

ALASKA LEGISLATURE SPECIAL COMMITTEE / SUBJECT FILE 8672
1604 SCOMM 60: HOUSING FINANCE TASK FORCE, 1989

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

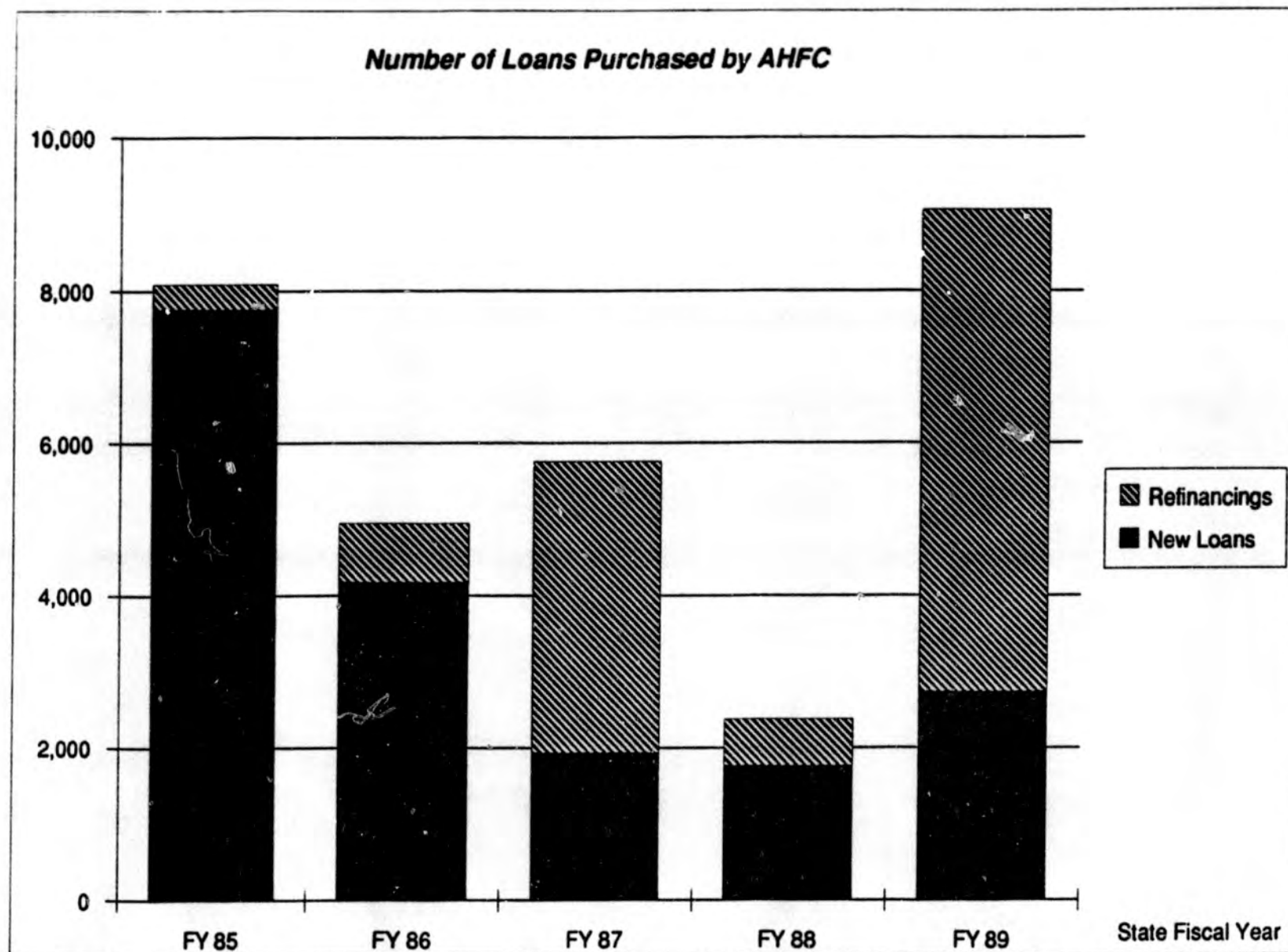
Program	Retained Earnings	Contributed Capital	Total
<i>Operating/General</i>	\$371	\$148	\$519
<i>Home Ownership Fund (HOF)</i>	(42)	103	61
<i>Insurance Fund</i>	<u>(44)</u>	<u>16</u>	<u>(28)</u>
Corporation Totals	\$285	\$267	\$552
<i>Bond Financed Programs</i>	53	766	819
Combined Totals	\$338	\$1,033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

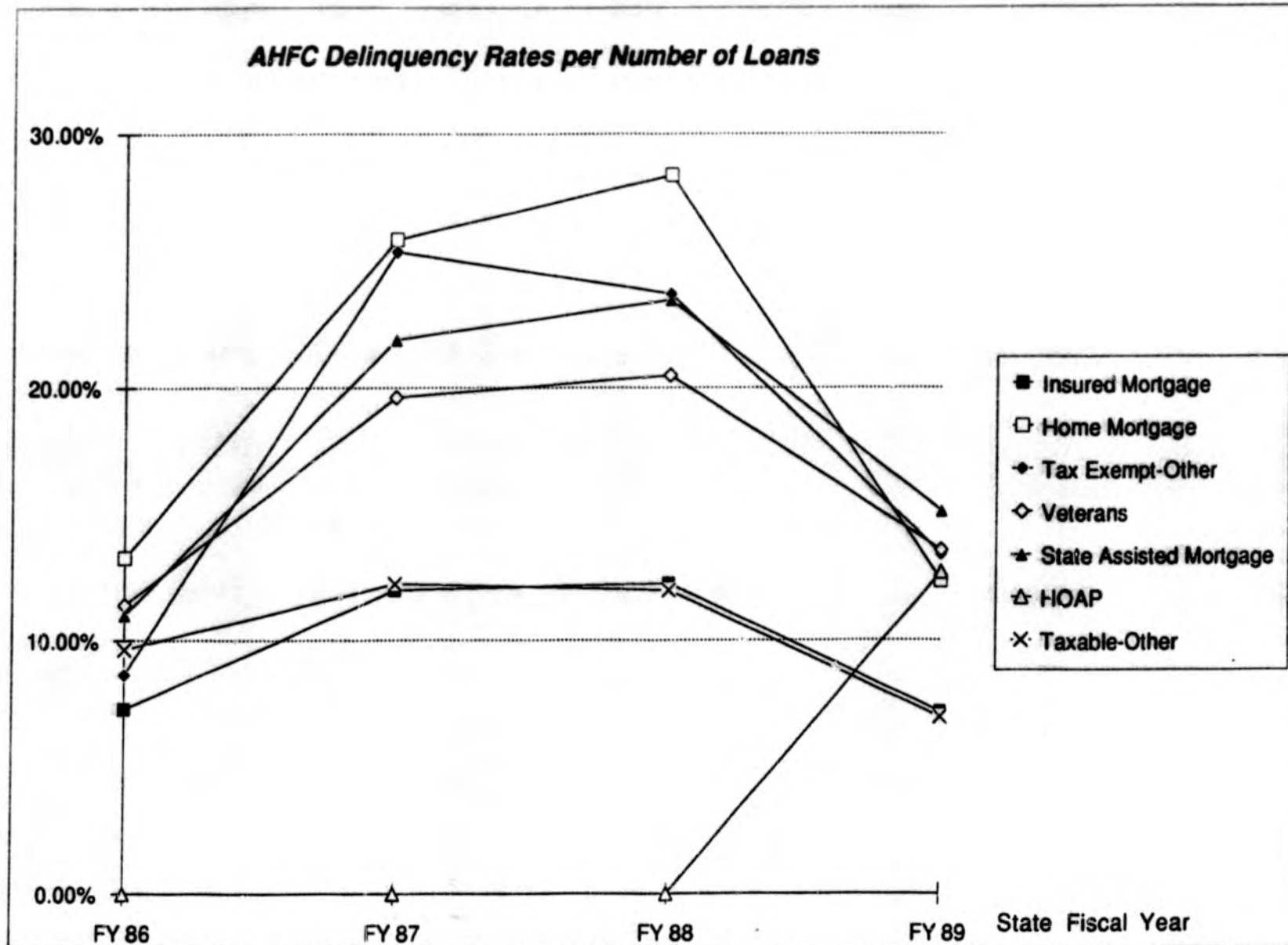
Other significant historical data which we reviewed relate to loan purchase activity, loan delinquency, and loan foreclosure and property disposal. From this review we noted the following significant items:

