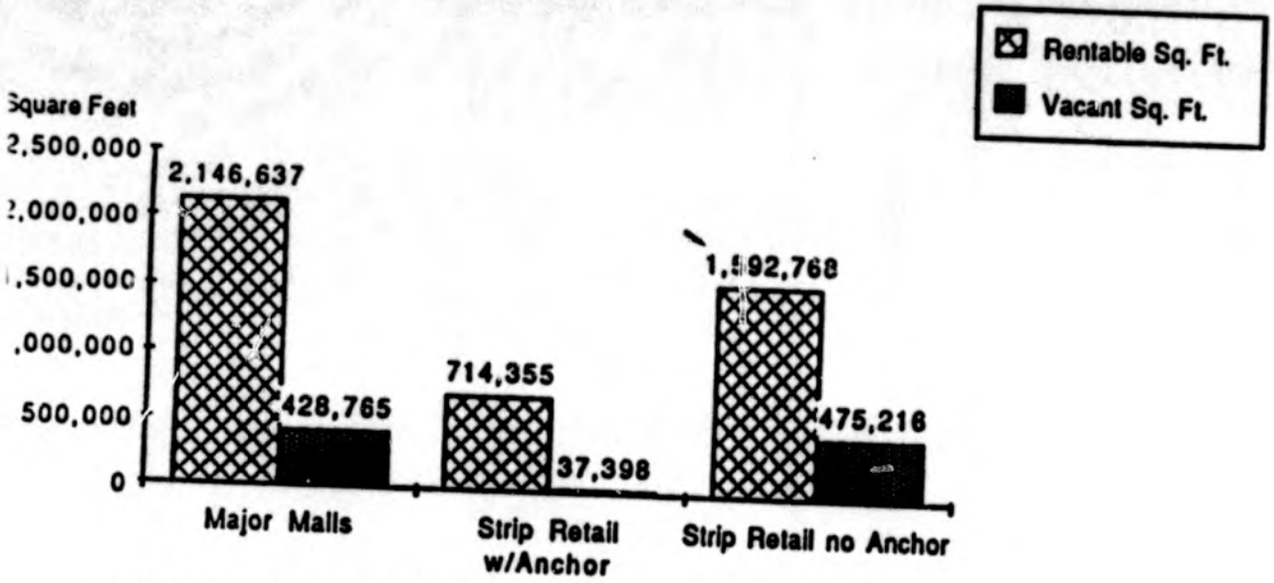
COMMENTS:

This chart demonstrates the asking rental rates for two-bedroom unfurnished apartments as advertised for sale on Dec. 6, 1987.

The two-bedroom unfurnished apartments were selected for analysis because MGIC condos fall into the two bedroom, unfurnished classification as rental properties.

This chart, therefore, gives you an idea of what can be expected for rental income in the various geographical locations. Utilities are not factored into these asking rental prices.

Anchorage Retail Inventory and Vacancies by Type of Mall



SOURCE: Alaska Valuation Services
Fred Ferrara, President

STATE OF ALASKA

STEVE COWPER, GOVERNOR

DEPARTMENT OF REVENUE

OFFICE OF THE COMMISSIONER

P.O. BOX S
JUNEAU, ALASKA 99811-0400
PHONE: (907) 465-2300

February 19, 1988

The Honorable Max F. Gruenberg, Jr.
Chairman, Joint Committee on Economic Recovery
Alaska State Legislature
P.O. Box V
Juneau, AK 99811

Dear Representative Gruenberg:

At the meeting of the Joint Economic Recovery Committee Thursday February 18, you asked whether I believed the legislature should consider social responsibilities as opposed to only considering what to do about the contraction that has occurred in the Alaska economy.

My answer was that I thought of the word "economic" as encompassing both the financial issues and the social and political issues.

I realize that may have been a confusing answer. Perhaps this will make it more clear.

State spending was the driving force behind the recent "oil boom." If we had spent at lower levels, and had much more moderate growth, then the adjustment would have been much easier. Hundreds of condos would not have been built, and would not stand empty today.

As pointed out by Erickson, and other economists, letting the real estate decline (or market correction) settle out will result in lower costs, and a quick growth rate because of that.

If the state intervenes, we will bias normal investment decisions, and make private dollars less productive than they otherwise would be. Economic recovery will be slowed, and the uncertainty and hardship will be prolonged. (Of course, if we could return spending to the per capita level of a few years ago, and keep it there, we will still be in fat city. But we can not - although we can squander our limited revenue).

Therefore, I think the most socially, politically responsible, and useful, thing we can do is to let the market correct itself.

04-D2LH

Intervening is not social responsibility. At best, it is tinkering. At worst, it will waste what money we have and create an enormous sense of unfairness. I am not suggesting we let anyone starve, or freeze in the dark. I am suggesting we foster a private economy.

Sincerely,

Hugh Malone
Commissioner of Revenue

HM:mll
88-46

cc: Members, Joint Committee on Economic Recovery

ALASKA INDUSTRIAL DEVELOPMENT
AND EXPORT AUTHORITY

1577 "C" STREET • SUITE 304 • ANCHORAGE, ALASKA 99501-5177 • (907) 274-1651

March 10, 1988

Honorable Kay Brown
State of Alaska
House of Representatives
P.O. Box V
Juneau, Alaska 99811

Dear Representative Brown:

Below is the additional information I promised to forward to you which explains the Small Business Administration (SBA) charts sent to you on March 7, 1988. (Those same charts are attached for your convenience.)

First of all, the chart, MARS 526, illustrates SBA's loan performance measurement system. This chart accounts not only for SBA loan guarantees, but also for SBA direct loans. Thus, on the chart , there is no distinction made between the direct loans or the guarantees which SBA has made over the last few years. However, you should be aware that SBA direct loans are minimal. The majority of business SBA sees is for loan guarantees.

The terms used in MARS 526 mean:

Cases Disbursed -	means the number of direct and guaranteed loans made in that year by SBA.
Failures (#'s) -	means the number of direct or guaranteed loans originated in that year which have failed. E.G. of 227 direct or guaranteed loans originated in 1986, 11 of those loans failed, not necessarily in 1986.
Percentage (by #'s) -	equals failures divided by cases disbursed, within the State of Alaska.
Region 10 Average -	refers to the SBA's Region 10 which includes Boise, Idaho; Portland, Oregon; Seattle and Spokane, Washington; and Alaska.
National Average -	refers to the average using the nation as a whole.
Cases Charged Off -	means actual number of loans that have been charged off as losses.
Dollars Disbursed -	means number of dollars for SBA's direct or

guaranteed loans originated for the particular year.

Dollars Charged Off - means number of dollars that have been charged off as a loss.

Percent (by $'s) - equals dollars charged off divided by dollars disbursed, within the State of Alaska.

Region 10 Average - refers to the SBA's Region 10 which includes Boise, Idaho; Portland, Oregon; Seattle and Spokane, Washington; and Alaska.

National Average - refers to the average using the nation as a whole.

The second chart, MARS 515, illustrates the number of direct loans and guaranteed loans extended by SBA during the years 1978 through 1987. This chart refers to Region 10 and the numbers you will see on the left hand side under the word "Office" correspond to each locale within Region 10. "1040" refers to Fairbanks; and "1084" refers to Anchorage. Here again, the chart is easier to understand when you consider that:

Disbursed in Dollars - means that direct loans or loan guarantees were extended by SBA in the amount of dollars shown for each corresponding year.

Purchase in Dollars - means that the SBA has had to disburse funds to honor guarantees. "purchase in dollars" does not necessarily mean that SBA is seeing a loss. E.G., the loan may have been rewritten.

Purchase Rate in Dollars - equals purchase in dollars (i.e. buy backs) divided by the total dollar amount of disbursed dollars to show the rate in dollars bought back by SBA.

