

ALASKA LEGISLATURE SPECIAL COMMITTEE/SUBJECT FILE 8672

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B. FEASIBILITY OF CHANGING OWNERSHIP**1. Sale of All or a Portion of AHFC Assets**

Proposals have been suggested for the sale of AHFC to a consortium of Alaska and/or "Lower 48" financial institutions. Should such a sale be feasible, the purchase price would probably be far below the State investment in AHFC, and the transaction would raise serious questions of public policy for that reason. Furthermore, the legality of such a sale could be challenged under the State constitution's prohibition on transferring public property, and because of the strictures of various bond covenants. Appendix E to this report provides a legal opinion regarding the sale of all or a portion of AHFC assets.

Also, affordable housing for low- and moderate-income individuals is a legislative objective of AHFC. There is a question of whether this public purpose of AHFC would continue to be served if AHFC were privately owned. Relief and support of the poor has been recognized by the courts as an obligation and a public purpose of government. It would be difficult to obligate a private entity to maintain such a public purpose unless terms and conditions of a transfer were imposed which required the private owner to continue the public purpose objectives of AHFC. Such terms and conditions would probably significantly impact the value of AHFC to any private purchaser.

The transfer of assets to the private sector may in fact be subject to constitutional challenge on the basis that it violates the Alaska constitutional prohibition against transferring public property. As pointed out in Appendix E to this report, the State's constitution prohibits transferring public property except for a public purpose. Under present conditions, there is arguably a public purpose served in selling some AHFC's assets which are causing a negative cash flow to AHFC which create a financial burden on the Corporation. However, if the REO properties were sold and the subsidy changed, and AHFC operated profitably, then a sale of AHFC's assets to the private sector could be considered in violation of the State's constitution because no public purpose is served in selling a profitable asset.

We did not identify a single potential buyer of AHFC assets. With respect to REO, no financial institution we interviewed was interested for obvious reasons. With respect to loans, it is the policy of most mortgage financial institutions not to hold residential real

estate loans but rather to sell these to secondary mortgage purchasers (like AHFC). We found little support or basis for assuming that these same institutions would buy back the loans or foreclosed properties, unless for a very deep discount on the assets. In fact, we have not even identified any formal inquiries regarding the purchase of all or any portion of AHFC assets.

2. Sale of REO to Investors

In much of Alaska the REO market is still a buyer's market, and REO prices are correspondingly depressed. Both local financial institutions and secondary market mortgage purchasers, such as AHFC, have substantial REO portfolios.

AHFC and others are vigorously marketing their REO holdings to both homeowners and investors. At this point there are some signs of market recovery, and REO is being sold more quickly than it is being generated through foreclosures. But any potential buyer of an REO portfolio as large as AHFC's (currently over 4,000 properties), should such a buyer exist, would probably seek extremely low prices to offset market risk and high holding costs.

We do not believe there is currently a buyer or buyers for AHFC's REO portfolio at a fair market price. Were one to appear, the buyer would probably offer a price which, in the long-term, would be below the realization AHFC can reasonably expect from its portfolio in an improving market.

3. Sale of Loans to Investors

If a private entity were to purchase AHFC loans, presumably these would be those loans owned by the Corporation and not pledged to the various bond programs. The loans purchased could be discounted if delinquencies are considered high, and if the underlying property securing the loan were worth less than the unpaid principal balance of the loan. As a result, AHFC could record a loss on sales of those loans not previously sufficiently written down by the Corporation.

The potential loss incurred on the sale of loans held by AHFC may or may not be any more than the loss which will ultimately occur or which AHFC already projects for the loans. The loan loss reserves maintained by AHFC may already have sufficiently considered the potential loss; in this case, the sale would be a simple transfer of assets, and there would be no economic benefit from the sale or transfer of the loans.

4. Contracting Out REO Disposition

One function which could be privatized is the property disposition function. The Corporation formed the Alaskan Home Properties Division to manage the pricing, marketing, and financing of REO properties. The functions performed are commercially available, non-governmental in nature, somewhat routine, and easily defined in terms of workload. A private firm(s) could avoid government restrictions which presently hamper the AHFC REO process, such as civil service requirements, procurement restrictions, and difficulty in authorizing needed additional staff positions. Control and supervision of the contract could be maintained by AHFC; this control is a key factor in assuring that the contract process is feasible and implemented according to the needs of the Alaska housing market.

Contracting out REO disposition will require AHFC to prepare a statement of performance requirements, specifying the technical requirements for the contract and the standards that will be used to determine if the requirements have been met. AHFC would also need to perform a cost-benefit analysis of continuing the REO functions in-house versus contracting out to determine if the private sector can actually perform the functions more efficiently.

**C. CONCLUSIONS CONCERNING CHANGE
OF OWNERSHIP OF AHFC**

The following conclusions are apparent from the preceding discussion:

First, the sale of AHFC as an entity is probably not feasible for several reasons:

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

Second, sale of AHFC assets, specifically loans or REO properties, to local financial institutions does not appear feasible because these institutions have no interest in such assets. Third, sale of AHFC's REO to other investors, were such a sale possible, would likely be of less economic benefit to AHFC than its current marketing policies, because the offering price would probably be too low.

Fourth, sale of AHFC's loans to other investors, were such a sale possible, does not appear to offer any significant economic benefit to the State. Sale of assets pledged to bond issues may be prohibited because of bond covenants, and the transfer of ownership would involve complex issues. Furthermore, transfer of restricted or unrestricted assets from AHFC to the private sector may violate the Alaska Constitution if no public purpose is served. A public purpose might be served by such a transfer, if it would reduce the financial burden on AHFC from the assets transferred. However, it does not appear that the transfer would reduce losses associated with the assets, but would only cause the loss to be realized earlier.

Finally, contracting out of the REO disposition process may be a viable option, and could offer cost savings to AHFC. Competitive bidding for providing the services could lower the cost of disposing of REO properties, and use of the private sector might avoid civil service restrictions and State procurement requirements. If AHFC does use the private sector rather than its own employees to deliver the REO service, it does not give up its responsibility to provide the service.

SECTION IX

**CONCEPTUALIZATION OF
AN IDEALIZED AHFC**

Ernst & Young

IX. CONCEPTUALIZATION OF AN IDEALIZED AHFC

The discussions in previous sections analyze the potential effects of implementing certain policy options with respect to AHFC. From time to time we have noted in text certain other measures that should be considered by the legislature in order to make AHFC more effective and to better define its role in Alaska's housing market.

In this section, we bring these comments together to present a blueprint for AHFC that should help define its role in the years ahead. We have attempted to ensure that the role of AHFC, as described in this section, makes good public policy sense and serves to stabilize Alaska's cyclical housing market in both good times and bad.

This section is organized as follows:

- *Introduction*
- *Define and Limit AHFC's Role in the Housing Market*
- *Structure AHFC to Operate on a Break-even or Profitable Basis*
- *Require AHFC to Adopt a Dividend Policy*
- *Protect AHFC's Capital Base and Avoid New Capital Infusions*
- *Restructure AHFC's Financing Mechanisms*
- *Make AHFC More Independent of Direct Legislative Control*
- *Summary of the Future of AHFC.*

A. INTRODUCTION

We understand from discussions with legislators and others that consideration of a reduction of AHFC's scope to its original legislative intent derives from the following:

- Belief that AHFC's current scope of activities, while possibly appropriate for good times, may contribute to a mis-allocation of scarce State resources in lean years
- Belief that AHFC's extensive involvement in the housing market may cause market distortions, and could possibly prevent the return of private capital to the market
- Belief that, were AHFC's scope to be more limited, its capitalization could be reduced and some contributed State capital might be returned to the State
- Finally, belief that State involvement in the housing market to the extent represented by AHFC's current role is questionable public policy in more general philosophic terms.

While these beliefs may not be universally held, our observations during the course of this study generally support them. Accordingly, we attempt in this section of the report to pursue the question of "return to original legislative intent" to its logical conclusion. In our view, return to original legislative intent should consist of more than just trimming programs. It requires a comprehensive, overall view of what AHFC should be and what role it should play. It also requires, ultimately, a clear legislative mandate with respect to AHFC defining its long-term direction.

Original legislative intent was to facilitate decent, safe, and sanitary housing for persons of low- or moderate-income, and for persons in remote, underdeveloped, or blighted areas. AHFC currently serves this intent through most of its programs, although the "remote, underdeveloped, or blighted areas" are perhaps more directly served by DCRA programs—AHFC's Non-conforming Loan Program is not currently very active. Reduction of the Taxable Program, as discussed in Section VII, would focus AHFC even more on its original intent.