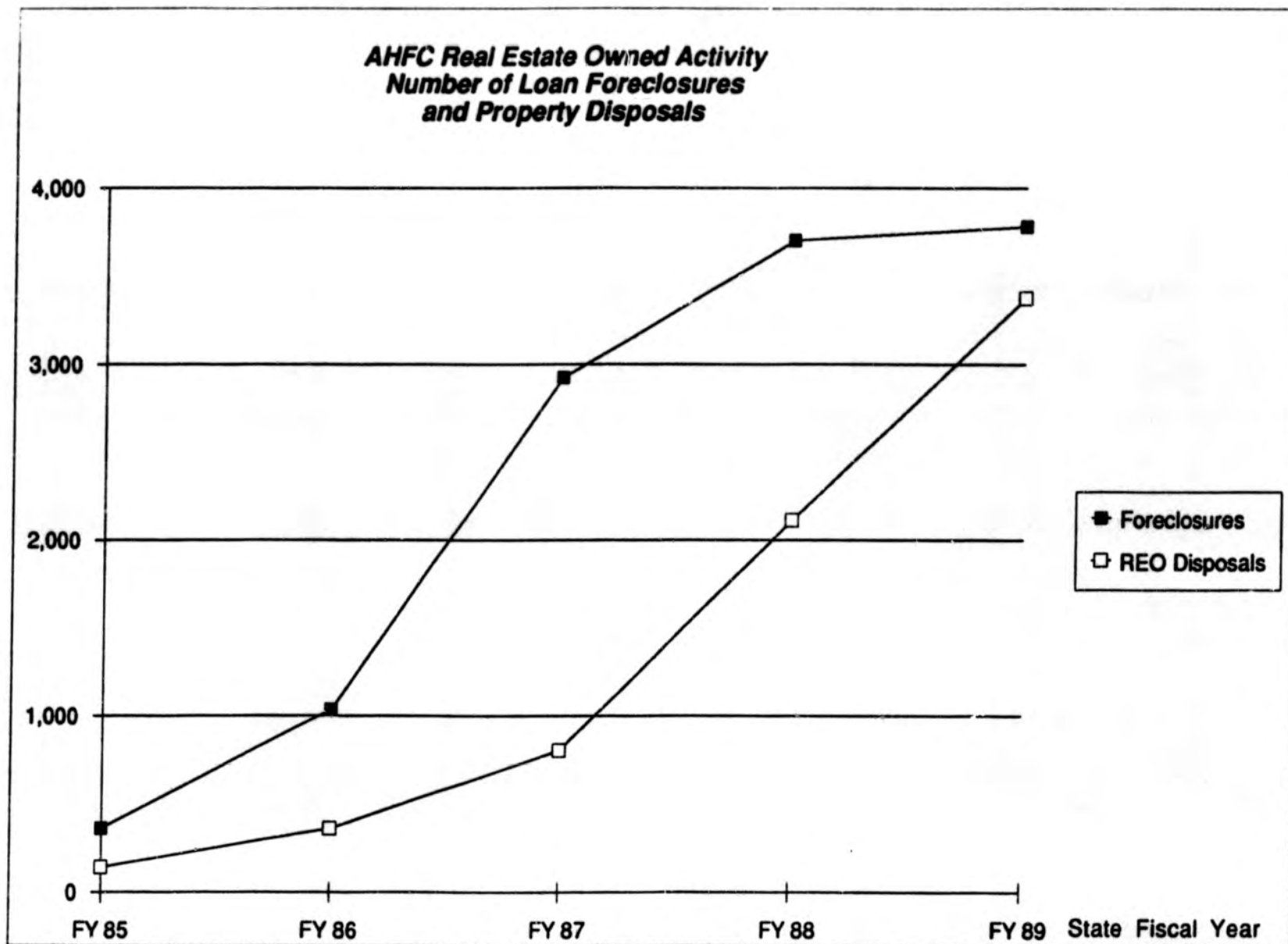
- **Exhibit III-3**, following this page, shows that new loan purchases decreased significantly since 1985. Refinancings, which were principally under the Home Owners' Assistance Program (HOAP), were dominant in fiscal years 1987 and 1989
- **Exhibit III-4**, following Exhibit III-3, illustrates the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

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

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







C. ANALYSIS OF PRESENT FINANCIAL POSITION

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

1. Bond Financed Programs' Equity

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

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

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

Equity of AHFC Bond Financed Programs

June 30, 1989
(\$ Millions)