I hope that this information helps you to more fully understand the SBA charts. I believe that this information is helpful in that it shows that AIDEA should approach any loan guarantee program with caution. This is because loans guarantees are not a profitable business. In reality, the Authority is lending its balance sheet and taking on a future liability.

If you have any questions, please feel free to call me in Anchorage at 274-1651.

Sincerely,

Bertram L. Wagnon
Executive Director

BLW/ga

Attachments

DATE RUN 10/16/87

SMALL BUSINESS ADMINISTRATION
LOAN PERFORMANCE MEASUREMENT SYSTEM
AS OF 09/30/87
(DOLLARS IN THOUSANDS)

Alaska Works, Including Direct

ANCHORAGE, ALASKA

	YEAR OF APPROVAL										FIVE-YEAR SUMMARY		
	YR-1 1986	YR-2 1985	YR-3 1984	YR-4 1983	YR-5 1982	YR-6 1981	YR-7 1980	YR-8 1979	YR-9 1978	YR-10 1977	YEARS 86-82	YEARS 81-77	YEARS 76-72
FAILURE RATES (LOANS IN LIQUIDATION OR CHARGED OFF)													
CASES DISBURSED	227	298	466	342	283	125	107	181	133	132	1616	678	760
FAILURES (#'S)	11	40	82	51	33	17	20	18	22	18	217	95	81
PERCENTAGE (BY #'S)	4.8	13.4	17.6	14.9	11.7	13.6	18.7	9.9	16.5	13.6	13.4	14.0	10.7
REGION 10 AVERAGE	3.5	11.5	16.6	15.5	21.0	26.8	26.7	23.0	16.7	15.3	14.0	21.8	13.7
NATIONAL AVERAGE	3.1	10.2	16.1	16.8	21.7	26.2	29.7	26.5	23.7	21.9	13.6	26.0	22.7
CHARGE-OFF RATES													
CASES CHARGED OFF	1	12	24	14	11	6	12	13	17	13	62	61	72
DOLLARS DISBURSED	55623	67353	98401	73656	56502	20149	15540	19253	17140	18596	351536	90680	72035
DOLLARS CHARGED OFF	39	1231	1644	1389	1055	1264	1112	617	1250	445	5561	4690	1[illegible]
PERCENT (BY $'S)	0.1	1.8	1.9	1.9	1.9	6.3	7.2	3.2	7.3	2.4	1.6	5.2	2.4
REGION 10 AVERAGE	0.3	1.4	2.8	3.1	6.9	14.5	12.7	10.1	6.3	4.4	2.8	9.9	4.9
NATIONAL AVERAGE	0.1	1.1	3.2	4.3	8.0	13.5	14.6	11.7	10.5	9.7	3.0	12.1	11.4

REGION 10

PERIOD ENDING FY 87

(S IN THOUSANDS)

DISBURSED IN DOLLARS

OFFICE	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987
1013	0	39,257	46,846	44,084	21,199	21,867	34,313	39,429	26,257	14,681
F 1040 > Anchorage	0	1,303	1,229	1,955	1,397	380	0	0	0	0
A 1084 > & Fairbanks	0	17,624	17,462	17,056	54,487	71,215	90,442	63,752	54,258	17,715
1086	0	34,480	55,600	42,277	21,891	24,888	21,222	18,530	14,985	13,345
1087	0	22,466	24,367	20,604	18,424	25,985	22,050	16,237	16,752	11,574
1094	0	18,608	19,128	16,335	6,367	10,377	13,955	12,155	17,598	10,788
TOTAL	0	133,739	164,633	142,311	123,764	154,712	182,022	150,104	129,850	68,103

PURCHASE IN DOLLARS

OFFICE	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987
1013	0	2,121	5,513	5,684	2,061	1,363	2,592	4,035	485	0
F 1040 > Fairbanks	0	0	0	0	0	0	0	0	0	0
A 1084 > & Anchorage	0	1,050	677	1,552	4,536	6,421	9,793	5,161	2,642	0
1086	0	2,696	3,869	1,801	2,545	3,008	982	2,079	282	157
1087	0	932	1,952	659	1,759	2,468	1,648	1,607	800	24
1094	0	614	1,313	338	449	745	640	345	199	0
TOTAL	0	7,413	13,324	10,034	11,350	14,006	15,655	13,228	4,409	181

PURCHASE RATE IN DOLLARS

OFFICE	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987
1013	0.0	5.4	11.8	12.9	9.7	6.2	7.6	10.2	1.9	0.0
F 1040 > Fairbanks	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
A 1084 > & Anchorage	0.0	6.0	3.9	9.1	8.3	9.0	10.8	8.1	4.9	0.0
1086	0.0	7.8	7.0	4.3	11.6	12.1	4.6	11.2	1.9	1.2
1087	0.0	4.2	8.0	3.2	9.5	9.5	7.5	9.9	4.8	0.2
1094	0.0	3.3	6.9	2.1	7.1	7.2	4.6	2.8	1.1	0.0
TOTAL	0.0	5.5	8.1	7.1	9.2	9.1	8.6	8.8	3.4	0.3

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CONDITIONS

University of Alaska Anchorage, Institute of Social and Economic Research February 1988, Vol. XXV, No. 1

Alaska Housing and the Recession

The recession that started at the end of 1985 turned the Alaska housing market on its head. Prices of houses, condominiums, and mobile homes—especially the last two—have come down so far that Alaskans have been left queasy and disbelieving. Recent ISER economic projections are for the recession to end in 1988, and a *gradual* economy recovery to begin—*if* oil prices remain stable in the $16- to $20-per-barrel range. Oil prices are the crucial element in ISER's projections. But if the Alaska economy does begin to recover in 1988, the effects of the recession on the housing market will not disappear overnight.

Since the end of 1985 Alaska has lost jobs, population, and income.[1] We now have much more housing than there is demand for. In Anchorage alone in 1987 nearly 14,000 housing units—including both owner-occupied and rental units—were vacant.[2] Thousands of Alaska houses, condominiums, and mobile homes have been foreclosed on over the past two years. Even after the economy bottoms out, the housing market will be slow in recovering. This is particularly true of the market for condominiums and mobile homes in Anchorage.

Recent ISER work indicates that it will likely be well into the 1990s before real—adjusted for inflation—condominium prices in Anchorage regain their 1985 levels. There are hundreds more mobile homes in Anchorage right now than are likely to be occupied by 1992. Very few condominiums or apartments will be built in Anchorage over the next few years: the units that already exist will more than meet the projected demand.

Single-family houses should fare better—because most buyers prefer houses when they can afford them. Lower prices in the past two years have put single-family houses within the reach of some buyers who in the early 1980s might have bought condominiums or mobile homes.

Economic conditions will of course be crucial in determining the future health of the Alaska housing market. But after economic conditions, how the major lenders handle their big inventory of foreclosed properties will make the most difference to the stability of the Anchorage housing market in the next few years. If they try to quickly sell large numbers of those properties, they will further depress prices and increase loan defaults.

Depressed prices and large numbers of loan defaults are serious problems for all Alaska homeowners and mortgage lenders—but particularly for AHFC, which holds more than 60 percent of the outstanding residential mortgages in the state.

This publication has two main parts. The first part describes conditions in the Alaska housing market in 1987, and contrasts them with conditions during the economic boom of the early 1980s. Those descriptions set the stage for the second part, which

This **Review** *is the second of two publications based on* **Alaska's Economy and Housing Market**, *a report ISER recently prepared for the Alaska Housing Finance Corporation (AHFC). AHFC commissioned the report to help the corporation in its efforts to stabilize the Alaska housing market. The first publication summarized the economic forecasts in the ISER report; this one discusses the report's findings on the housing market.*

[1] See "Alaska's Economy: What's Ahead?" *Alaska Review of Social and Economic Conditions*, December 1987, Vol. XXIV, No. 2, University of Alaska Anchorage, Institute of Social and Economic Research.