Beyond original intent, however, we note that three additional issues have arisen which are of concern to the legislature:

- First, the State is expecting increasingly severe fiscal pressures from a likely diminution of oil revenues. It is asking whether it should perhaps expect some return on its investment in AHFC to help supplement other revenues in balancing future budgets
- Second, the State is asking whether or not the capital contributed to AHFC is totally committed, or whether under some future circumstances some of that capital might be returned to the State
- Third, there is the issue of AHFC's effectiveness both in operational terms and in terms of its freedom to act in accord with market versus political conditions.

The first and second questions have been briefly addressed in Section VII of this report, and will be further discussed below. The third question, we believe, can be dealt with only by removing AHFC a further step from day-to-day oversight and control by the legislature. We believe that, in order to address all three questions in an effective manner, a clear and formal legislative mandate is required to define policy for AHFC on a long-term basis. The elements of a proposed mandate are discussed below.

**B. DEFINE AND LIMIT AHFC'S ROLE
IN THE HOUSING MARKET**

The first part of the proposed formal legislative mandate is that AHFC should generally serve homebuyers in lower income levels. This concept is evident in the enabling legislation. The basic premise is that scarce State resources should be allocated where they best serve public policy, that is, in providing decent housing for those otherwise unable to obtain it.

At the same time, it is important that AHFC retain a role as "backstop" for the more general housing market, should one ever be required. Alaska's residential mortgage market is capital-poor and depends almost entirely on outside capital to function. At the same time the State is largely dependent on commodity markets for its economic health, and commodity prices tend to fluctuate frequently and widely. Thus, residential mortgage demand and housing prices will continue in the future to be affected both positively and negatively by swings in the overall economy.

This combination of a capital-poor mortgage market and an unstable housing market dictates that the State maintain an ultimate housing backstop mechanism to add stability to the market. AHFC is the ideal mechanism because it is already established, it has existing institutional relationships with outside capital sources, it has an existing substantial equity base, and it has both experience and expertise in funding the residential market.

But the backstop role brings with it certain responsibilities and the necessity for discipline:

- First, this is a "reserve role." That is, the backstop function should only be brought into play in economically hard times. It should not be used as a social benefit in good times, as has been the case in the recent past
- Second, to fulfill this role, AHFC should be allowed to bank good years against bad. Since the backstop role is not compatible with AHFC's long-term goal of break-even or profitable operations, AHFC should be allowed to retain sufficient earnings in good years to subsidize the market as necessary in bad years.

Public policy, in other words, must avoid the temptation to use AHFC as a channel for public benefits at precisely those times when such benefits can best be afforded. It must instead allow AHFC to earn some profits in good years, bank some of those profits, and use the resulting reserves to support the market in bad years.

**C. STRUCTURE AHFC TO OPERATE ON
A BREAK-EVEN OR PROFITABLE BASIS**

The second part of the proposed formal legislative mandate is to structure AHFC programs to operate on an overall break-even basis, or to earn some profit. This supports two policy goals:

- First, it generates funds in good years which AHFC can retain to perform its backstop role
- Second, it generates earnings from operations for dividends which can be paid to the State.

There are several mechanisms to increase profitability:

- Terminate the subsidy. The subsidy of mortgages below AHFC's cost of funds will cause AHFC to incur continuing losses, diminish State-contributed equity, and ultimately require further State funding
- Reduce the taxable program. Under current financing mechanisms, the requirement for overcollateralization of bond issues ties up significant amounts of cash, even without a subsidy
- Consider termination of programs with minimal demand. Several AHFC programs served fewer than thirty Alaskans in fiscal year 1989. The cost of retaining and administering such programs likely far outweighs any benefits received
- Consider termination of programs which are uneconomic by nature. Whenever AHFC programs fund housing types that other market sources avoid, or on terms substantially better than other market sources, the potential for ultimate loss exists and may well be realized.

D. REQUIRE AHFC TO ADOPT A DIVIDEND POLICY

The third part of the proposed formal legislative mandate is to require a prudent dividend policy of AHFC. To the extent that AHFC has positive earnings, and those earnings are not required to fund reserves for AHFC's backstop or other market critical stabilization roles, the State should expect that these earnings from operations will be returned to the State.

Although it is not evident from original intent that such a return was expected, it is also clear that AHFC's subsequent massive funding was not anticipated at that time. Taking the opportunity cost of funds into account, the State (viewed as an investor) is incurring substantial conceptual losses on its investment in AHFC. A prudent dividend policy, combined with a more profitable AHFC, should help remedy this situation.

Again, discipline will be needed. The temptation may be to seek dividends at precisely those times when Alaska's economy (and most likely the housing market as well) is undergoing difficulties. Since these will probably be the times when AHFC is fulfilling its backstop role, no dividends are likely to be available. In other words, dividends should be most available at the times when they are least needed.

**E. PROTECT AHFC'S CAPITAL BASE
AND AVOID NEW CAPITAL INFUSIONS**

The fourth part of the proposed formal legislative mandate is two-fold:

- Rule out any appropriation of AHFC's capital base to the State, either directly or indirectly. An example of an indirect appropriation is the proposed Senate Bill 245 requiring AHFC to purchase mortgage loans from the Housing Assistance Division. We evaluated this proposal and report our findings in Appendix D to this report
- Clearly state a policy of not further subsidizing AHFC through capital infusions.

The first part of this mandate is to protect AHFC's financial integrity. So long as AHFC must access capital markets for funds on a general obligation basis, and so long as substantial general obligations of AHFC's capital base exist, any threat of capital appropriation may impact AHFC's borrowing ability. Financial markets see even the threat of appropriation as reducing the security of their loans. Furthermore, AHFC may need substantial reserves in the near future to deal with continuing REO losses and contingent losses from insurance disputes. Ultimately AHFC may not need such a substantial capital base if funding mechanisms are changed (see below), but for the time being it is important that its capital not be threatened.

The second part of the mandate offsets the first. If AHFC is to be put on a break-even or profitable basis, and if its capital is not to be threatened, then it is reasonable that AHFC and its capital markets expect that the State not supply further funding. Proper maintenance of reserves to support AHFC's backstop role will mean that, even in bad years when AHFC may be required to subsidize the market, no further capital will be required.

F. RESTRUCTURE AHFC'S FINANCING MECHANISMS

The fifth part of the proposed formal legislative mandate is that AHFC implement a long-term program to restructure its financing mechanisms. Because its focus is to support low- and moderate-income housing, it is reasonable that it consider tax-exempt revenue bonds as a primary funding source, as do other states with housing finance agencies operating in a similar role.

While original legislation clearly allowed issuance of general obligation bonds, the effect of those issuances has been to use all contributed State capital as collateral for money borrowed by AHFC. Revenue bonds, unlike general obligation bonds, are not guaranteed by the "full faith and credit" of the Corporation. Their security is far more limited.

As the situation currently stands, any appropriation of money from AHFC to the State is likely to be viewed as weakening AHFC's financial position, thus threatening the security of holders of AHFC bonds, regardless of specific collateral requirements of the bond indentures. Revenue bonds, since they are secured only by mortgage income streams plus whatever specific reserve funds are required for additional security, would not have this effect.

**G. MAKE AHFC MORE INDEPENDENT
OF DIRECT LEGISLATIVE CONTROL**

The final part of the proposed formal legislative mandate would be to redefine AHFC's organizational positioning to allow more independence from legislative pressures, and limit the legislative role to providing long-term policy direction and assessment of management's success in fulfilling policy objectives. Particular steps to be considered include:

- Increase the size of AHFC's Board of Directors and allow a higher percentage of private sector representation on the Board. It is essential that the Board be composed of knowledgeable and active members, and that the private sector members adequately represent the range of industry interests in the housing markets
- Free AHFC from the legislative appropriation process so far as possible, and judge organizational effectiveness based on results obtained.
- Allow AHFC within reason to set its own personnel policies, including hiring, termination, promotion, and compensation levels
- Allow AHFC to obtain in-house counsel of a strength commensurate with the magnitude and complexity of its activities.

H. SUMMARY OF THE FUTURE OF AHFC

The net effects of the proposed legislative mandate would be positive, and would make AHFC a more effective organization in carrying out public policy:

- Focusing AHFC's role on low- and moderate-income housing would reduce AHFC losses. Retaining the backstop role would help stabilize the housing market in the longer term
- Restructuring AHFC to operate on a break-even or profitable basis would mean no need for new State capital, funding for a backstop role, and the potential of dividends for the State
- Requiring operating dividends to the State is a reasonable step considering the potential profitability of AHFC's operations and the investment made
- Protecting AHFC's capital base and avoiding new capital infusions are both desirable. One protects AHFC's financial integrity and minimizes its cost of doing business; the other follows from the fact that, since AHFC will be breaking even or making a profit, no new capital should be needed
- Restructuring AHFC's financing mechanisms to concentrate on tax-exempt revenue bonds is consistent with its newly redefined focus and holds the long-term potential of freeing up part of AHFC's capital base
- Making AHFC more independent of close legislative control promotes both operating efficiency and the ability to respond to market conditions based on long-term legislative policy.