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

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

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

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

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

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

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

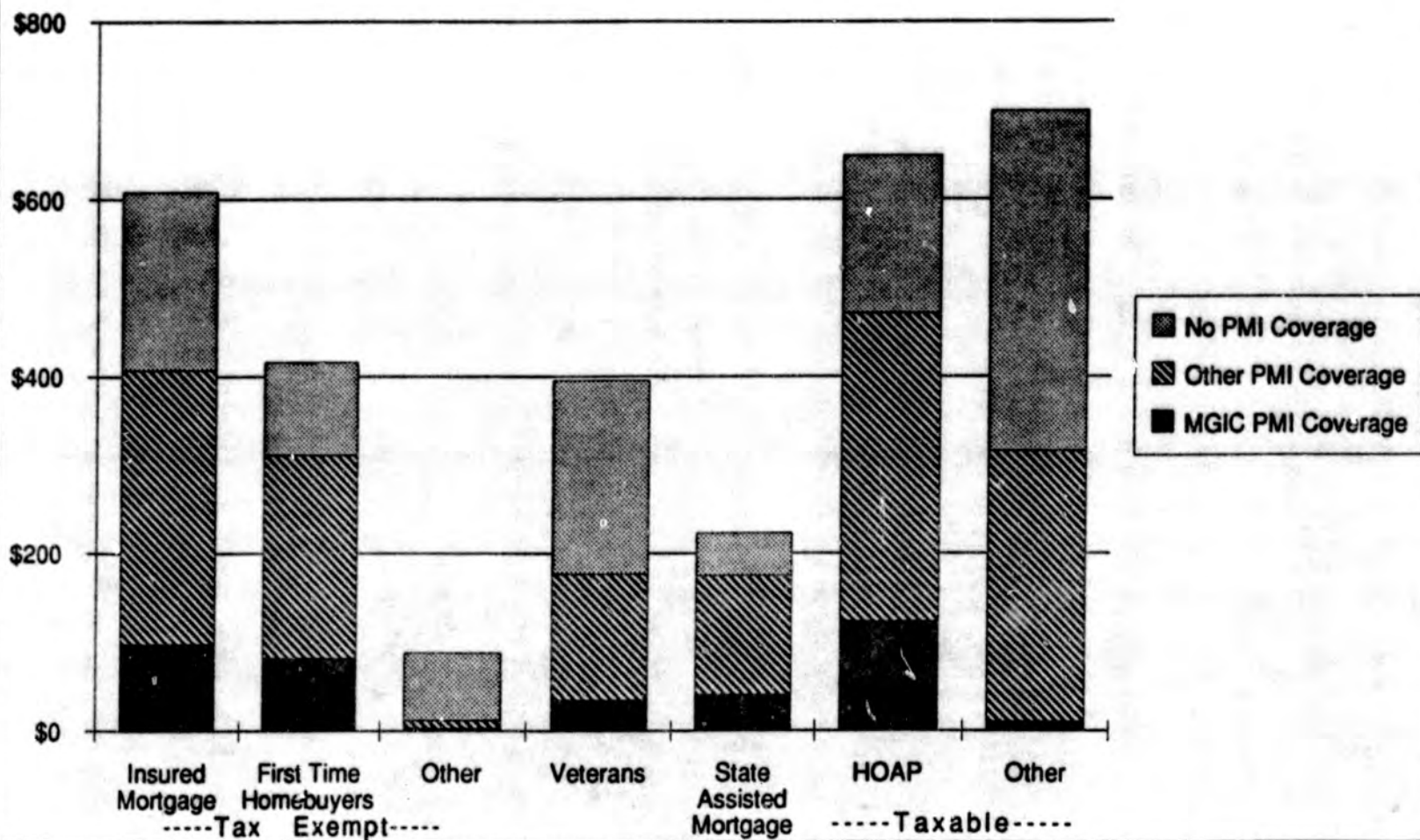
Exhibit III-7, following this page, shows loans outstanding as of June 30, 1989, and the representative portion of loans by program which are insured by a private mortgage insurance (PMI) carrier, and by MGIC specifically. MGIC also is the principal pool coverage carrier, providing this secondary coverage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

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

2. Corporation Equity

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

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



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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