[2] Vacancies as of July 1987, as reported by the Municipality of Anchorage's Community Planning Department in *1987 Anchorage Population Profile*, December 1987.

Winter scene in a residential area of south Anchorage. *Photo: Bob Hallinen/Anchorage Daily News*

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Donald O'Dowd–President, University of Alaska
Marvin O. Looney–Chancellor, University of Alaska Anchorage
E. Lee Gorsuch–Director, Institute of Social and Economic Research

Editor: Linda Leask
Editorial Assistant: Kandy L. Crowe
907-786-7710

Main Institute Office:
3211 Providence Drive
Anchorage, Alaska 99508

Alaska Housing and the Recession

This publication is based on several chapters of *Alaska's Economy and Housing Market*, an October 1987 report by O. Scott Goldsmith, Matthew Berman, Lee Huskey, Linda Leask, and Teresa Hull. All the authors except Huskey are ISER faculty and staff members. Huskey is associate professor of economics with UAA's School of Economics and Public Policy.

reports on how various policies available to AHFC and other lenders might affect the housing market.

ALASKA MORTGAGES AND FORECLOSURES

National Secondary Lenders

Alaskans planning to buy houses generally apply for mortgage loans at banks or savings and loans or mortgage companies. These institutions—known as primary lenders—process the applications, approve or disapprove the loans, and collect the monthly mortgage payments. But very rarely do the banks themselves actually hold the mortgages: they sell almost all of them on the secondary market. In fact, primary lenders as a rule won't make a mortgage loan without first determining that a secondary lender will buy it. This system greatly reduces the risks for primary lenders in making long-term loans and frees their money for other uses.

The biggest secondary lenders nationally were created by the federal government to help increase the amount of home mortgage money available—on the grounds that a healthy housing industry is important to the U.S. economy. Of these, by far the biggest is the Federal National Mortgage Association (FNMA)—widely known as Fannie Mae—which holds about $100 billion in mortgage loans. Another—much smaller—secondary lender is the Federal Home Loan Mortgage Corporation (FHLMC, or Freddie Mac).

The Federal Housing Administration (FHA) and the Veterans Administration (VA) are federal agencies that do not actually buy mortgage loans but rather insure or guarantee them. Loans insured by FHA or guaranteed by the VA sell easily on the secondary market because they carry government backing. Most FHA-insured or VA-guaranteed loans go onto the secondary market through mortgage-backed securities that are issued by yet another federal organization--the Government National Mortgage Association (Ginnie Mae)—and are sold to investors. FHA and VA are often thought of as secondary lenders, because their backing for a loan generally insures its marketability.

The Farmers Home Administration is another federal agency that makes home loans, but only to farmers and to low-income Americans living in rural areas. This agency holds its own mortgages.

Alaska Housing Finance Corporation

The national lenders and insurers described above all operate in Alaska, but here the state government has also created several secondary lenders. The biggest is of course the Alaska Housing Finance Corporation, which holds more than $4 billion in Alaska residential mortgages, or about 60 percent of the outstanding home mortgage debt in Alaska in 1987.

AHFC is a public corporation created by the

Alaska Legislature in 1971. As a public corporation, AHFC is under the control of the state government, but it has more autonomy than traditional state agencies, and it can sell bonds to raise mortgage money.

The state legislature originally established AHFC to help Alaskans with low or moderate incomes get housing at reasonable costs. Alaska officials said that the high cost of housing in the state, the lack of mortgage money in many rural areas, and other factors was making it hard for many Alaskans to buy houses.

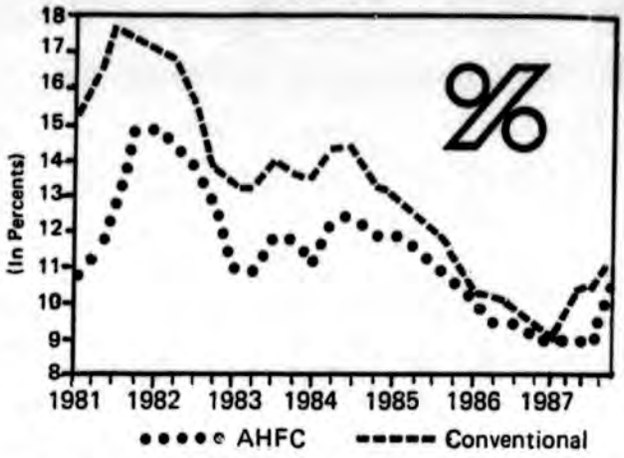
At the start of the 1980s the state legislature made several decisions that quickly transformed AHFC into the dominant mortgage lender in Alaska. National mortgage interest rates were at all-time highs, peaking above 17 percent. The legislature decided to begin subsidizing home mortgage interest rates. As Figure 1 shows, in 1981 Alaska borrowers could get a $135,000 loan from AHFC for less than 11 percent—or they could go to a national lender and pay more than 15 percent. AHFC's interest rate advantage narrowed in later years as the legislature tied AHFC's rates closer to its costs of borrowing money, but through 1985 AHFC loaned money at significantly lower rates than the national lenders.

The legislature also decided to open AHFC's lending programs to virtually all Alaskans by removing the income ceilings for borrowers, and to establish special new programs that would make it easier for more Alaskans to buy houses. Examples of those programs are the mobile home program that makes long-term mortgages available for mobile homes in trailer parks, and the Home Ownership Assistance (HOF) program that pays part of monthly mortgage payments for borrowers whose incomes aren't high enough to qualify them for conventional loans.

AHFC's lower interest rates and special programs drew 80 percent of Alaska borrowers to AHFC in the first half of the 1980s. In the past several years AHFC's share of Alaska mortgages has declined steadily. Market interest rates began dropping off sharply in 1985, and in 1987 they reached their lowest point since the 1970s. At one point in 1987 rates under AHFC's biggest loan program were the same as those of other lenders (see Figure 1).

As national interest rates fell, special conditions and restrictions on AHFC loans prompted more borrowers to look to other lenders. For example, most AHFC loans written before 1985 couldn't be assumed, and before 1986 AHFC didn't have the authority to refinance loans. Also, in 1982 the corporation had adopted the Alaska Building Equity (ABE) payment system that increases mortgage payments five percent a year from the fourth through the ninth year of the loans. Still, in 1987 AHFC remained the biggest single buyer of mortgages written for home sales.

Figure 1. Home Mortgage Interest Rates, AHFC Taxable Program and Conventional,* 1981-1987



*Mortgage rates for a $135,000 loan under AHFC's taxable program and under FNMA's 30-year, fixed-rate mortgages.

Since 1980 AHFC has raised several billion dollars in mortgage money by selling bonds. The legislature appropriated about $1 billion for AHFC mortgage subsidies between fiscal years 1981 and 1984. For the past several years, AHFC has had a revolving loan fund and received no subsidies.

Other Sources of Mortgage Money

The Alaska Department of Community and Regional Affairs also acts as a secondary lender, but it buys loans only in the most remote areas of Alaska. Its operations are small as compared with AHFC's, and it gets its loan money not through bond sales but through state appropriations.