These steps toward an "idealized AFHC" should allow AHFC to serve the residential mortgage market in Alaska more effectively, both in good times and in bad. Although implementation is likely to be a long and arduous process in some instances, we believe the proposed mandate is worthy of consideration by the legislature.

APPENDIX A

**SELECTED AHFC
OPERATIONAL CONCERNS**

Ernst & Young

APPENDIX A

SELECTED AHFC OPERATIONAL CONCERNS

This appendix presents selected comments regarding AHFC's organization and operations. Although we did not perform a specific analysis per se of AHFC operations, our analysis of policy options did require that we interview a number of AHFC personnel, use the management information systems at AHFC, and obtain performance data on some AHFC operations (e.g., Property Disposition (REO) unit). As a result, we note areas where we had concern or where it appeared the operation of AHFC might be improved. In this appendix we present specific recommendations regarding the organization, management, and operation of AHFC.

Organization of this section is as follows:

- *Management and Personnel Recommendations*
- *Internal Improvement Recommendations*
- *Programmatic Recommendations*
- *Legislative Recommendation.*

A. MANAGEMENT AND PERSONNEL RECOMMENDATIONS**1. Evaluate the Size and Composition of the AHFC Board of Directors**

A five member Board of Directors governs AHFC. The Board consists of three members of Alaska State Government and two public members. The Governor appoints all five members of the Board.

We found just one member of the Board, a private citizen involved in the real estate industry, to actually take an active part in our study. The assistance was invaluable to our entire study effort because of the insight and experience obtained on AHFC operations, housing markets, and the capital markets. Assistance from other Board members could have provided additional advice on our evaluation of policy options.

More importantly, the Board should be assisting the CEO and other AHFC management in guiding the direction of AHFC, providing input on organizational improvements, and establishing various committees for governing the manner in which AHFC conducts its business. This requires active participation of Board members, particularly in light of the significant changes in the housing market which AHFC serves.

We recommend that the Legislature evaluate the effectiveness of the current Board composition, and determine whether the Board composition and size should be changed. This includes an analysis of the advantages and disadvantages of having a majority of the Board be public members rather than State Government representatives. An alternative Board arrangement could be nine members, either with five members government representatives or public members.

2. Conduct a Staffing and Organizational Effectiveness Review

The Corporation has almost doubled in staff over the last three years, primarily because of increased workload related to REO dispositions. We noted a significant turnover in certain areas of the Corporation, particularly in key financial staff positions which were assisting us during this study. The rapid growth of AHFC and apparent staff

turnover problems could create a shortage of trained and experienced financial management and staff.

We recommend that AHFC conduct a study of current and future personnel requirements to facilitate an orderly development of qualified staff. This study should include an evaluation of management and staff compensation compared with those available in private industry. This study then should be followed by a program to recruit and retain qualified personnel to meet future needs.

Other areas should be addressed in the study as well:

- Sufficiency of staffing levels in various parts of the organization
- Depth and breadth of the management structure
- Effectiveness of AHFC in fulfilling the various components of its legislative mandate.

3. Obtain Authorization and Fill Legal Counsel Position at AHFC

The Corporation does not have an internal legal counsel, but rather obtains the services of a staff attorney from the Attorney General's Office. The Attorney General recently assigned to AHFC its third different staff attorney in 1989. This high turnover in staff at the Attorney General's office causes considerable expense for AHFC and inhibits the AG's responsiveness to AHFC. In addition, the Attorney General's attorney currently assigned has not had sufficient experience in business and corporate law, nor the background in bond financing, to effectively address and respond to the diverse and complex legal issues which arise at AHFC.

AHFC should substantiate and request authorization for a position for a Corporate attorney reporting directly to the Chief Executive Officer. This will require developing an appropriate job description, estimating the salary and benefits for a full-time attorney, and preparing a written justification for the new position. After the position is authorized, AHFC should fill the position, following appropriate procedures for State civil service (if not an exempt position).

4. Obtain Authorization and Fill Internal Auditor Position at AHFC

The Corporation does not have an internal auditor. The use of an internal auditor (or internal audit staff) would be an effective means of providing AHFC with the following benefits:

- Strengthening AHFC's internal financial and operating controls over assets and increasing the reliability of accounting records
- Reducing the amount of time spent on developing internal procedures
- Increasing assurance that AHFC policies are being adhered to and that internal procedures and controls are being reviewed objectively
- Providing a training ground for future management positions at AHFC.

This position (or audit staff) would report directly to AHFC's Executive Director.

We recommend that AHFC develop the job description and justification for an internal auditor position and submit a budget request for this new position. Upon authorization, the position should be filled.

B. INTERNAL IMPROVEMENT RECOMMENDATIONS**1. Establish a Formal Financial Forecasting System**

Improved forecasting techniques are needed at AHFC to more accurately determine working capital needs, short-term financing needs, and longer-term results of specific loan programs. They also would assist in responding to requests from management, the Board, and the Legislature regarding the financial condition of the Corporation and assist in the identifying funds available for investment. These techniques, which should ultimately be expressed as formalized forecasting systems, should be able to forecast financial results by bond and loan program.

We found only informal techniques being used by AHFC for forecasting the financial condition of AHFC. It should be noted that AHFC does have very detailed and formal models for structuring a specific bond issue. There were no formalized systems for projecting cash flow, changes in unrestricted assets, or projected performance of individual bond and loan programs.

We recommend that AHFC design, develop, and test a formalized financial forecasting system. The new system would allow analysis of changes in loan demand, interest rates, loan programs, and debt structures, and how various changes impact the financial condition of AHFC and its loan programs.

2. Evaluate Adequacy of Existing Management Information System

We often had to rely on information regarding AHFC housing programs which is maintained by Data Processing (DP) systems. The report we primarily relied upon was the "Statistical Abstract," a 300-page document generated by DP containing information about loans, bond issues, markets served, and seller/servicer listings. We cannot comment on the accuracy of the information although we frequently had to get help from AHFC staff to interpret the report, to tie numbers reported in different sections of the report, and, in some cases, to correct the data reported. Due in part to the age of the system, we were told that our special requests for ad-hoc reports would be very difficult and time consuming to complete, and that there was not available staff time to complete special requests.

The role of DP should be to develop and maintain information systems throughout AHFC to meet the needs of management and staff. The recent growth of AHFC's property disposition activities, and the start-up of new loan programs, has put significant pressure on DP to keep up with user requests for new reports, while maintaining existing systems. Also new programs internal to AHFC may not be getting the priority or attention of DP. An example is the the critical need for management information regarding claims filed with MGIC.

We recommend a review be conducted of the effectiveness of the existing management information systems, and that an upgrading of DP systems and procedures be considered. This includes a determination of the significant information needs of management, and identification of program areas needing automated management information support.

3. Improve Cash Management Function

We noted during our discussions with AHFC staff that many of the cash management functions of the Corporation were being performed by staff with no substantial experience in treasury or cash management functions. There are many potential areas where improvement can be made in cash management activities which might result in direct and significant cash savings (and income enhancement) to AHFC.

We recommend that AHFC evaluate the entire cash management function and implement changes to improve this function. This includes evaluation of cash management techniques, cash reporting system, and investment strategies and goals.

4. Define Formal Investment Criteria

We noted that AHFC does not currently have formalized investment criteria to control investment of liquid assets. Wherever a significant portfolio of investments must be maintained, such criteria should be in place to assure responsible diversification of investments by industry sector, investment type, and investment grade. Specific risk and

return criteria should be spelled out . We recommend that AHFC management prepare such criteria, and implement a more formal investment management system based on the criteria.

C. PROGRAMMATIC RECOMMENDATIONS**1. Re-evaluate Loan Loss Reserves and Exposure to Insurance Losses**

Because several months have passed since the last evaluation of AHFC's loan loss reserves, and because delinquencies and defaults are a continuing problem in most of AHFC's marketplace, it would be advisable to track loan loss reserves on a basis more frequent than yearly. Combined with this interim review should be a thorough review of MGIC's problems and AHFC's potential exposure arising therefrom.

We recommend that AHFC management arrange an interim loan loss reserve review, and re-evaluate its potential exposure to MGIC's situation.

2. Review REO Pricing and Disposition Policies

The Corporation maintains a very large inventory of REO. Since REO pricing and disposition policies have direct and potentially conflicting impacts on AHFC's financial position and on the housing markets, AHFC policies in this area have always been controversial. The picture is further complicated by the presence in the REO disposition market of other significant sellers (FNMA, FDIC, HUD, etc.)