2. Conclusion of Financial Position of AHFC

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

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

SECTION IV

**PRESENT ECONOMICS OF
ALASKA HOUSING MARKET**

Ernst & Young

IV. PRESENT ECONOMICS OF ALASKA HOUSING MARKET

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

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

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

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

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

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

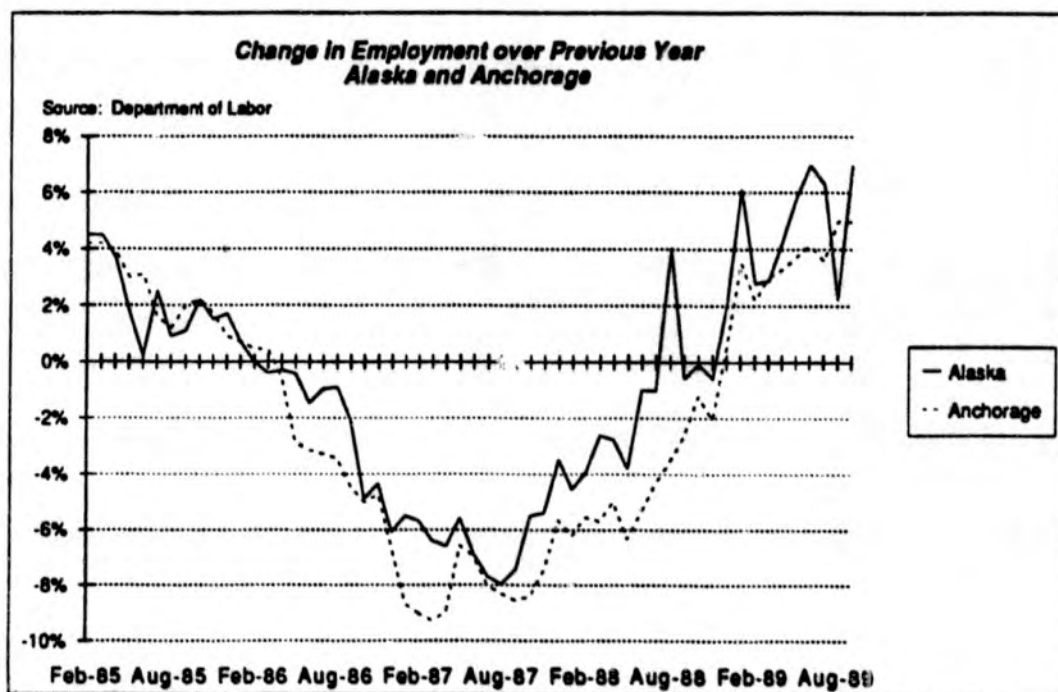
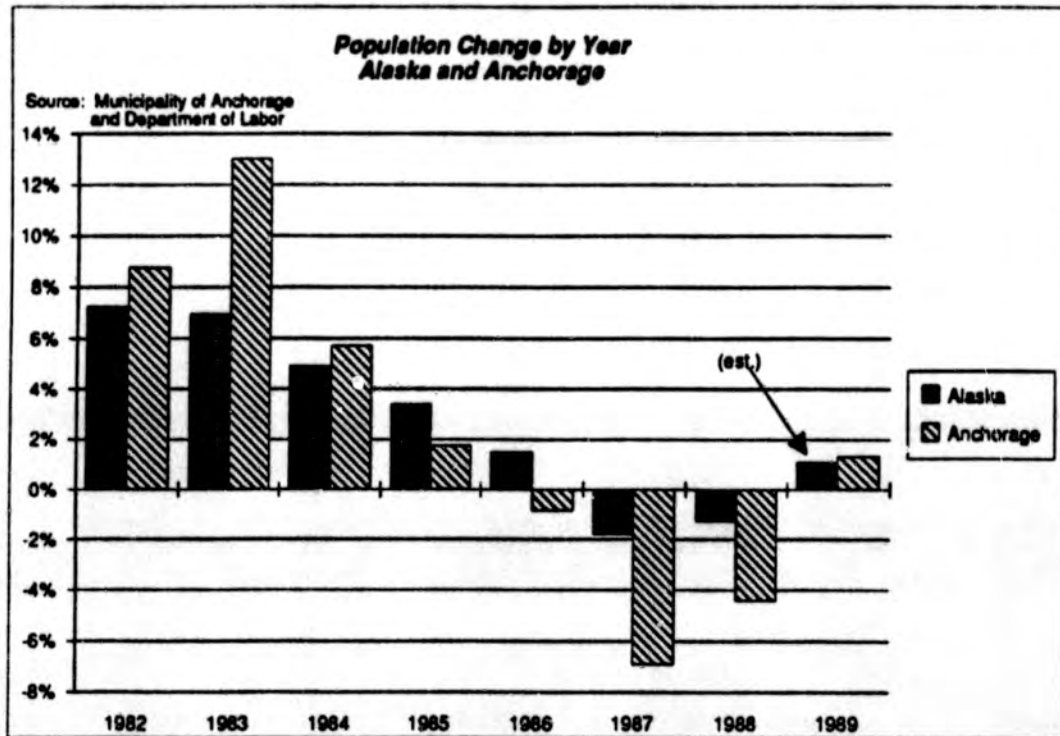
Anchorage, which contains about half of Alaska's population, showed a similar but even more pronounced swing. A graphical summary of changes in population is shown in Exhibit IV-1, following this page.

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

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

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

Alaska Population and Employment Change



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

2. Employment

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

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

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

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

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

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

3. Construction Industry

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

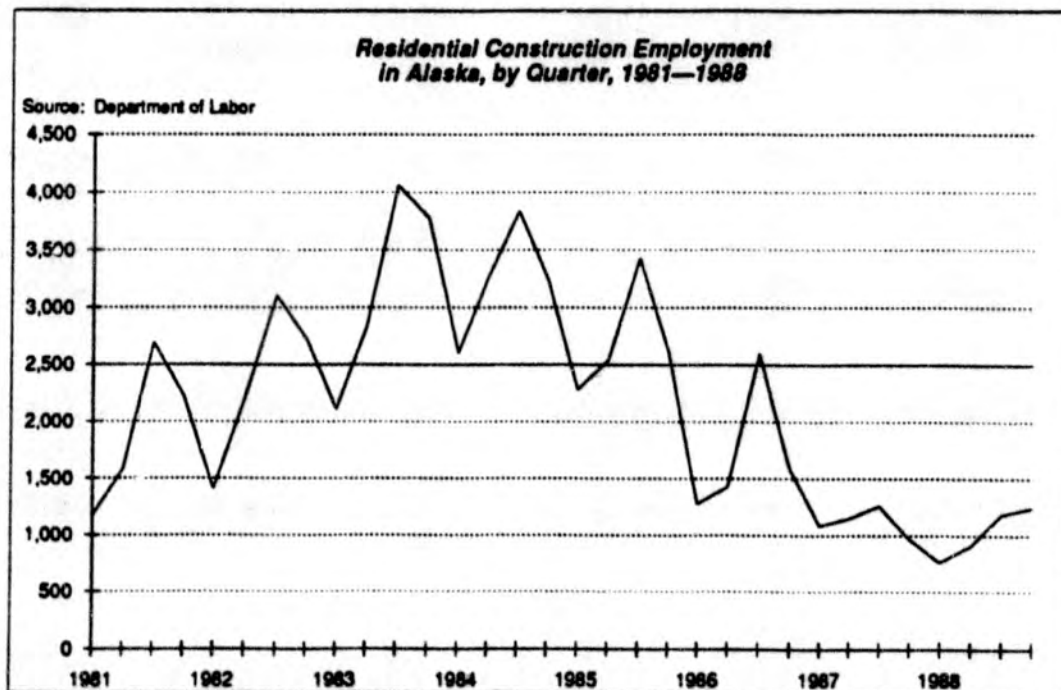
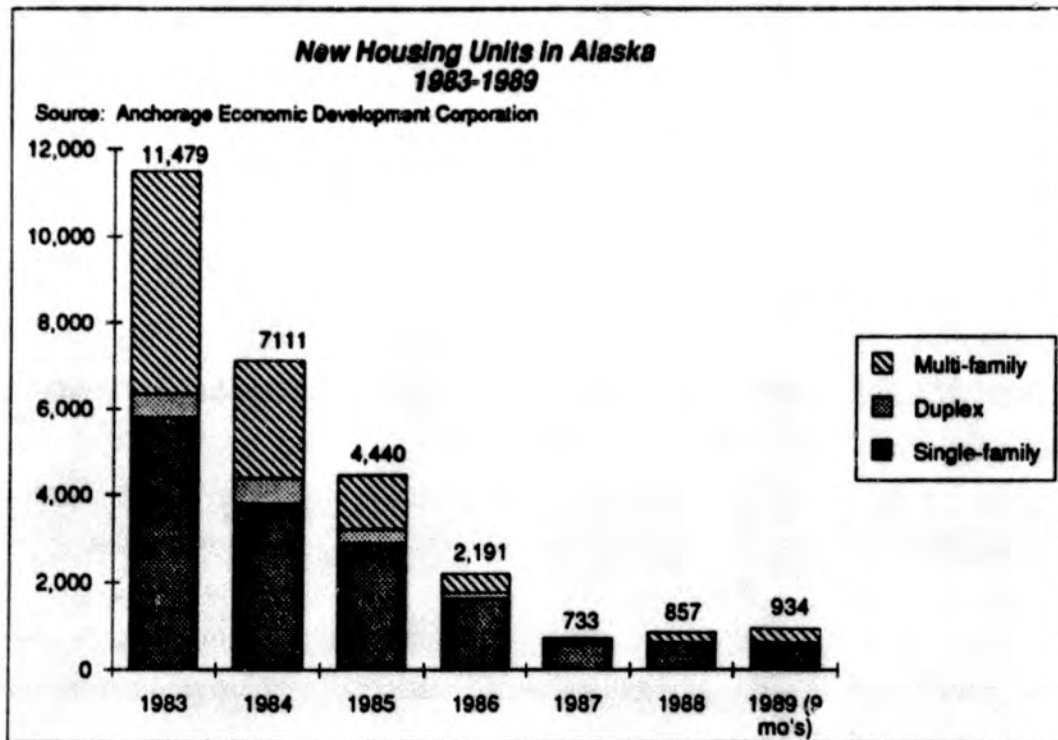
Exhibit IV-2 also shows total employment in the industry by quarter since 1981. Seasonal peak employment hit about 4,000 in 1983 and has been generally falling since. Current employment is less seasonal, reflecting a high percentage of plumbing, electrical, and remodelling work rather than new unit construction.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