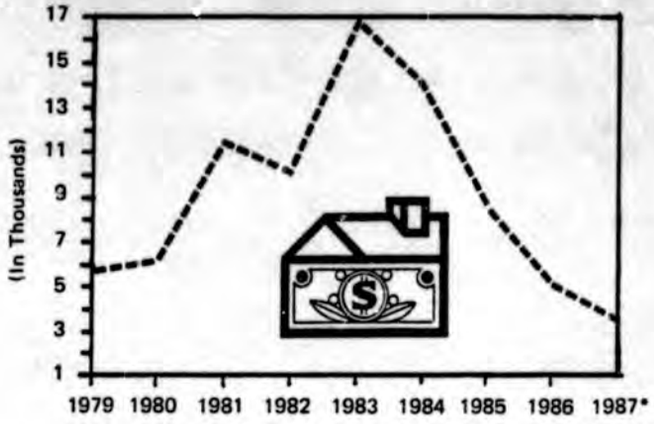
The managers of the Alaska Permanent Fund and the state pension funds (the Public Employees Retirement System and the Teachers Retirement System) also buy some residential mortgage loans—but not many as compared with the other secondary lenders, and frequently those that exceed the loan limits of other lenders. In recent times, however, those agencies have bought very few loans.

There are a variety of others who hold some Alaska mortgage loans. Credit unions hold rather than sell some mortgages. Individuals sometimes finance the sale of their own houses. Figures on mortgages held by those and others are not available, but they are few compared with those held by the big lenders.

Mortgage Activity, 1979-1987

Figure 2 marks the ups and downs of housing sales in Alaska from 1979 through 1987: it shows the numbers of mortgages written for home sales. (The figure excludes mortgages for refinancing, which are shown in Figure 3.)

Figure 2. Alaska Mortgages Written for Home Sales, 1979-1987*



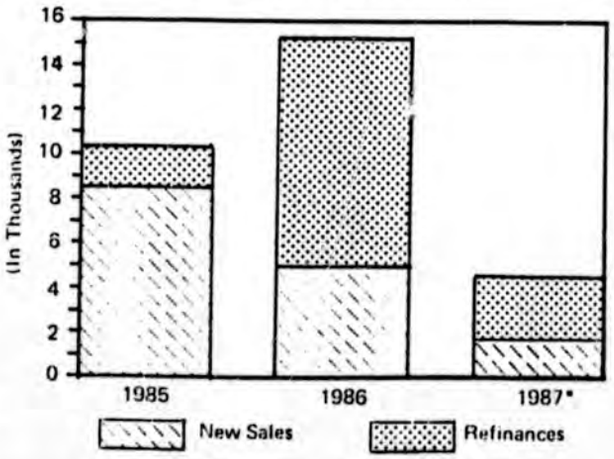
*1987 figure is an estimate based on numbers for the first six months of the year.

About 5,500 mortgages worth $380 million were written in Alaska in 1979. That was a slow year as compared with what was to come. The economic boom created by construction of the trans-Alaska pipeline was over; some people were leaving the state; and mortgage interest rates were on their way up. Mortgage activity in 1980 was not much higher, but the stage was set for the next boom. High oil prices were fattening the Alaska treasury. The state government began spending its oil revenues in many ways that sparked unprecedented economic growth. At the same time, the legislature also voted to subsidize mortgage interest rates.

The economic boom created by state spending drew tens of thousands of people into the state. The combination of a burgeoning population, growing incomes, and special programs tripled numbers of new mortgages between 1979 and 1983, when more than 16,500 mortgages for home sales were written. Numbers of new mortgages began dropping in 1984, but it was in 1985 that the really sharp decline started.

The recession began toward the end of 1985, as state spending declined. In 1986 the recession worsened as oil prices plummeted. Fewer than 5,000 mortgages for home sales in Alaska were written in 1986—fewer than had been written in 1979. And in 1987 an estimated 3,000 mortgages were created for home sales in Alaska.

Figure 3. Alaska Mortgages Written for Home Sales and Refinancing, 1985-1987*



*The 1987 figure is just the first six months.

Home Refinancing

In 1985 national interest rates began dropping sharply, and many Alaskans who held home loans at much higher rates refinanced their houses. As Figure 1 shows, AHFC's subsidized rates in 1982 were as high as 14 percent; by late 1985 conventional and AHFC rates were below 11 percent. And in 1986 and early 1987 rates were near 9 percent.

Firm figures on how many mortgages are written for Alaskans refinancing their homes are hard to get. Figure 3 shows our estimates of how many mortgages written in Alaska in 1985, 1986, and the first half of 1987 were for refinances and how many for sales. Presumably there was very little refinancing before 1985, when interest rates were much higher.

The figure shows that in 1985 less than 20 percent of the 10,000 mortgages created in Alaska were for refinancing. In 1986, 15,000 mortgages were written—but more than 10,000 of those, or 70 percent, were for refinancing. In the first half of 1987, more than 60 percent of new Alaska mortgages were for refinancing.

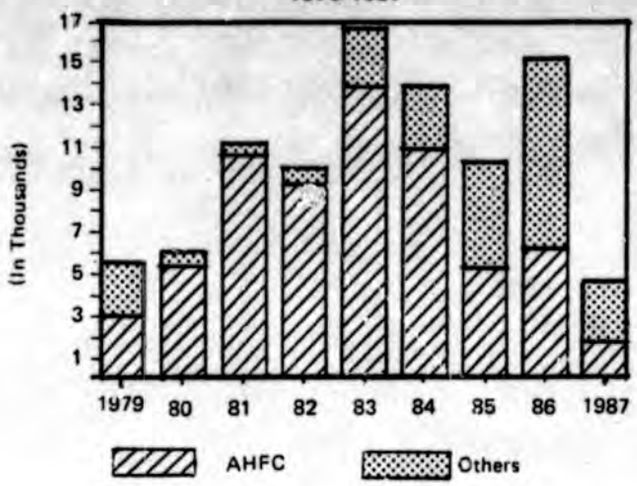
AHFC's Market Share

Figure 4 clearly shows why AHFC is the biggest mortgage holder in Alaska: it identifies shares of total mortgages (including those for sales and for refinances) AHFC and other lenders bought each year from 1979 through the first half of 1987. From 1980 through 1982, when AHFC's rates were several percentage points below those of other lenders, AHFC bought 90 percent or more of new mortgages. Through 1984 AHFC still had 80 percent of the market. In the past several years interest rates and terms of other lenders became more competitive. AHFC's share dropped from about 50 percent in 1985 to less than 40 percent in the first half of 1987.

1987 Mortgage Holdings of Major Alaska Lenders

What is at stake in the Alaska housing market? How much home mortgage debt is there in the state? Table 1 shows the mortgage holdings of major Alaska lenders as of mid-1987.

Figure 4. AHFC's Share of New Alaska Mortgages,[a] 1979-1987[b]



[a]Includes mortgages for sales and for refinances.
[b]Figures for just the first six months of 1987.

In 1987 the major lenders in Alaska held more than 84,000 home mortgage loans worth $7 billion dollars. The biggest mortgage holder is AHFC, which as of June held more than 52,000 home mortgages with an outstanding balance of about $4.3 billion. Other state government entities held another 3,000 loans with a balance of $230 million.

National lenders and insurers are also carrying tens of thousands of loans. AHFC holds some FHA-insured and VA-guaranteed loans; to avoid double-counting, those are included in AHFC's holdings and excluded from FHA's and VA's. In addition to those held by AHFC, there were nearly 8,500 FHA-insured loans and 8,600 VA-guaranteed loans in Alaska in 1987, with a combined unpaid balance of $1.6 billion. FNMA and FHLMC were each carrying more than 5,000 mortgage loans with a combined balance of nearly $900 million.