The Corporation's REO policies can generally be divided into the segments of pricing, marketing, and financing. All three of these areas should be reviewed to ensure that a balance is being maintained among AHFC's financial integrity, the need to support the housing market, price levels versus holding costs, and AHFC's competitive position with respect to other REO sellers. We recommend that management undertake such a review.

3. Evaluate Costs of Maintaining Bond Ratings

The Corporation maintains excellent bond credit ratings largely through overcollateralization of bond issues. The cost of overcollateralization, to the extent that it commits substantial sums of money for extended periods of time, may be high if compared with the lowered interest cost obtained.

There is a need to formally evaluate the costs of "buying" good bond ratings versus the benefits derived (i.e., lower interest costs) from these ratings. We recommend that AHFC management undertake such a study to determine if current policies in this area are cost-effective.

4. Implement a Mortgage Insurance Program

AHFC is authorized to provide its own insurance on loans purchased by the Corporation, but the program has not been implemented. This is particularly relevant because private mortgage insurance is difficult to obtain in Alaska, pushing a higher percentage of buyers into FHA financing. Conventional mortgages are difficult to obtain unless the buyer has at least 20 percent of the purchase price in cash as a down payment.

We recommend that AHFC complete an evaluation of a self-insured mortgage program, and implement the program if appropriate. Such evaluation would include the effect of AHFC mortgage insurance availability on the housing market and, ultimately, on AHFC's own financial position. Implementation would involve: (1) developing goals and objectives for the program, (2) obtaining original capitalization, (3) developing procedures, manuals, and forms (e.g., for underwriting and claims processing), and (4) staffing, accounting, and developing investment strategies (for premiums collected).

D. LEGISLATIVE RECOMMENDATION**1. Exempt AHFC from the Executive Budget Act**

The Corporation operated for its first ten years without direct legislative oversight or approval of its annual operating budget. It was only beginning in fiscal year 1981/82 that the legislature required that AHFC's operating budget be subject to the Executive Budget Act, and, therefore, be subject to review and approval by the legislature and the Governor. This was the same period when the subsidy was introduced, and AHFC's loan programs were opened up to all Alaskans.

The AHFC has operated and continues to operate in an industry that has seen significant and rapid changes. The economic changes in the State are amplified in the housing industry, and AHFC must respond rapidly to these changes. However, civil service requirements and procurement restrictions can prevent AHFC from responding. Recent insurance losses related to MGIC insured bond programs are an example where AHFC could not respond quickly enough. Requests for increased staff to handle the increased workload and complex requirements of claims filed with MGIC were reduced by the Division of Audit and Management. As a result of a shortage in staff, AHFC may have paid costs attributable to the insurer and lost several million dollars of valid claims.

We recommend that the Legislature consider the appropriateness of exempting AHFC from the Executive Budget Act. An exemption would allow AHFC to respond more quickly to its staffing needs, and operate more effectively as a result. More efficient operations would allow for break-even operations or the possibility of returning an operations dividend to the State.

APPENDIX B

**PROJECTIONS OF AHFC
UNRESTRICTED NET
LIQUID ASSETS**

Ernst & Young

APPENDIX B

PROJECTIONS OF AHFC UNRESTRICTED NET LIQUID ASSETS

In this Appendix we present projections of the change in unrestricted net liquid assets of the Corporation over a five-year period ending June 30, 1994. We begin the Appendix with an overview of the projection model and assumptions, and then provide results of projections under alternative assumptions. These projections are presented in the following subsections:

- *Projection Methodology*
- *Projection Assumptions*
- *Projection Results.*

A. PROJECTION METHODOLOGY

The projection period was for the five fiscal years 1989/90 through 1993/94. We prepared projections of changes to the Corporation's balance sheets; specifically changes to the Corporate Operating and General accounts' unrestricted net assets. Unrestricted assets represent assets of the Corporation which are not pledged as collateral for specific bond indentures. We did not prepare projections of the individual bond programs, except to estimate assets which will be released from bond programs and could subsequently be used by the AHFC without restrictions.

Included in AHFC's unrestricted liquid assets, net of short-term obligations of AHFC (e.g., Euro commercial paper), were the following:

- Cash and short-term investments
- Mortgage loans available for pledging to bond issues
- Claims receivable and pledged receipts
- Net payments due from various bond programs
- Long-term investments which mature within the five-year projection period
- Investments, mortgage loans, and mortgage-backed securities which currently are pledged to a specific bond issue but which will be released because the bond issue is paid off in entirety or otherwise retired.

We excluded from liquid assets of AHFC those loans identified by the Corporation as having potential problems, and REO assets. Therefore, we do not project any future losses for these loans and REO properties already held by AHFC. However, our analysis does consider potential losses from loans to be purchased in the future, and additional REO acquired through foreclosure.

The financial operations of AHFC are quite complex, and the transactions affecting the Corporation's financial position are considerable and diverse. Because there was no formal forecasting system already developed for internal use at AHFC, we prepared a simplified model to project the change in unrestricted net liquid assets. With the assistance

of AHFC, we identified the following as significant items affecting changes over the five-year period:

- *Increases in Unrestricted Net Liquid Assets*
 - Collateral which is pledged to specific bond issues but which will be released because the bond will be retired. Collateral includes investments, mortgage-loans, and mortgage-backed securities
 - Interest earned on mortgage loans and investments of the Corporation. This is interest on short- and long-term investments, and interest on mortgage loans held by the Corporation in its Operating and General accounts and scheduled for pledging to bond issues
- *Reductions in Unrestricted Net Liquid Assets*
 - Interest rate subsidy provided to home buyers whose loans are purchased by AHFC. The subsidy is an amount based on the difference between AHFC's cost of funds and the rate the loans are purchased for, if the cost of funds is greater than ten percent (nine percent for veterans). The interest rate subsidy is a component of the original overcollateralization of a bond issue. That is, the total principal of loans and investments pledged to a bond issue is greater than the aggregate principal of the bonds
 - Overcollateralization of bonds also includes a "credit enhancement" component which presently allows for the Corporation to obtain a high credit rating on bonds. It should be pointed out that this overcollateralization theoretically will be released to AHFC after the specific bond issue against which the collateral pledged against is retired
 - Bond sales costs. These costs were assumed to be one percent of the bond issue, except for tax-exempt veterans bonds, which costs were assumed to be 1.75 percent of the bond issue
 - Reserve accounts. These were assumed established for the veterans mortgage bonds issued (at five percent of the total bond issue) and for the taxable and HOAP III bonds issued (at ten percent of the total bond issue)
 - An additional \$50 million of State financed loans. These loans were assumed purchased over the five-

year projection period, using monies drawn from AHFC's accounts and not from the proceeds of bond issues

- Interest costs on short-term borrowings. These are the costs of borrowing for Corporate working capital through Euro commercial paper or other mechanisms
- Estimated losses on mortgage loans purchased in the future and losses on dispositions of properties acquired in the future through foreclosures (real estate owned)
- General and administrative costs of AHFC (for example, salaries and benefits).

We estimated the cumulative total dollar amount of each of the items listed above over the five-year projection period. We then added the total estimated five-year increases and subtracted the total five-year reductions to arrive at a net change in unrestricted net liquid assets through June 30, 1994.

B. PROJECTION ASSUMPTIONS

A number of assumptions were made for baseline case projections¹. These assumptions are presented in Exhibit B-1, following this page. An implicit assumption we made for preparing our projections was that interest rates over the projection period would remain at their current rates, or in fact decrease slightly over the next five years. This was based on a review of interest rate projections made by various forecasters, including a consensus forecast prepared by a group of Wall Street economists, and a forecast prepared by Business Week magazine.

We developed two baseline scenarios for discussion purposes. The first (*Baseline A*) is based on assumptions shown in Exhibit B-1. The alternative baseline (*Baseline B*) assumes interest rates will rise by two percent in fiscal year 1990/91 and remain at the higher rate through June 30, 1994. As a result, for the alternative baseline scenario (B) we assumed that the subsidy on the taxable program would be two percent through fiscal year 1993/94, and for the veterans mortgage bond program, there would be a 0.5 percent subsidy through fiscal year 1993/94. This increased rate was assumed to have no effect on tax-exempt bond programs.

We also assumed that annual interest earnings on loans and investments of the Corporation remain constant over the five-year projection period. In reality, these earnings will fluctuate depending on actual interest rates, the number of loans held for pooling, the number of days loans are held by AHFC, and total dollars invested. We did not attempt to model changes in loan or investment balances, although these fluctuations will occur over time. Therefore, interest earnings could actually be more for those scenarios where we project an increase in unrestricted net liquid assets, and less for those scenarios where we project a decrease in unrestricted net liquid assets.