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

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

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

Alaska New Housing Units and Residential Construction Employment



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

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

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

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

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

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

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

2. Anchorage

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

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

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

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

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

3. Fairbanks

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

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

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

4. Matenуска-Susitna Valley

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

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

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

5. Juneau

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

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

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

6. Kenai Peninsula

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

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

7. Ketchikan

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

8. Sitka

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

C. SUMMARY OF HOUSING MARKETS IN ALASKA

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

Table 1
Summary of Housing Markets in Alaska

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

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

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

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

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

D. GENERAL COMMENTS ON ALASKA'S HOUSING MARKET

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

2. AHFC's Role in the Secondary Market

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

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

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

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

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

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

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

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

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

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

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

Table 2
Analysis of AHFC Non Tax-Exempt Mortgage Purchases

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

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

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

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

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

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

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

SECTION V

DESCRIPTION OF POLICY OPTIONS AND EVALUATION METHODOLOGY

Ernst & Young

V. DESCRIPTION OF POLICY OPTIONS AND EVALUATION METHODOLOGY

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

This section of the report is organized as follows:

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

A. POLICY OPTIONS

Three options were evaluated during the course of this study:

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

Each of these is described in the subsections which follow.

1. Change AHFC Subsidy

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

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

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

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

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

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

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

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

2. Return AHFC to Original Legislative Intent

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

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

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

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

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

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

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

Table 1
Average Annual Income of AHFC Borrowers

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

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

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

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

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

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

3. Change Ownership of AHFC

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

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

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

B. EVALUATION METHODOLOGY

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

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

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

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

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

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

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

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

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

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

C. ANALYSIS ASSUMPTIONS

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

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

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

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

SECTION VI

**POLICY OPTION TO CHANGE
AHFC SUBSIDY**

Ernst & Young

VI. POLICY OPTION TO CHANGE AHFC SUBSIDY

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

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

A. OVERVIEW OF SUBSIDY

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

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

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

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

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

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

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

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

B. DESCRIPTION OF ALTERNATIVES TO CHANGE SUBSIDY

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

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

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

C. ANALYSIS OF ELIMINATION OF SUBSIDY

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

D. ANALYSIS OF PHASE-OUT OF SUBSIDY

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

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

E. IMPACTS OF CHANGING THE SUBSIDY

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

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

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

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

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

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

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

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

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

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

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

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

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

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

F. CONCLUSIONS CONCERNING THE SUBSIDY

Because the subsidization of interest rates, by definition, causes a major drain of the Corporation's equity, it must either be terminated at some future date or AHFC will eventually require additional State contributions. The cessation of the subsidy will not only make possible some long-term future return on prior State appropriations, it also will provide a great stride towards long-term fiscal responsibility for the Corporation.

We believe that the elimination of the subsidy as defined in this section, is currently feasible and desirable because of the unique window(s) of opportunity previously discussed. However, because this elimination only makes economic sense under these very favorable conditions, both urgency and caution must be followed in implementing the necessary changes.

SECTION VII

POLICY OPTION TO RETURN AHFC TO ORIGINAL LEGISLATIVE INTENT

Ernst & Young

VII. POLICY OPTION TO RETURN AHFC TO ORIGINAL LEGISLATIVE INTENT

Among the options defined by the State Legislature concerning future policies for AHFC was a return of AHFC to its original legislative intent. Since this policy option was not further defined, we investigated the original enabling legislation of AHFC and early subsequent amendments in order to determine original legislative intent.

Based on this interpretation of intent, we made a determination of which AHFC programs would be affected, and to what degree, and estimated the impact of these program changes on Alaska's housing market and on the financial position of AHFC and the State.

The effects of terminating the subsidy have been discussed previously in Section VI of this report. In discussing the effects of changes analyzed in this section (*i.e.*, termination of the Taxable Program) we assumed that the subsidy has already been terminated unless otherwise noted.

This section of the report is organized as follows:

- *Original Legislative Intent*
- *Effect on AHFC Programs of Return to Original Intent*
- *Implementation of Terminating the Taxable Program*
- *Potential Effects of Terminating the Taxable Program*
- *Summary and Conclusions Concerning Return to Original Intent.*

A. ORIGINAL LEGISLATIVE INTENT

AHFC was created by HB 167 in 1971, which amended AS 18.56. Enabling language clearly emphasized that AHFC was to assist in providing housing for lower income persons. Section 18.56.010, "Findings and Purpose," is quoted here in full:

- "(a) There exists within the State a serious shortage of decent, safe and sanitary residential housing available at low prices or rentals to persons of lower income. This shortage is inimical to the safety, health, welfare and prosperity of the residents of the State and to the sound growth of urban and rural communities.
- "(b) The legislature finds and declares that private enterprise has not been able to provide, without assistance, an adequate supply of safe and sanitary homes at prices or rents which persons of lower income can afford, or to achieve rehabilitation of much of the present housing for persons of lower income, and that existing federal programs are inadequate to meet housing needs of persons of lower income. It is imperative that the supply of housing for persons of lower income be increased and that coordination and cooperation among private enterprise, state and local government be encouraged to sponsor, build and rehabilitate residential housing for these persons.
- "(c) The legislature finds and declares further that, in accomplishing this purpose, the creation of the Alaska Housing Finance Corporation is essential to assist in the acquisition and development of land and the construction, rehabilitation, financing, management, maintenance, sale and rental of dwelling units for persons of lower income and that these activities serve a public purpose in benefiting the people of the State. The Alaska Housing Finance Corporation is empowered to act on behalf of the State and its people in serving this public purpose for the benefit of the general public."