Table 1

Residential Mortgage Holdings of Major Alaska Lenders, June 1987[a]

	Number of Loans Outstanding	Unpaid Principal Balance ($ millions)
AHFC		
Mobile Homes	4,760	$ 151
AHFC/FNMA[b]	10,722	1,170
AHFC/Other	36,686	2,967
Total	52,168	$4,288
FNMA[c]	5,471	$400
FHLMC[d]	5,152	479
FHA-Insured[e]	8,437	844
VA-Guaranteed[f]	8,602	763
Alaska Dept. of CRA[g]	1,194	123
Farmers Home Admin.[h]	1,322	106
Alaska Permanent Fund	300	42
Alaska Pension Funds[i]	NA	NA
AIDA & Div. of Invest.[j]	1,565	68
Total	84,211	$7,113

[a]As of June 1987, unless otherwise noted.

[b]These are loans financed with FNMA money from early 1984 through 1986; AHFC makes principal and interest payments to FNMA on collateralized notes. FNMA is, however, liable for any losses not covered by private mortgage insurance if borrowers default.

[c]Excluding loans cited in note b; these are loans purchased from banks and other primary Alaska lenders.

[d]Figures are for FHLMC loans serviced by Alaska lenders as of June 1987; they may include some loans on homes outside the state but serviced by Alaska lenders and exclude some loans on Alaska homes that are serviced by lenders outside the state.

[e]Outstanding loans as of December 31, 1986, excluding AHFC loans insured by FHA. The unpaid principal balance is an estimate, based on average size of outstanding loan. Although FHA is an insurer rather than a lender, FHA-insured loans are included here because most of those loans go to lenders other than those listed in this table. Most FHA-insured loans go into mortgage-backed securities (MBSs) issued by the Government National Mortgage Association (GNMA) and sold to various investors.

[f]Figures as of March 31, 1987, excluding VA-guaranteed loans held by AHFC. A very large share of new VA-guaranteed loans in Alaska in the first half of the 1980s were purchased by AHFC. Most VA-guaranteed loans not purchased by AHFC go into MBSs issued by GNMA and sold to various investors.

[g]As of March 1987.

[h]Outstanding loans as of May 1987. Unpaid principal balance is an estimate based on average size of outstanding loan.

Good estimates of cumulative Alaska residential mortgage holdings of the pension funds are not available because figures on such holdings are combined with figures on other mortgage holdings of the funds.

[i]These are mortgage loans made under a state veterans' loan program that no longer exists; it was replaced in the early 1980s by the state veterans' program administered by AHFC. Most of these loans are now held by the Alaska Industrial Development Authority (AIDA); the Division of Investments in the Alaska Department of Commerce and Economic Development holds a few and services those held by AIDA.

Source: *Alaska's Economy and Housing Market*, ISER Report, October 1987, Tables 3.1 and 3.3.

Mortgage Liabilities

The current recession has pushed thousands of Alaska homeowners into default and foreclosure. Before we look at 1987 figures on properties in foreclosure, we'll broadly outline liability on mortgage loans when borrowers default. When we say "mortgage liabilities," we mean just losses lenders and borrowers take when individual borrowers default. There are of course other kinds of liabilities—for instance, AHFC is liable for payment on the billions of dollars in bonds it sold to finance mortgage loans. We don't discuss that or other potential liabilities here.

Table 2 summarizes insurance requirements and liabilities of home buyers and major lenders. When agreeing to make a mortgage loan, lenders generally require two kinds of protection against default. The first step is requiring a down payment, generally 5 to 10 percent of the sales price. The chief exception is the Veterans Administration program, under which qualified veterans can borrow up to a specific amount with no money down.

Second, lenders typically require borrowers to carry private mortgage insurance (PMI) on loan amounts above 70 to 80 percent of the purchase price. If the borrower defaults, the private mortgage insurer pays the lender any losses on the insured portion of the loan. Loans in remote areas of Alaska generally don't carry private insurance because it usually isn't available in those areas. Loans held by the Alaska Department of Community and Regional Affairs and the Farmers Home Administration are uninsured. Also, some loans made before 1980 under various state loan programs are uninsured.

So what happens when a borrower defaults and his property goes into foreclosure? First, borrowers who default lose their down payments and any additional amount they've paid on the loan principal.

Another liability borrowers face is that lenders may institute what is known as a judicial foreclosure. If a lender believes that a borrower who defaulted could have continued to make his payments but chose not to, he may go to court to try to make the borrower liable for any losses when the property is re-sold. In a non-judicial foreclosure, the lender accepts that the borrower has neither the income nor the assets to meet his payments and does not press for any further liability. (Damage that defaulting does to a borrower's future credit is also certainly a loss, but a less measurable one.)

The losses that lenders and insurers face when properties go into foreclosure are complicated to calculate. The biggest factor is the condition of the housing market. If prices are rising, insurers and particularly lenders don't generally lose money—because they can expect to re-sell the relatively few properties that go into foreclosure for enough to cover the outstanding mortgage and foreclosure costs. But when prices are falling—as they have been in Alaska over the past two years—it's a different story: there are thousands of foreclosed properties and they frequently sell for less than the outstanding mortgage, especially if the mortgage was written when prices were at their peak.

In Alaska's housing market today, insurers face the first losses when properties with private mortgage insurance go into foreclosure. They try of course to keep those losses to a minimum, and they have two broad choices. The insurer can take a foreclosed property and re-sell it, or the insurer can let the lender re-sell it and pay the lender a claim up to the maximum insured amount.

Say for example that a property with a $100,000 outstanding mortgage goes into foreclosure, and that private mortgage insurance covers $20,000 of that mortgage.[3] Estimate the foreclosure costs at $5,000. Suppose the insurer thinks the property will be hard to re-sell (which means that there will also be substantial interest and other holding costs) and that it might command only $70,000 when it does sell. If the insurer took the property, held it, and re-sold it at a depressed price, his costs could easily exceed $35,000. On the other hand, if the insurer let the lender take the property and simply paid the maximum insurance claim, he would limit his costs to $20,000. Only in cases where the insurer thinks he can keep his costs below the maximum insurance claim will he be likely to try to re-sell it himself.

What about lenders? What losses do they take in foreclosures? Again, in a market where prices are rising, lenders who require down payments and mortgage insurance don't generally take any losses. But in the Alaska market today, values of many properties are so much lower than the outstanding mortgages that insurance doesn't cover all the losses. And on loans not covered by insurance, lenders take all the losses.

AHFC's liability on mortgage loans varies considerably among loans made at different times and under different programs, as Table 3 shows. But AHFC has better protection than most lenders on the majority of loans it made between 1981 and 1986. Most AHFC loans made during that period carry private mortgage insurance and additional features that limit AHFC's liability.

Most AHFC loans made between 1981 and early

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[3]These figures are simplified to make the example straightforward. To show precisely how much private insurance covered of any given loan we would have to know original purchase price, size of down payment, subsequent payments on principal, and amount of insurance the lender required.

Table 2

Liability* in Home Foreclosures

Lender	Insurance Requirements	Liability of Borrowers in Foreclosure	Liability of Lenders in Foreclosure
FNMA/FHLMC	Borrowers required to carry private mortgage insurance (PMI) on loan amounts above 80% of the house price.	*Borrowers in all cases lose their down payments, which can be as low as 0-5% but are generally 10% or more of the purchase price. Also forfeited is any amount subsequently paid on the loan principal. And, in some cases, lenders will undertake judicial foreclosures, in which they go to court to try to make borrowers who default liable for losses on resale of the properties.*	Lender liable for any losses not covered by PMI.
FHA-Insured Loans	Borrowers pay premium for government insurance, either in lump sum or as part of monthly payments.		FHA liable for all losses.
VA-Guaranteed Loans	The federal Veterans Administration guarantees up to $27,500 on mortgage loans to veterans as a benefit of military service; this guarantee takes the place of private mortgage insurance.		VA liable for losses up to $27,500 on each loan, additional liability falls on primary or secondary lender.
Farmers Home Administration	This federal agency makes loans to low-income households in rural areas; no private mortgage insurance.		Farmers Home Administration liable for all losses.
State of Alaska			
AHFC	Most borrowers required to carry private mortgage insurance on loan amounts above 75% to 80% of the house price; on mobile home loans, borrowers must carry private credit insurance on 40% of the loan amount.		Varies substantially among different types of loans; see Table 3.
DCRA	Loans in rural areas; no private mortgage insurance required (because it is not available in many cases).		DCRA takes all losses.
Ak Permanent Fund	Borrowers required to carry private mortgage insurance on loan amounts over 70% of the house price.		Permanent Fund bears any losses not covered by PMI.
Division of Investments and AIDA	These loans were made to veterans before 1981 through the former Division of Veterans Affairs; no private mortgage insurance required.		Losses accrue either to Veterans' Revolving Loan Fund or AIDA.