¹ The "baseline" case generally assumes as-is conditions over the five-year projection period. A comparison with this baseline case is our measure of the impact of alternative policy option scenarios.

Summary of Assumptions Used to Prepare Projections of AHFC Financial Position

Subsidy

No subsidy on tax-exempt or veterans mortgage bond program

A 0.75 percent subsidy on taxable program

A 2.5 percent subsidy on HOAP II program in FY 1989/90, a 2.0 percent subsidy on HOAP III program

Changes in AHFC subsidy were assumed not to have an impact on the total demand for loans statewide.

Total collateral released from retirement of debt over the five-year projection period was assumed to be as follows:

SAM D	\$38.9 million
SAM H	2.2 million
SAM I	(3.9) million ¹
SAM J	(0.8) million ¹
SAM K	0.4 million
SAM L	0.4 million
SAM M	10.5 million
SAM N	9.0 million
FNMA #4	16.5 million
FNMA #5	<u>7.5 million</u>
Total	\$80.7 million

(SAM = State Assisted Mortgage bond program)

AHFC Loan Activity

AHFC's volume of loan activity over the next five years was assumed to be approximately the same level as the previous five fiscal years. We reviewed these with AHFC financial personnel. Specifically, the total purchases of loans over five years was assumed as follows:

Tax exempt	\$300 million
Veterans	\$150 million
Taxable	\$680 million
HOAP III	\$100 million
State financed	\$50 million.

Other Changes In Unrestricted Net Liquid Assets

Investment interest earnings were assumed to be equal to FY 1989/90 actuals. Interest earnings on loans held by AHFC were assumed equal to eighty percent of the average earnings over the last five years, which approximated the FY 1988/89 loan interest

Borrowing arrangements (Euro commercial paper) remain in effect, short-term borrowings remain constant, and debt covenant restrictions on assets and equity remain the same

AHFC general and administrative expenses were assumed to be \$10 million annually, approximating the annual budget for fiscal year 1989/90

Net loan losses and REO losses total \$50 million over five years.

Bond Sales and Retirements

Bonds sold by AHFC were assumed overcollateralized by two percent in order to improve the bonds' credit rating

Total bond sales over the five-year projection period were assumed to be as follows:

Tax-exempt	\$348 million
Veterans	\$145 million
Taxable	\$725 million
HOAP III	\$90 million.

¹ A negative number represents contributions from AHFC required to accommodate payment of principal in full at maturity.

C. PROJECTION RESULTS**1. Baseline Scenario A**

Based upon the assumptions presented in Exhibit B-1 for our first baseline scenario, we have projected that unrestricted net liquid assets of AHFC may decrease by approximately \$107 million through June 30, 1994. Exhibit B-2, following this page, is a summary of the projected increases and reductions in unrestricted net liquid assets over the succeeding five-year period.

We estimated in Section III of this report that, as of June 30, 1989, AHFC had approximately \$10 million of unrestricted net liquid assets after considering debt covenant requirements which are required to be maintained by various short-term borrowing agreements. The projected net decrease of \$107 million over five years would consequently eliminate these net liquid assets.

2. Baseline Scenario B

As an alternative baseline scenario, we assumed the interest rate subsidy on the taxable program would be two percent in fiscal years 1990/91 through 1993/94. This is up from 0.75 percent which we assumed for our Baseline Scenario A. We also assumed that there would be a 0.5 percent subsidy on the veterans mortgage bond program in fiscal years 1990/91 through 1993/94. With these two changes, the total interest rate subsidy was projected to increase by \$48 million over our original (Baseline A) projections.

3. Elimination of the Subsidy

The potential elimination of the subsidy as of June 30, 1990 was discussed in Section VI of this report. In order to project the impact on AHFC unrestricted net liquid assets from this alternative, we made two changes to our Baseline Scenario A assumptions:

- There is no subsidy on the taxable program beginning July 1, 1990 (we had originally assumed a 0.75 percent subsidy)

**Change in Unrestricted Net Liquid Assets
For Five Year Period Ending June 30, 1994
Baseline A
(\$ Millions)**

<i>Increases Over Five Years</i>	
Collateral Released From Retirement of Bonds	\$80
Interest Earnings on Loans and Investments	215
Subtotal of Increases	<u>\$295</u>
<i>Reductions Over Five Years</i>	
Interest Rate Subsidy	\$83
Overcollateralization of Bonds (a)	109
State Financed Loan Purchases	50
Interest on Short-Term Borrowings	60
Loan Losses and Net REO Losses	50
AHFC General and Administrative Expenses	50
Subtotal of Reductions	<u>\$402</u>
Total Five-Year Change in Unrestricted Assets	(\$107)

Assumptions

No subsidy on tax-exempt or veterans bond programs

A 0.75 percent subsidy on taxable program

A 2.5 percent subsidy on HOAP II program during FY 1989/90

A 2.0 percent subsidy on HOAP III program during FY 1989/90 and 1990/91

Total purchases of loans over five years as follows:

• Tax exempt	\$300 million
• Tax exempt veterans	\$150 million
• Taxable	\$680 million
• HOAP	\$100 million
• State financed	\$50 million

Bonds are assumed overcollateralized by 2 percent for credit rating enhancement.

Bond sales costs are 1.0 percent of bond sale (1.75 percent for Veterans bonds).

Reserve accounts for taxable bonds equals 5 percent, and for HOAP bonds,

10 percent. No reserve accounts assumed for tax-exempt or Veterans bonds.

Annual interest expenses and earnings of Corporate and General accounts are assumed equal to 80 percent of the average of the previous five years.

(a) This line item also includes bond sales costs and reserve accounts.

- There is no subsidy for HOAP III loans purchased in fiscal year 1990/91 (we had originally assumed that there would be a two percent subsidy, the maximum allowed by the program).

As a result of these two new assumptions, we estimated that the total amount of overcollateralization necessary to fund the interest rate subsidy over the projection period would decrease by approximately \$43 million from our Baseline Scenario A case. All other increases and reductions noted for the Baseline Scenario A (Exhibit B-2) remain unchanged.

4. Elimination of the Taxable Program

The policy option of returning AHFC to its original legislative intent was discussed in Section VII of this report. As presented in Section VII, this essentially involves phasing out the taxable program. For purposes of preparing a projection of the impact of this option on AHFC's financial position, we made the following changes to the Baseline Scenario A assumptions:

- No subsidy for the HOAP III program beginning fiscal year 1990/91
- No taxable bonds sold after June 30, 1990.

Based upon these two changes to our Baseline Scenario A assumptions, we projected a \$19 million net reduction in unrestricted net liquid assets over the five-year projection period. This compares with a \$107 million decrease over the same five years under our Baseline Scenario A assumptions, or an \$88 million difference.

5. Summary of Results

Table 1, following this page, summarizes the five-year projected change in AHFC unrestricted net liquid assets, under the various scenarios evaluated. There usually will be differences between the projected and actual results, because events and circumstances frequently do not occur as expected, and those differences may be material. Therefore, we provided a possible range of estimates (i.e., using two baseline scenarios) of the change in

AHFC financial position over the five-year period, rather than a point estimate of the final June 30, 1994 balance.

Table 1
Five-Year Projected Change in Unrestricted Net Liquid Assets
(\$ Millions)

Scenario	Baseline A (No Increase in Interest Rates)	Baseline B (A Two Percent Increase in Interest Rates)
No Change in Programs	(\$107)	(\$155)
Eliminate Subsidy July 1, 1990	(\$64)	(\$64)
Eliminate Subsidy and Taxable Program July 1, 1990	(\$19)	(\$19)

APPENDIX C

**SURVEY OF THE ALASKA
REAL ESTATE MARKET**

Ernst & Young

APPENDIX C SURVEY OF THE ALASKA REAL ESTATE MARKET

In order to evaluate the potential effects of changes in State policy on the housing market and on AHFC, it is necessary to understand the recent history of the market and its current status. In this appendix, we review the real estate market in those locations from which AHFC buys most of its mortgages and provides the most market support.

This appendix is organized as follows:

- *Introduction*
- *Anchorage Real Estate Market*
- *Fairbanks Real Estate Market*
- *Matanuska-Susitna Valley Real Estate Market*
- *Juneau Real Estate Market*
- *Kenai Peninsula Real Estate Market*
- *Ketchikan Real Estate Market*
- *Sitka Real Estate Market.*

A. INTRODUCTION

The Alaska residential real estate market has seen substantial changes since 1985. A general decline in the economy brought hard times to most locations in Alaska, although the depth of the decline in real estate values varied from place to place, and some locations are showing a strong recovery already.