To accomplish this purpose, AHFC was given a broad range of powers including making construction or mortgage loans, purchasing mortgage loans, subsidizing rental or mortgage interest payments, dealing in real property, selling mortgages to FNMA, and borrowing money. AHFC was specifically empowered to sell either revenue or general obligation bonds.

One year later, in 1972, CSHB 547 amended the language given above to specifically include housing for:

- Persons of moderate income
- Persons in "remote, underdeveloped or blighted areas."

If we include this 1972 amendment in the definition, then the words "original legislative intent" are taken to mean that AHFC's primary role is to facilitate decent, safe and sanitary housing for persons of low or moderate income, and for persons in remote, underdeveloped, or blighted areas.

AHFC's programs for persons in "remote, underdeveloped or blighted areas" have never been strong or active. Even programs for non-conforming housing, which are not very active currently, have been as much oriented to urban areas as rural ones. We understand that there are at least two reasons for this:

- Most rural non-conforming loans are handled by DCRA, and AHFC activity in this area would be duplicative
- AHFC, unlike DCRA, is not organizationally set up to qualify large numbers of borrowers or service loans in rural areas.

Therefore, in the discussion which follows, we do not assume any changes in AHFC activities relating to "rural, underdeveloped, or blighted areas."

**B. EFFECT ON AHFC PROGRAMS OF
RETURN TO ORIGINAL INTENT**

Active AHFC programs serving low- and moderate-income Alaskans, as defined by the average income of borrowers in fiscal year 1989 (see Exhibit II-4 on page II-22), include:

- Tax-exempt (1,371 loans, average borrower income of \$42,305)
- MGIC Special Financing (161 loans, average borrower income of \$36,507)
- Mobile Home (18 loans, average borrower income of \$33,018)
- Non-conforming (16 loans, average borrower income of \$42,354)
- HOF (26 loans, average borrower income of \$25,431).

Only the first of these programs is bond-financed, the others being financed by State-appropriated monies.

It would probably be advisable to retain special REO programs so long as the disposal of real estate owned is a significant problem to AHFC, regardless of borrower income. Of the programs shown above, the MGIC Special Financing Program is specifically designed to help AHFC dispose of its REO. We understand that this program will soon be replaced by the "Yes You Can" Program.

Two other programs deserve special mention because, even though they do not strictly meet the definition of original legislative intent, this section does not assume their elimination:

- The tax-exempt Veterans Program (254 loans in fiscal year 1989, average borrower income of \$59,125) is assumed to continue for two reasons: First, it serves public policy in helping veterans obtain housing at preferential rates; and second, it enables qualified Alaska residents to take advantage of federal programs providing tax-exempt funding at no net cost to the State

- The HOAP Program (6,316 loans in fiscal year 1989, average borrower income of \$56,158) is not a new mortgage purchase program, but allows mortgage holders with existing AHFC loans to refinance their mortgages. This provides a variety of benefits both to homeowners and to AHFC. Also, this program will phase out as its purpose is served.

Therefore, only two active AHFC programs remain which do not meet the definition of original legislative intent:

- Taxable Program (892 loans in fiscal year 1989, average borrower income of \$59,948)
- Second Mortgage Program (two loans in fiscal year 1989, average borrower income of \$79,368).

Thus, with the provisos above, the concept of returning AHFC to its original legislative intent involves eliminating these two programs. Since the magnitude of the Second Mortgage Program is negligible, all discussion following relates to eliminating the Taxable Program only. The discussion also applies to any future programs which might meet the same criteria as the Taxable Program, that is, they serve Alaskans by purchasing standard mortgages without specific policies with respect to housing type, income, or special need.

**C. IMPLEMENTATION OF TERMINATING
THE TAXABLE PROGRAM**

Discussion of elimination of the Taxable Program following assumes that program termination, or the beginning of a phased termination, occurs on June 30, 1990. This date is chosen to be consistent with the analysis of termination of the subsidy in Section VI. A review of AHFC management's planned bond issuances indicates that the program should have several million dollars in uncommitted funds as of June 30, 1990.

1. Possible Elimination Mechanisms

There are two basic scenarios for Taxable Program elimination: Sudden or phased. The definition of a sudden termination is simple—after a certain date no new bonds would be issued to purchase loans under this program, and no new mortgages would be purchased after existing funds have been committed.

For the following reasons, a sudden termination would be unwise and should be avoided:

- It gives the State no way to test the secondary market. If the slack created by program termination cannot be filled by alternative sources (FNMA, FHLMC, etc.) then mortgage capital available will be less than demand and real estate transaction volumes and prices may suffer
- Because AHFC uses its Taxable Program to finance a significant portion of REO sales, abrupt termination might harm REO disposition efforts
- Even though the uncommitted funds as of the termination date should provide some "cushion" for a transition period, there is always a possibility that the cost of these funds will be below prevailing market rates even with the subsidy eliminated. This could potentially cause a "run" on remaining funds. Based on industry forecasts of interest rates, however, this scenario appears unlikely
- Since much of the real estate community perceives this program as important to the market, sudden termination may create a market shock beyond any otherwise foreseeable economic effects.

Therefore, a gradual process of phasing out the program is preferred. The phasing out could be accomplished either by limiting supply or limiting demand.

Limiting supply could be accomplished through smaller bond issues, or issues more widely spaced, until at some point no more bonds were issued. Advantages would include those generally applicable to gradual program termination (*e.g.*, "testing the waters" of the secondary market), and there would be no need to modify down payment or qualifying criteria or other loan characteristics. A major disadvantage to this approach, however, might be a "run" on AHFC mortgage funds if the Corporation's cost of funds were below prevailing market rates at some point during the phase-out. This could cause housing market fluctuations and damage market stability.

A sounder approach would be to limit demand for AHFC funds. This might be done by gradually increasing down payment requirements, other loan requirements, or interest rates. Advantages to this approach include:

- Housing market fluctuations would be avoided as demand for AHFC funds tapered off gradually
- Loan originators would increasingly seek alternative lending sources, such as FNMA or FHLMC, thus testing the availability of the secondary market in a gradual way
- In the case of higher interest rates, AHFC net income should increase. This income could either partially be returned to the State or used to fund necessary AHFC reserves.