*Includes just losses the various parties may be liable for when individual loans go into foreclosure; does not include AHFC's liability for repayment of bonds and notes financing the loans, or other kinds of liabilities.

1984 carry pool insurance—insurance that covers any losses not covered by private mortgage insurance. Mortgage Guarantee Insurance Company (MGIC) provided that pool insurance as a provision of bonds AHFC sold to finance loans during that period. So AHFC has virtually no liability when borrowers default on those particular loans.[4]

From 1984 through 1986, the national lender FNMA financed a large share of AHFC loans—and on those particular loans, FNMA rather than AHFC is liable for any losses not covered by private insurance. (AHFC is, of course, liable to re-pay principal and interest to FNMA on the notes that financed the loans.)

AHFC's liability on other loans varies, as Table 3 shows. Some loans it took over from earlier state loan programs carry no insurance. Mobile home loans made before 1983 carry no insurance; loans made after that time carry private credit insurance on 40 percent of the value of the loan. AHFC takes losses beyond what private credit insurance covers.

[4]However, the pool insurance is in effect only until the bonds financing the loans have been paid off—when the bonds are paid off, AHFC becomes liable for losses not covered by private mortgage insurance.

Homes in Foreclosure

We've seen the mortgage holdings of major lenders and how the losses are divided up when borrowers default. Now we turn to the grim evidence of Alaska's battered housing market: properties in foreclosure.

Table 4 shows foreclosed properties held by the major lenders and insurers as of mid-1987. In June 1987, lenders and insurers were holding more than 4,200 foreclosed properties. During the preceding 18 months, they had sold an additional 1,600 properties that had been foreclosed on. Taken together, the foreclosed properties still in inventory and those re-sold during the preceding year and a half totaled nearly 5,900—or 7 percent of outstanding residential mortgages in Alaska in mid-1987. And there were doubtless other foreclosures not recorded on Table 4—properties held by individual banks and private mortgage insurers other than MGIC, for instance. Reliable figures on such foreclosures are hard to get.

Table 3

AHFC's Liability* in Foreclosures

All Loans Except Mobile Homes	AHFC Liability
Loans with private mortgage insurance and pool insurance; include most loans made from 1981 to early 1984.	None, until bonds carrying pool insurance provision are paid off; then AHFC liable for any losses not covered by PMI.
Loans with private mortgage insurance that were financed by FNMA, 1984-1986; include most loans made during that period.	None. FNMA is liable for any losses not covered by PMI on loans it financed for AHFC during this period.
Loans with just private mortgage insurance; include some loans made throughout AHFC history and almost all loans made since January 1987.	AHFC is liable for any losses not covered by PMI.
Loans with no insurance; include loans made under several special programs that no longer exist.	AHFC liable for all losses.
Loans with federal government insurance or guarantee; include loans made throughout most of AHFC's history.	FHA takes all losses on FHA-insured loans. VA takes liability only up to $27,500 on each VA-guaranteed loan; AHFC liable for additional losses.
Mobile Home Loans	
Loans before 1983 with no insurance.	AHFC liable for all losses.
Loans since 1983 with private credit insurance.	AHFC liable for losses not covered by PCI.

*Includes just losses AHFC is liable for when individual borrowers default.

It's no surprise that AHFC held about 65 percent of foreclosed properties in mid-1987. AHFC bought most of the new mortgages written in Alaska in the 1980's and in particular most of those written when prices were at their peak. Also, from 1980 on, AHFC bought almost all the mortgage loans on mobile homes—which have seen tremendous losses in value during the recession.

FNMA, FHA, and VA were also holding several hundred properties each in the middle of the year. Other lenders held fewer. The 100 properties that the insurer MGIC was holding at that time were just properties it had actually taken title to; remember that MGIC carries substantial liability on properties that are in AHFC's inventory.

We don't have foreclosure figures more recent than mid-1987 for most individual lenders, but we do have them for AHFC through the end of 1987. We know that, like AHFC, other lenders continued to add to their inventory of foreclosures in the second half of the year.

Table 5 and Figure 5 document the relentless climb in AHFC's inventory of foreclosures from 1984—before the start of the recession—through 1987. At year-end in 1984, AHFC held just 129 properties. By the end of 1985 that had grown to more than 500, and in 1986 to more than 1,600. At the end of 1987 AHFC held 3,700 properties. If we compare those figures with the mid-1987 figures in Table 4, we see that at the end of 1987 AHFC held 1,000 more properties than it had six months earlier.

Table 6 shows a more detailed breakdown of properties in AHFC's inventory as of the end of 1987: 1,325 single-family houses and duplexes, 1,171 condominiums and townhouses; 1,192 mobile homes; and 13 triplexes and fourplexes.

It's easy to see why the problems in the condominium and mobile home markets are more severe than in the market for single-family houses: there are a great many more single-family houses in Alaska

Table 4

Inventory of Foreclosed Properties Held by[a] Major Alaska Lenders and Insurers, June 1987

	Held in Inventory June 1987	Foreclosed Properties Sold 1986-June 1987
AHFC		
Mobile Home	965	143
Other	1,793	1,075
Total	2,758	1,218
FNMA	394	160[e]
FHLMC[b]	78	–
FHA-Insured	385	87
VA-Guaranteed[c]	366	80
MGIC	105	25[f]
Alaska Dept. of CRA	40	1
Farmers Home Admin.	100	30
Alaska Permanent Fund	23	11
AIDA and Div. of Invest.	5	6
Others[d]	NA	NA
Total	4,254	1,618

[a]Properties "held by" each lender or insurer include just those to which each already held title or was in the process of acquiring title as of June 1987.

[b]Includes both completed and nearly completed foreclosures.

[c]Includes both properties the VA had already acquired title to and pending title acquisitions. Excluded are properties that the VA paid claims on but did not take possession of. Most such properties probably went into AHFC's inventory of foreclosed properties; some ended up in the hands of mortgage companies, banks, or other primary lenders.

[d]Some foreclosed properties are held by a wide range of Alaska banks, other primary lenders, and private mortgage insurance companies other than MGIC. Figures on such holdings are extremely difficult to get, and the numbers are small compared with the holdings of the secondary lenders and largest insurers.

[e]Properties sold 1986–May 1, 1987.

[f]Estimated sales from November 1986–June 1987.