In investigating the Alaska real estate market, we attempted to gain a good understanding of recent events in each location, current volumes and prices, and industry views of likely future market conditions. To do this, we depended on data supplied by local governmental entities, real estate associations, multiple listing services, brokers, appraisers, and financial institutions.

Much of the data gathered were "hard" data compiled from large numbers of actual sales. Other data, especially in smaller locations, was judgmental in nature and involved estimates by industry sources. In small or thin markets, the judgment of professionals is often more valuable than statistical information due to non-comparability of data from period to period.

Our market investigation focussed on several key points. The questions we felt had to be answered included:

- What has been the history of the market?
- What is the current status and direction of the market?
- What are current annual sales volumes?
- What is the distribution of sales by price range?
- How important to market health is the AHFC subsidy?
- How important to market health is AHFC participation in the broader sense?

The answers to some of these questions varied from place to place. Others received similar answers in most locations.

The areas investigated represent about 96 percent of AHFC's total portfolio as shown in Table 1, below.

Table 1
Areas Investigated and Portfolio Performance

Location	Percent of AHFC Portfolio	Delinquency Index	Foreclosure Index
Anchorage	57.99%	1.01	1.15
Fairbanks	13.15	1.18	0.92
Mat-Su Borough	7.68	1.38	1.67
Juneau	7.11	0.71	0.38
Kenai Peninsula	5.91	0.76	0.62
Ketchikan	2.36	0.79	0.08
Sitka	1.57	0.63	0.13

In the table above, the "delinquency index" is the ratio of each location's delinquency rate to the delinquency rate of AHFC's overall portfolio as of October 31, 1989. The "foreclosure index" is defined similarly. Thus, the areas worst hit by the real estate market downturn, as defined by the calculated "foreclosure rate", are Mat-Su Borough, Anchorage, and Fairbanks, in that order. The Kenai Peninsula market was damaged somewhat less, and Southeast locations suffered the least damage.

The following sections describe the real estate market in each of the above locations. Disproportionate space is given to Anchorage in this description, for three reasons:

- Anchorage represents almost 60 percent of AHFC's portfolio and an even higher percentage of foreclosures. Anchorage is AHFC's biggest customer and biggest problem
- Detailed data from various sources in Anchorage support considerable analysis, generating findings that may be generally relevant in other Alaskan communities
- The history of the Anchorage housing market, which is presented in some detail, parallels the histories of other markets, even those in Southeast.

B. ANCHORAGE REAL ESTATE MARKET**1. General**

The Anchorage area is the main focus of AHFC mortgage purchase activity. As of October 31, 1989, Anchorage represented 60 percent of AHFC's portfolio by value. Anchorage's delinquency and foreclosure rates were both above total portfolio average for AHFC.

The Anchorage market peaked in late 1985 and early 1986. Since that time demand has fallen, caused mainly by a net population outflow. Housing prices have decreased dramatically, and many Anchorage homeowners have negative home equities. Foreclosures are a continuing problem.

Vacant units represent ten years' demand at current absorption rates. Although the drop in single-family home prices appears to have slowed or stopped, substantial recovery is probably a long ways off. Condominium prices remain at extremely depressed levels. Financing is difficult because of a number of factors. Foreclosures appear to be slowing but remain a significant problem.

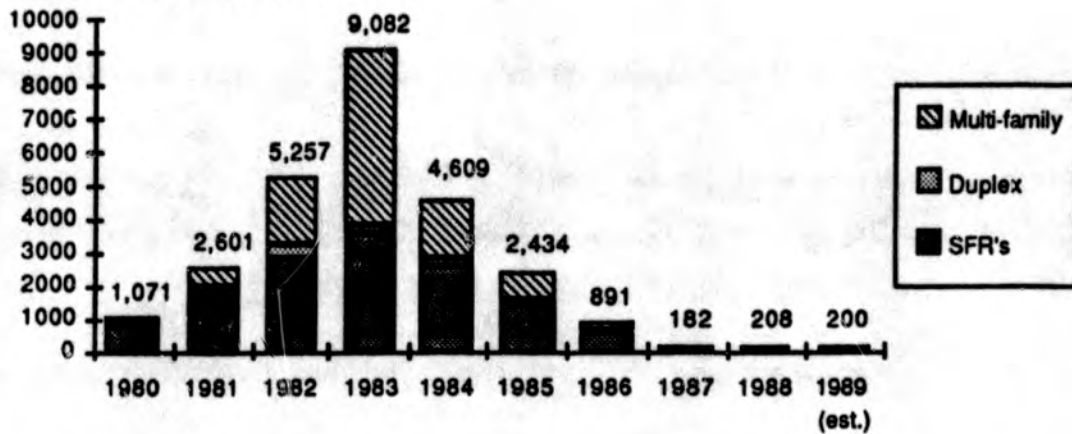
The 1989 population increase appears to have affected mainly the rental market—rental vacancies in larger projects have dropped from 24 percent to 8 percent over the past twelve months. Otherwise, the market remains depressed and signs of recovery are few.

2. Supply and Demand

Housing starts in Anchorage increased nine-fold between 1980 and 1983, peaking at over 9,000 units in 1983 (see chart below):

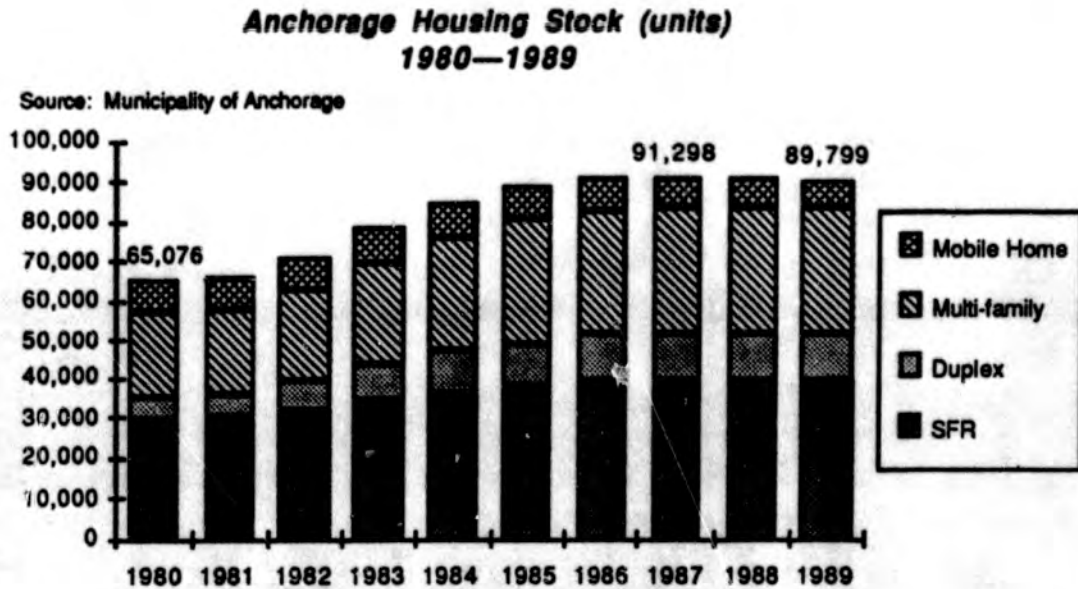
**Anchorage New Housing Units Authorized
1980—1989**

Source: Municipality of Anchorage



After 1983 starts decreased quickly and have hovered around 200 per year since 1987. Most starts currently are higher-end detached single family residences, ranging from \$140,000 to \$250,000 or higher.

Total stock peaked at 91,298 units in 1987 and had declined to 89,799 units by 1989 (mid-year):



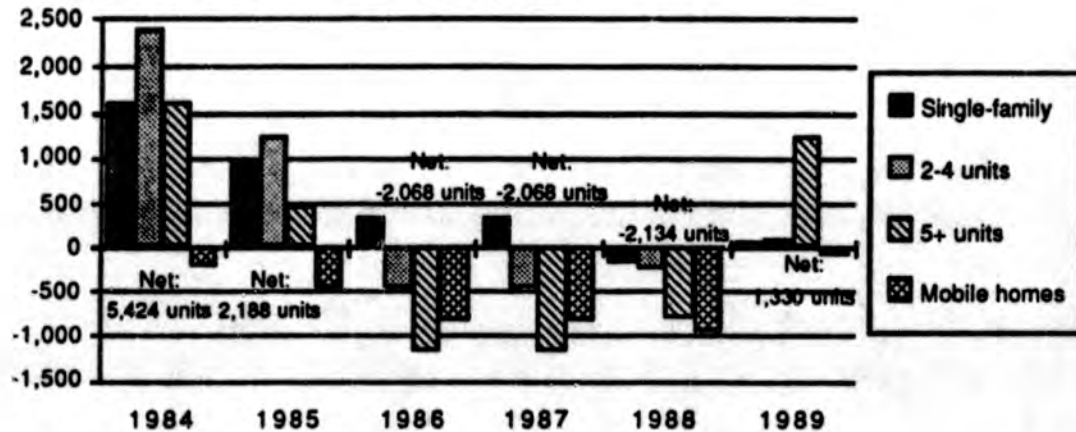
The decrease in units has been due to demolition or removal from the State of a substantial number of mobile homes and the boarding up of about 550 residential units in properties slated for demolition.