2. Preferred Phase-out Mechanism

Each of the above gradual phase-out mechanisms could be applicable at different times and under different market conditions. Any one mechanism used by itself would probably be unpopular or unfair to specific groups of borrowers. Of all the mechanisms, sudden termination potentially could cause the most problems and should definitely be avoided.

A combination of several approaches, cautiously applied and tuned to the housing market as it changes, would be the best approach. We therefore recommend that a phase-out program include the following:

- AHFC management is given a formal legislative mandate to phase out the Taxable Program over the long term (*e.g.*, over a five-year period) while maintaining flexibility to act as a long-term "backstop" for the Alaska housing market (this concept is further discussed in Section IX of this report)
- Management prepares a plan to reduce Taxable Program demand using a combination of demand-reduction measures
- Management estimates the potential reduction in demand from this plan and scales down planned bond issues accordingly (thus limiting supply without significant market disruption)
- Management implements its plan and tracks actual demand reduction against its expectations, as well as the increases in direct market share of other secondary mortgage purchasers, in order to ensure that the phase-out does not adversely affect the Alaska housing market
- Management reviews results of the plan against its expectations, makes revisions as required, and continues with the phase-out program.

This phase-out program serves four purposes:

- It gives AHFC management control over the phase-out. Hands-on management control is essential if market disruption is to be avoided, since adjustments to the program may have to be made frequently and judiciously
- It allows AHFC to "pace" the phase-out to the rate at which other secondary market purchasers are filling any vacuum left by its departure
- It allows retention of the Taxable Program for a period of time so that the program can continue to serve as one of AHFC's vehicles for financing REO sales
- It scales down future bond issues based on decreased demand for borrowing, rather than trying to limit borrowing by rationing funds.

D. POTENTIAL EFFECTS OF TERMINATING THE TAXABLE PROGRAM

1. Effects on the Real Estate Market

The key to the effect of a phase-out of AHFC's Taxable Program on Alaska's housing markets is the availability of alternative funds for the residential mortgages purchased under the program. As discussed in Section IV of this report, many industry sources believe that availability of alternative funds is limited.

a. Magnitude of the Taxable Program Compared with the Housing and Mortgage Markets

Prior to addressing this issue directly, it is useful to review the magnitude of the Taxable Program in relation to statewide housing sales, new mortgage generation, and AHFC mortgage purchase activities, as shown in Table 1, below:

Table 1
Alaska Home Sales and Mortgage Statistics
Fiscal Year 1989

Category	Number	Percent
Total home sales	7,700	100% (1)
Total new mortgages	4,600	60 (2)
AHFC New Mortgage Purchases	2,740	36 (3)
AHFC Taxable Program purchases	892	12 (3)

Notes: (1) Estimated based on market survey, Appendix C
 (2) Estimated based on AHFC management's stated 60 percent share of the current new mortgage market
 (3) AHFC statistics.

As can be seen from this table, purchases of mortgages under the Taxable Program currently support about 12 percent of total statewide home sales, or 19 percent of new mortgage generations in the State. While these percentages presently appear small, programs supported by taxable bond issuances have historically served an important

segment of AHFC's financing activities. The Taxable Program is also important to AHFC's financing of REO dispositions. Finally, the percentages shown above would probably be higher in a "normal" year in Alaska, for the following reasons:

- Most current transaction activity (64 percent in 1989) is below the tax-exempt limit because of the general fall in housing prices. This shifts demand for AHFC mortgage purchases into the tax-exempt programs. In a normal market the general price levels would be higher and the Taxable Program might play a larger role
- Further demand for tax-exempt program financing is caused by the wide availability and aggressive marketing of REO, which tends to be lower-end property. In more normal times, REO would represent a much smaller portion of the market
- The prevalence of negative home equities in the market has led to an evident high percentage of home sales made on the basis of mortgage assumptions or direct buyer-seller contracts. In a more normal market this situation would not exist. There would be a higher demand for new mortgages overall, and demand for AHFC's Taxable Program would be correspondingly larger.

The situation is further complicated by the differential in demand between AHFC Taxable Program funds (available at 10 percent as of this writing) and alternative funds (generally about 10 percent to 10.5 percent). To the extent that demand for AHFC funds is price-sensitive, then demand for Taxable Program funds is probably higher than it would be if alternative funds were relatively less expensive.

b. Marketability of Loans Purchased Under the Taxable Program

Availability of an alternative secondary market for loans which AHFC purchases under the Taxable Program will be largely determined by the types and quality of these loans. The following discussion addresses these issues.

Loans purchased under the Taxable Program are of the same type purchased by other secondary market purchasers. They are either FHA-insured, VA-insured, or conventional loans. All conventional loans have either a 20 percent down payment or 10 percent down with private mortgage insurance (PMI). **Table 2**, following this page, shows the relative percentages of loans purchased that fall into the three categories:

Table 2
AHFC Taxable Program Mortgage Purchases

Year	Percentage FHA-insured	Percentage VA-insured	Percentage Conventional
FY 1989	55%	10%	35%
FY 1990 (6 mos.)	59%	8%	33%

Source: AHFC management

The increasingly high percentage of FHA-insured loans is probably due to the fact that PMI is difficult to obtain. We understand that there is only one company currently providing this coverage in Alaska, and that it is applying very strict underwriting criteria to its new policies. Thus, the FHA program is the only method available to many borrowers to avoid a 20 percent down payment requirement.

Since AHFC's underwriting criteria are in accordance with those of FNMA and FHLMC and other secondary market purchasers, the loans appear to be fully acceptable to the secondary market in general. If an alternative market is available, these loans should be readily marketable.

In fact, while AHFC appears to be the secondary market purchaser of these loans, they are routinely sold through to other secondary market purchasers, with AHFC acting as a facilitator. The ultimate secondary market for the Taxable Program loans is currently AHFC's pool purchaser, FHLMC, which is in effect lending money to support Alaska mortgages under the program. We also found that FNMA is active in the Alaska market, and we understand that they have purchased more Alaska loans independently of AHFC during FHLMC's current commitment period than has FHLMC under its pool purchase commitment with AHFC.

c. Summary of Effects on the Housing Market

The following findings summarize the analysis above:

- AHFC's Taxable Program currently serves only a minor portion of Alaska's housing market. In more normal times the program would play a relatively larger role, but the size

of this role would be affected by the subsidy available and the cost of funds from other sources

- AHFC loans under the Taxable Program are of types which are readily marketable and are, in fact, currently being marketed to FHLMC. In effect, FHLMC is the ultimate secondary market and is using AHFC as a vehicle to buy Alaska mortgages under the program
- The role of the Taxable Program is therefore facilitating in nature, and may not be critical to the housing market in the long term.