Sources: See Sources, Table 3.1, *Alaska's Economy and Housing Market.*

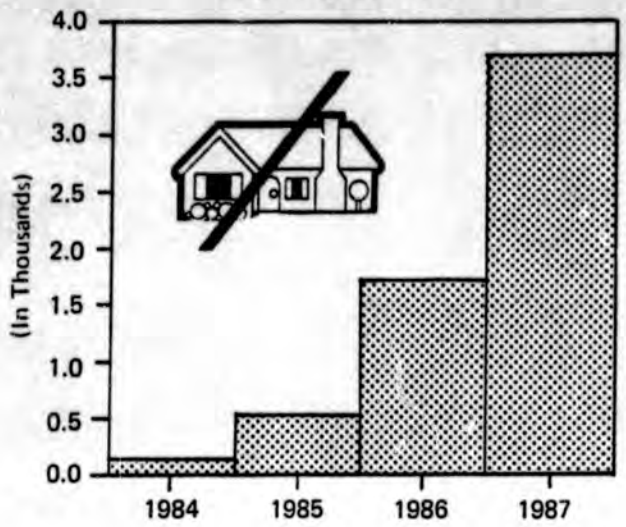
Table 5

AHFC Cumulative Inventory* of Foreclosed Properties, Year-End, 1984-1987

	1984	1985	1986	1987	% of 1987 Total
Mobile Homes	38	186	610	1,192	32%
Other	91	322	1,061	2,509	68%
All	129	508	1,671	3,701	100%

*The year-end inventories are total properties foreclosed on minus those resold. These figures are AHFC's statewide inventory.

Figure 5. AHFC Year-End Inventory of Foreclosed Properties, 1984-1987



than there are either condominiums or mobile homes, but there are just about as many mobile homes and condominiums in foreclosure as there are single-family houses.

As the last column of the table shows, houses and duplexes made up more than 75 percent of active AHFC loans in 1987, but just 36 percent of foreclosures. By comparison, condominiums and townhouses made up 15 percent of total loans but 32 percent of foreclosures. Mobile homes, while making up just 7 percent of active AHFC loans, accounted for 32 percent of foreclosures.

Table 6

AHFC Inventory of Foreclosed Properties, Year-End 1987

	Number of Foreclosures	Percent of Total Foreclosures	Active AHFC Loans by Type
Single-Family Houses & Duplexes	1,325	36%	77%
Condominiums & Townhouses	1,171	32	15
Mobile Homes	1,192	32	7
Triplexes & Fourplexes*	13	1	1
Total	3,701	100%	100%

Source: AHFC.

*Although AHFC loans by type give us a good idea of the composition of housing stock in general, this is not true of triplexes and fourplexes, of which AHFC finances few. Most are financed by other lenders.

POLICY OPTIONS

Future economic conditions will be the biggest force in the recovery of the Alaska housing market. But the next biggest force will be the mortgage lenders and insurers with big inventories of foreclosed properties. They can help stabilize the market by selling their holdings at a moderate pace rather than selling large numbers quickly—which would further depress prices and put more homeowners at risk of default.

What is the Problem?

The problem in the Alaska housing market today is that we have more housing than we have households: too many condominiums, mobile homes, houses, and apartments. Having too big a supply and too little demand has created an unstable market, where prices have already fallen dramatically and there is great anxiety about the future.

Thousands of homeowners have defaulted on their mortgages over the past two years. Some lost their jobs and were unable to keep up the payments; some had to move and were unable to sell the houses for what they still owed on them. Still others simply walked away from their properties because they had lost value. Many thousands more Alaskans are still making their payments but have negative equity—that is, their homes are worth less than their outstanding mortgages.

The big lenders and insurers are holding depressingly large inventories of foreclosed properties. They have already taken tens of millions of dollars in losses.

The worst thing for the housing market right now would be panic. If the big lenders decided to dump their inventories of housing on the market at any price in an attempt to cut their losses, they could create panic among homeowners with negative equity. Large numbers of homeowners might simply walk away from basically sound properties that will appreciate in value in the future. The result of such panic would be a continuing downward spiral of prices and many more foreclosures.

What would help the housing market most is a move toward stability: a leveling-off of prices and a reduction in defaults. Such a move toward stability would boost confidence among homeowners, and make them more likely to try to stay in their homes. Fewer defaults would ease the pressure on the lenders. Stability would help buy time toward solutions of the housing problems and eventual recovery of the market.

We are not saying that lower prices are bad for everyone and that higher prices are universally good.

Lower prices are obviously good for some Alaskans who might not have been able to buy houses a few years ago. What we are saying is that a *stabilization* of prices would be good. If prices became stable, the stage would be set for the recovery of the market and Alaskans could become more confident that housing is a good investment.

If, on the other hand, prices continue to fall and defaults persist in such disheartening numbers, investors will be reluctant to put money into the Alaska housing market in the future. That reluctance will translate into more expensive mortgage money for Alaskans. AHFC's ability to sell bonds could be hampered. Mortgage insurers might pull out of the Alaska market entirely, or charge much higher premiums for staying in.

So how can the market be stabilized? The biggest factor in the recovery of the housing market will of course be economic conditions. ISER projects that if—a crucial qualifier—oil prices remain stable in the $16-to-$20-per-barrel range, the state economy should bottom out in 1988 and begin a gradual recovery. This is our medium-case projection, and we consider it the most likely, if oil prices stay in that range. The economic recovery would be faster over the next several years if oil prices suddenly rose to around $25 a barrel (our high-case projection) and stayed that high. At the other extreme, if oil prices dropped to $15 a barrel or less and stayed that low for many months, the economy could continue to decline into 1989 and we would see very little growth over the next few years (the low-case projection).[5]

The next biggest factor in stability of the housing market will be—for reasons we describe below—sales of foreclosed properties. In the following pages we assess how rates of foreclosure sales and other factors could affect the Anchorage housing market between now and 1992.[6] We don't have enough information to make such assessments for housing markets in other areas of the state, but movements in the Anchorage market will reflect general trends in housing markets throughout Alaska—with some obvious regional differences.

An important point to keep in mind is that we cannot forecast what is going to happen in the Anchorage housing market. To do that we would have to know how many foreclosed units the institutional sellers are going to put on the market and at what rate. What we can show are effects on the market of various rates of sale.

[5]Those economic projections appear in "Alaska's Economy: What's Ahead?" *Alaska Review of Social and Economic Conditions*, Vol. XXIV, No. 2, December 1987.

[6]Anticipating what may happen is of course complicated by the fact that each lending institution has its own interests in and constraints on holding foreclosed inventory.

Sliding Prices and Rising Defaults: A Vicious Circle

Figure 6

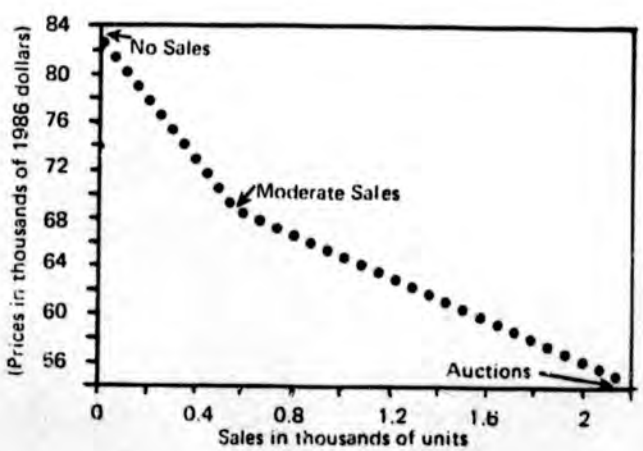
The faster AHFC and other big lenders and insurers put foreclosed properties on the market—at the extreme, through large auctions without bid floors—the more prices will be depressed and defaults persist, as illustrated by Figure 6. More defaults will mean the lenders will end up with even more foreclosed properties.

Flooding the market with housing pushes prices down. As prices go down, more and more homeowners find themselves with negative equity—that is, their mortgages are larger than the market prices of their properties. If owners with negative equity are forced to sell, many will likely default because they are unable or unwilling to make up what can be a very substantial difference between what they owe and what the properties will sell for

Also, a continuing downward spiral of prices erodes confidence among would-be buyers and existing homeowners. Alaskans who might be attracted by lower housing prices won't buy if they think prices could go much lower. Demand for housing could dry up. Existing owners with negative equity become more likely to walk away from their properties if the value continues to drop and they can see no turnaround in sight.