Net absorption was negative in 1986, 1987, and 1988, totalling about 6,300 units: That is, by 1989 there were 6,300 fewer occupied units in Anchorage than in 1985.

The year 1989 (twelve months through July) saw the first positive net absorption in several years. On July 1, 1,330 more units were occupied than one year previously:

**Anchorage Net Absorption of Housing Units
1984—1989**

Source: Anchorage Economic Development and Planning



This increase was almost entirely in multi-family housing and appears to be mostly rental in nature. The annual Anchorage rental survey revealed that rental occupancy of projects with 20 or more units dropped from 24 percent in 1988 to 8 percent in 1989 (mid-years). Ken Kincaid of Shorett and Riely, who performs the annual rental survey, lays the increase in rental occupancy to three causes:

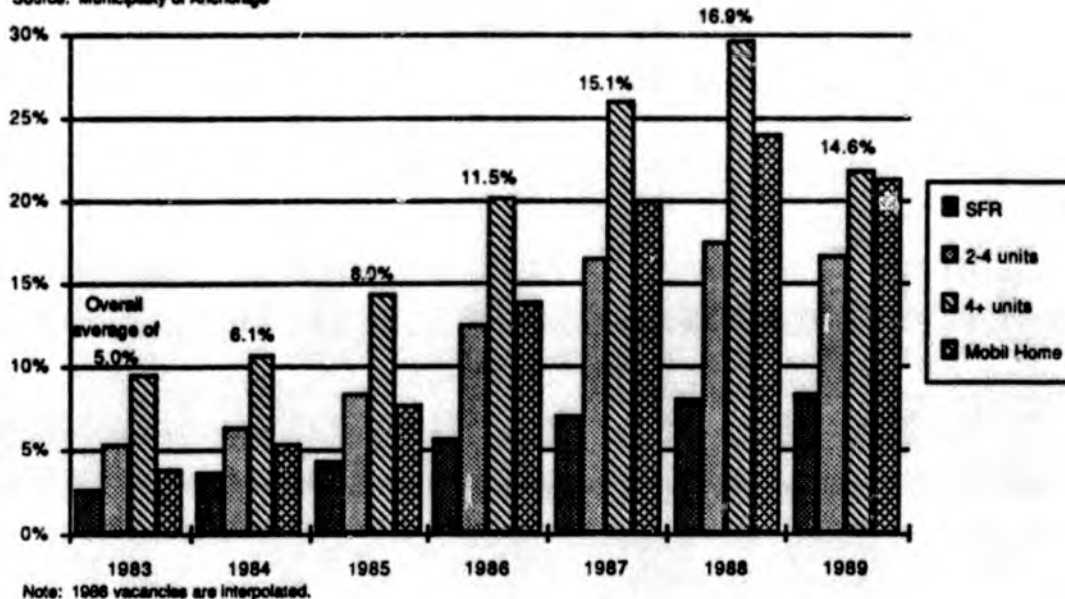
- Temporary population increase from oil spill activity
- Long-term population increase from an improving economy
- Rental demand by former homeowners who have undergone foreclosure and do not wish to leave the city.

Only the second of these three factors contributes to long-term demand for housing unit occupancy.

Vacancies peaked in 1988 at 16.9 percent and have declined somewhat in 1989 to 14.6 percent, with the improvement led by multi-family housing:

Anchorage Vacancies by Housing Type
1983-1989

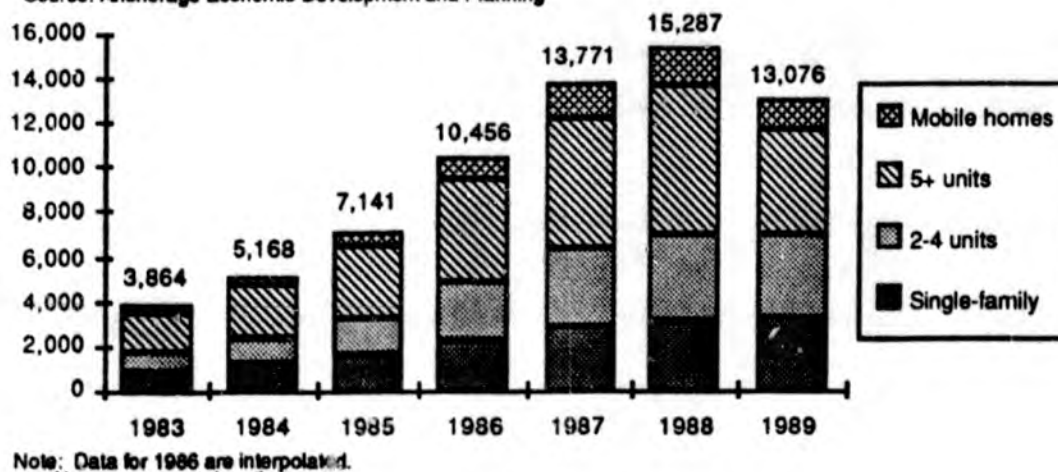
Source: Municipality of Anchorage



Single-family residences (including zero lot lines) have the lowest vacancy rate at about 8 percent, 2- through 4-plexes run about 17 percent, while condominiums and apartments show about 22 percent vacancies. Mobile homes have improved from 1988's 24 percent to about 22 percent, reflecting demolition or out-of-state shipment of many units. Overall vacant stock is still over 13,000 units:

Anchorage Vacant Units
1983-1989

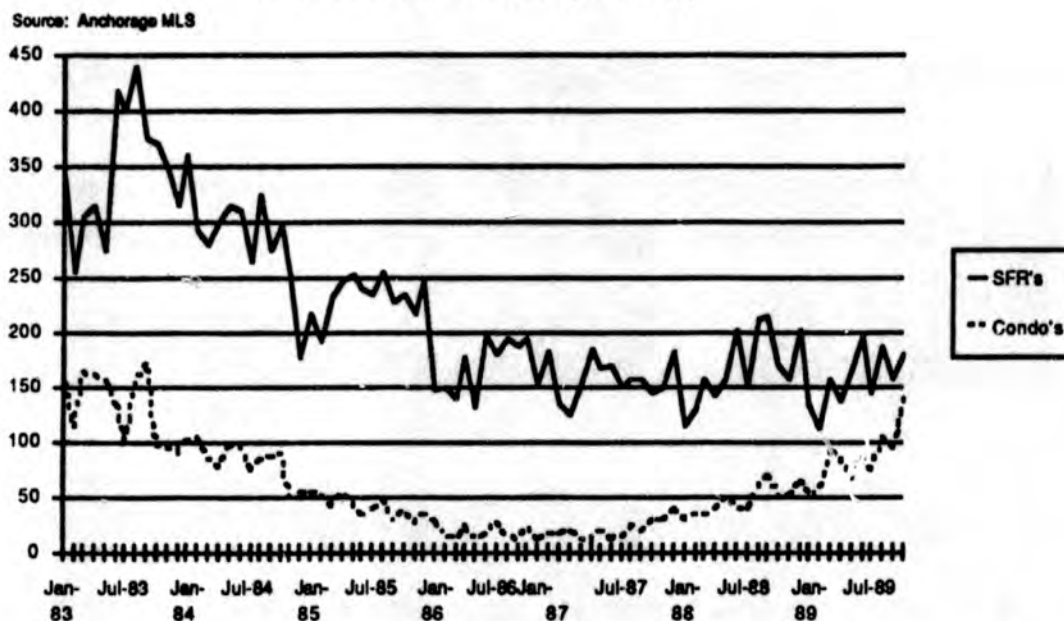
Source: Anchorage Economic Development and Planning



This represents about 10 years of demand at the 1989 absorption rate of 1,330 units. But since 1989 absorption was probably artificially high due to the oil spill, the actual picture may be even worse.