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

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

2. Effects on AHFC

The effect of terminating the Taxable Program on AHFC's financial position is measured by the change in unrestricted net liquid assets, that is, those AHFC liquid assets which are not used to directly collateralize any AHFC obligations. The potential change in these assets arises from two sources:

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

Since this section presupposes elimination of the subsidy, only increases arising from the second source need be considered.

As can be seen in Appendix B of this report, the additive effect (over and above elimination of the subsidy) of eliminating the Taxable Program as of June 30, 1990, would be to increase unrestricted net liquid assets of the Corporation by \$45 million through June 30, 1994. Assuming the program is phased out rather than terminated abruptly, the potential increase in unrestricted net liquid assets might be half that amount, or \$22.5 million.¹ It should be noted that these figures represent dollars that are "tied up" but not necessarily lost.

The assets freed up on a per-mortgage basis can be calculated from these amounts. Capital tied up on a long-term basis is approximately \$8,000 per \$100,000 mortgage, net of subsidy costs.² The composition of this \$8,000 is:

- Overcollateralization for credit enhancement (about \$2,000), from AHFC assets. These assets are encumbered for the life of the bonds, as are interest earnings from the funds. They are not available for any other purpose prior to issue retirement
- Other reserve funds (about \$5,000), from AHFC internal funds. These funds are also encumbered for the life of the bonds

¹ Savings from eliminating the subsidy on the Taxable Program only, which are not included in these amounts, might vary from \$31 to \$73 million over the same period assuming abrupt termination, or \$16 to \$37 million under a gradual phase-out, depending on future interest rates. These amounts are based on the assumptions stated in Appendix C under scenarios A and B, and represent about three-quarters of AHFC's total expected subsidy costs over the period.

² Subsidy costs per \$100,000 mortgage might range from \$5,000 to \$12,000, depending on prevailing interest rates in the future. These are true costs, since monies pledged to the bonds for interest rate subsidies are intended to pay debt service and are not returned to the Corporation.

- Bond issuance costs (about \$1,000), funded from bond proceeds and repaid with interest over the life of the bonds.

Thus, of this \$8,000, about \$7,000 should ultimately become available to AHFC after bond retirement. However, even this amount is at risk during the life of the bonds. The remaining \$1,000 is a true cost and would never be recovered.

3. Effects on State-Appropriated Monies

While the expected increase in AHFC's unrestricted net liquid assets from Taxable Program termination may seem to make the Corporation's assets more appropriable to the State, in practice the opportunities for such appropriation are limited. Because most AHFC bonds are general obligation bonds, and thus secured by the "full faith and credit" of AHFC, any move toward appropriation of AHFC assets will be seen by existing and potential bondholders as an attack on AHFC's financial integrity. This could have the effect of lowering ratings on AHFC bonds, thus reducing the market value of existing bonds and making future bond sales more difficult and expensive.

Over the long term, there appear to be two principal ways that AHFC assets will become more readily appropriable by the State:

- Modify AHFC programs so that the Corporation can operate on a break-even basis or make a small profit, and implement a program of returning some of this profit to the State as a dividend from operations
- Shift AHFC's financing emphasis over the long term to revenue bond issues, which is consistent with low- to moderate-income housing financing entities in other states. Since the security of revenue bonds is limited to mortgage payments and other specific funds set up as reserves, much of the remainder of AHFC's capital base would ultimately become less relevant to bondholders and potentially could be appropriated to the State.

These mechanisms are consistent with Section IX of this report, which discusses the conceptualization of an idealized AHFC.

**E. SUMMARY AND CONCLUSIONS CONCERNING
RETURN TO ORIGINAL INTENT**

Our conclusions relating to this section of the report are presented below:

- Under the concept of "original legislative intent," only the Taxable Program of AHFC should be considered for elimination. Certain other programs lie outside the scope of original intent, but they are largely oriented to REO sales and refinancings and serve important near-term needs in the current distressed market. However, need for these programs should diminish over time
- The Taxable Program currently serves only a minority of Alaska's housing market, although it supports an important segment of the market. Relative program size would probably be higher in a more normal housing market
- Loans originated under the Taxable Program should be readily marketable to other secondary market purchasers. In effect, the secondary market for these loans already exists in FHLMC though its current commitment with the Corporation
- Reduction of the Taxable Program should be very carefully conceived and controlled, and should be phased in over a period of years
- Net increase in AHFC's unrestricted net liquid assets from abruptly eliminating the Taxable Program are estimated at \$45 million through June 30, 1994. Under a gradual reduction of the Taxable Program, as recommended, the increase should be about half that amount
- These additional unrestricted net liquid assets will not be readily available to the State. The legislature may wish to consider a long-term program for AHFC based on the concepts in Section IX of this report, which may ultimately provide dividends or return of capital to the State
- Even though the Corporation's unrestricted net liquid assets would be decreased the least over the next five years the sooner the taxable program was eliminated, the negative effect this policy option change would have on the housing market is overriding.

SECTION VIII

**POLICY OPTION TO CHANGE
OWNERSHIP OF AHFC**

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VIII. POLICY OPTION TO CHANGE OWNERSHIP OF AHFC

The legislature requested an evaluation of the potential for "privatizing" all or a portion of AHFC. This section presents a discussion of this option and draws conclusions regarding the feasibility and likelihood that such an action could occur. We have organized this section as follows:

- *Ownership Alternatives*
- *Feasibility of Changing Ownership*
- *Conclusions Concerning Change of Ownership of AHFC.*

A. OWNERSHIP ALTERNATIVES

Faced with fiscal pressures to find alternative sources of funds, and perhaps hearing calls to streamline AHFC operations, the legislature desired to evaluate the concept of privatizing AHFC. Typically, privatization has been an arrangement in which the private sector provides goods, facilities, and services that have been traditionally provided by the public sector. Contracting out has been the most common alternative service delivery method used by governments. The contract services can be provided directly to the consumer, or improve the operations of the government entity.

However, in the case of the Housing Finance Task Force request, this policy option actually extends to selling all, or a portion, of the Corporation's assets and related liabilities to a third party. This policy option could possibly include the following alternatives:

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

The buyer(s) theoretically might be financial institutions (banks, mortgage companies, and credit unions) or private individuals (if stock were sold).