Figure 7 illustrates how prices of Anchorage condominiums are related to the number of fore-

Figure 7. Relationship Between Real Prices and Sales of Foreclosed Anchorage Condominiums, 1988



closed units on the market. The prices shown on the vertical axis of the figure are for a particular kind of unit and are *not* intended to represent average prices of all condominiums on the Anchorage market. (We know that in recent months condominiums in Anchorage have sold for as little as $25,000 and as much as $100,000.) What we are showing here is how different rates of sale could affect the price of the same condominium. So it is more important to look at the difference in the prices at various rates of sale than at the dollar figures.

As the figure shows, if all foreclosed condominiums were kept off the market—a very unrealistic scenario—condominium prices could be nearly 50 percent higher than if the market were flooded with condominiums through large auctions. At more moderate rates of sale, prices would be about 25 percent higher than if large auctions were held.

Holding properties off the market is of course very expensive for lenders and insurers: they pay in the neighborhood of $18 to $30 a day for each unit, depending on the size of the outstanding mortgage and the interest rate. We are not suggesting that lenders and insurers should hold onto all their foreclosed units: that simply is not feasible. We are pointing out that lenders should consider the future costs they might face if their selling policies contribute to more defaults.

Sliding property values and rising defaults have already cost Alaska lenders, insurers, and borrowers tens of millions of dollars. The foreclosure process itself is expensive. Costs of judicial foreclosures—under which the lender goes to court to try to make borrowers liable for any losses when the property is re-sold—are particularly high. And falling property values also have other social costs. For example, some homeowners who could find better jobs elsewhere don't move because they can't sell their houses for what they owe on them, and they don't want to default.

What Can Be Done?

We examined a number of policies AHFC and other lenders might try to increase demand, reduce supply, stabilize prices, and reduce defaults. Those include loosening down payment and other loan requirements; easing restrictions on owner-occupancy in AHFC-financed condominium complexes; subsidizing interest rates; removing housing stock; and limiting or transferring mortgage liability in some circumstances.

We made our analysis with a complex computer model that simulates the Anchorage housing market and incorporates ISER's medium-case economic projections. Our findings about how various policies might affect the Anchorage housing market are detailed in ISER's recent report, ***Alaska's Economy and Housing Market.*** Below we summarize our main findings:

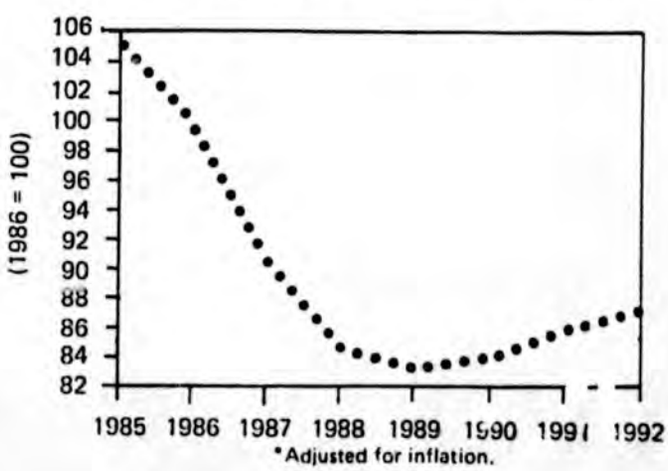
- How the big lenders manage their large inventories of foreclosed properties will be far more important than anything else they do to try to stabilize the market. If they sell those properties very quickly—at the extreme, through big auctions without bid floors—and push prices further down, the housing market will continue to be unstable and defaults will persist.

- The market for single-family houses will recover more quickly than the market for condominiums. Most buyers prefer houses when they can afford them—and today's lower prices mean houses are within the reach of more buyers. Once the economy turns around, the market should be able to absorb the inventory of foreclosed single-family houses relatively quickly. And there will be some construction of single-family houses in Anchorage over the next several years—but the total number of new houses built between now and 1992 will likely be smaller than the number built during the peak construction year of 1983.

- Very few condominiums or apartments will be built in Anchorage between now and 1992, if our medium-case economic projections prove correct. The existing supply will be more than ample to meet demand. Under that same case, real rents—rents adjusted for inflation—in Anchorage in 1992 will still be below 1985 and 1986 levels (see Figure 8).

- Because such a large proportion of Anchorage condominiums are in foreclosure, it will likely take several years beyond 1992 to sell the inventory of

Figure 8. Projected Anchorage Real* Rent Index



foreclosed condominiums without further depressing prices.

- For some Alaskans there is a silver lining in the real estate cloud: lower prices will mean that they can move into better-quality housing than they could afford before. But a big barrier for those who already own homes is that many now owe more on their houses than the houses will sell for. Lenders may want to consider a policy that allows those who want to buy better houses in Alaska to transfer a portion of their current mortgage liability to new homes.

Faster or Slower Economic Recovery

We consider our medium-case economic projections most likely, if oil prices stay in the range of $16- to $20- per barrel. The findings outlined above are based on those medium projections. But it's always possible that the economy could grow faster or slower than we expect: the Alaska economy is often surprising. If oil prices were significantly higher or lower than we assume in the medium case, the housing market would of course be affected. Figures 9 and 10 illustrate the possible range of change in two housing market variables under the low, medium, and high economic cases.

Figure 9. Real Prices, Anchorage Condominiums Under Three Cases, 1985-1992

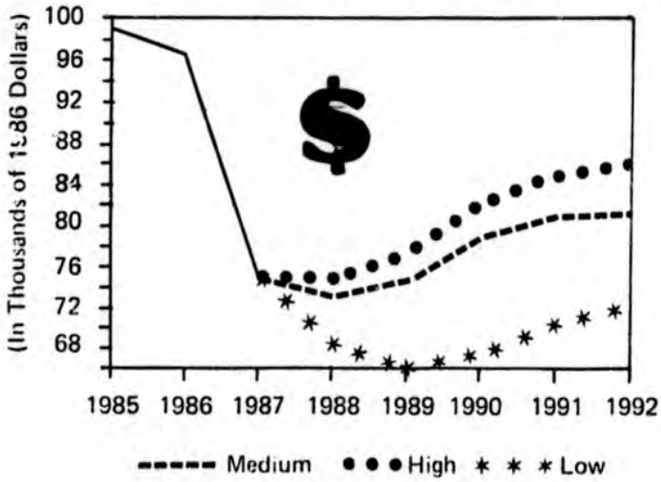


Figure 9 shows how real—adjusted for inflation—prices of Anchorage condominiums would be different under the high, medium, and low economic projections. All three cases assume the same moderate rate of sales of foreclosed properties. If more or fewer foreclosed properties were sold, the projections would change.

In the medium and the high cases, average real prices for a standard condominium would bottom out in 1988 and in the low case in 1989. Prices would then begin a very gradual recovery. But even under the most optimistic case, 1992 average condominium prices when adjusted for inflation would still be far below their 1985 peak of around $100,000.

Real prices of single-family houses should rebound faster, and—unlike the case for condominiums—a number of new houses will likely be built in Anchorage in the next few years. Figure 10 shows projected cumulative numbers of building permits for new single-family houses in Anchorage from 1987 through 1992 under high, medium, and low economic projections. Under any of the cases total construction over the next few years would be modest as compared with the frenzied building of the early 1980s: under the medium case, a total of fewer than 3,000 new houses would be built in Anchorage between now and 1992. By contrast, in 1983 alone 3,500 new houses were built in Anchorage.

Figure 10. Projected Cumulative Building Permits for Anchorage Single-Family Houses, Under Three Cases, 1987-1992