A good indicator of market activity is sales volumes in units, as shown in the graph below:

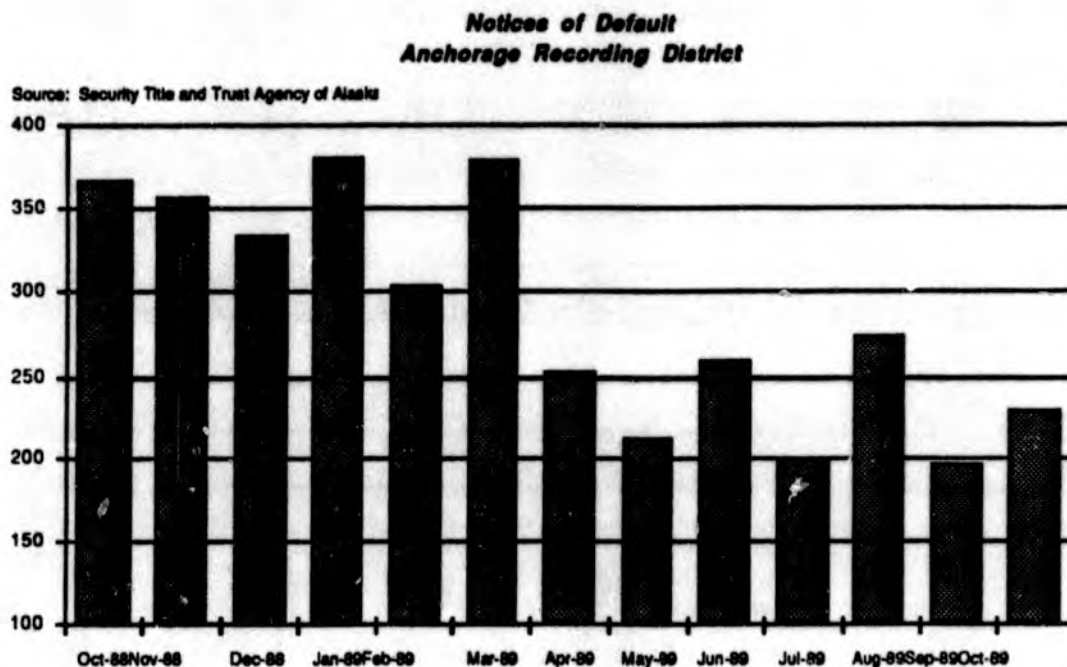
**Anchorage Unit Sales, Single Family Homes
and Condo's, 1982-1989 (MLS only)**



Sales of single family residences, which peaked at over 400 per month in the summer of 1983, showed a steady decline to their current levels of 120-150 per month (winter) and 150-200 per month (summer) by 1986. There has been no apparent increase in activity through October 1989, at least considering only MLS figures; direct REO sales are now a significant portion of the market, and lack of data in this area may mask a slight upward trend.

Sales of condominiums dropped from a level of 100-150 per month in 1983 to under 20 per month in the 1986-1987 period. There has been an upward trend since mid-1987, however, to over 100 sales per month; there were almost 150 sales in the latest known month, October, 1989. This trend appears to be due to investment buying and purchases by low-income families brought about by depressed prices and availability of attractive financing programs from some REO holders.

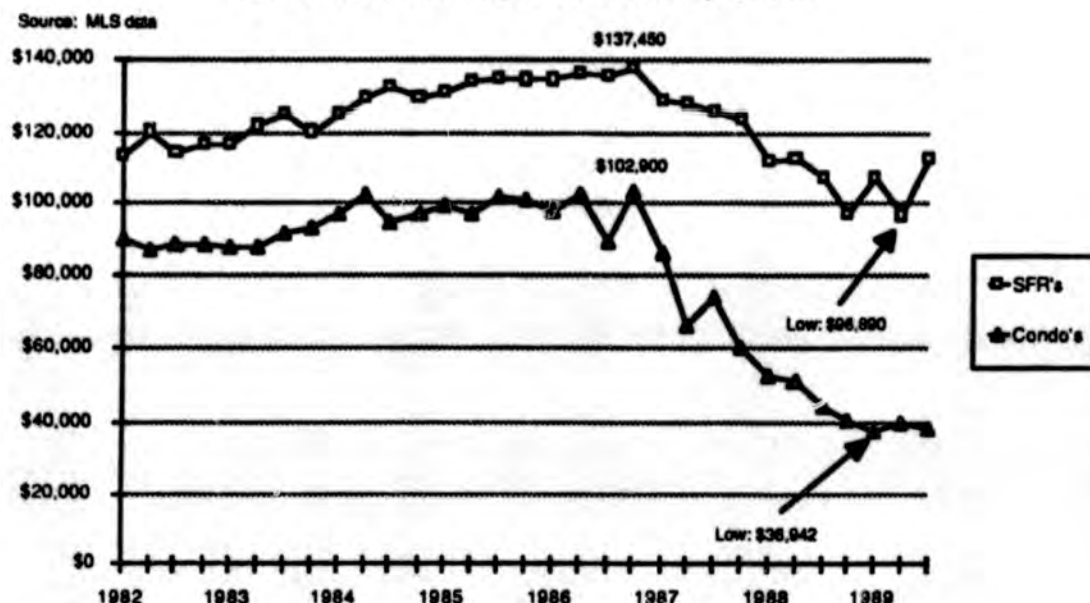
There is little doubt that, without a substantial boost to Anchorage's economy from some outside source, the large stock of unoccupied properties will continue to depress prices for some time to come. There is an additional danger that FDIC review of its portfolios will result in an additional REO spike, adding to the problem, but for the time being it appears that REO generation through foreclosure is slowing down. As the following graph shows, foreclosures from all sectors (but mainly residential) in the Anchorage Recording District have declined over the past year from a level of 300-400 per month to about 200-250 per month:



3. Prices

A general review of price movements in the Anchorage market is presented in the graph below:

*Housing Prices, Single-family Homes
and Condo's, Anchorage, 1982-1989 by quarter*



Although the MLS data presented in this graph are not corrected for mix of types and qualities sold in each period and do not include substantial REO sales by various parties, the general picture is clear—real estate prices peaked near the end of 1986 (well after the economic downturn began) and have declined precipitously since.

Single family home prices averaged \$137,450 in the peak quarter of 1986. They fell to a low of \$96,890 by the second quarter of 1989, a drop of 29.51 percent. Prices rose to \$112,512 in the third quarter, reflecting a possible recovery; but in October (the latest month available), single-family homes prices averaged only \$103,171. It is unclear, therefore, whether recent price moves signal a recovery in this segment of the market.

Condominium prices fared far worse than single family prices. A peak of \$102,900 was reached in 1986; prices then plummeted to a low of \$36,942 in the first quarter of 1989, a drop of 64.10 percent. Prices were a bit stronger in the second and third quarter, but in October (the latest month) they averaged only \$34,699.

In summary, prices for Anchorage homes appear to have stabilized at low levels. Some recovery may be present in the single family home segment, but condominium prices remain flat.

Stratification of prices follows, in Table 2, below. These figures are derived from total MLS sales in Anchorage for the latest three months available, August through October, 1989, and reflect actual sales prices for mixes of all residential property types:

Table 2
Price Stratification of Housing Sales in Anchorage

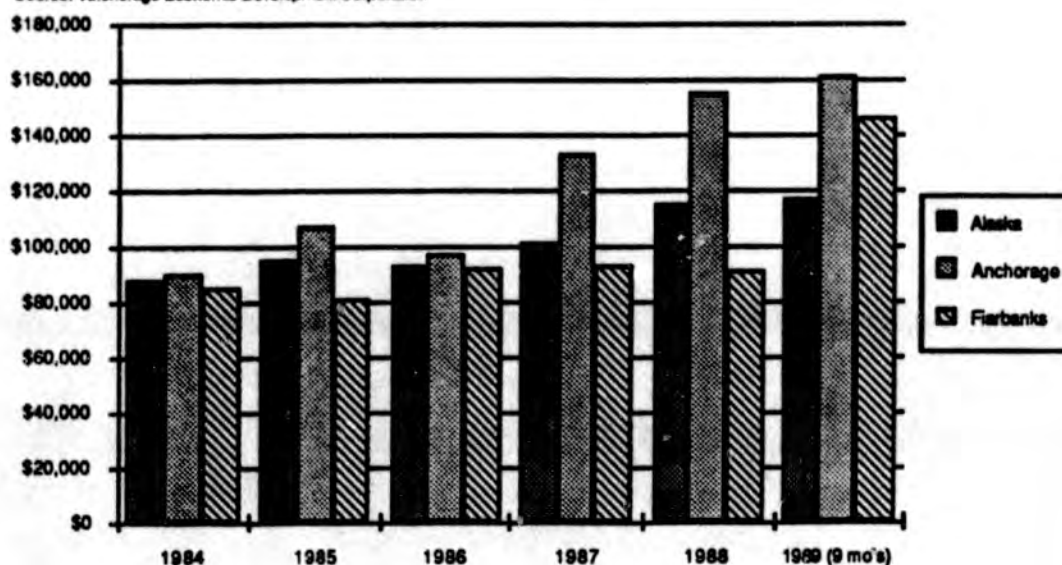
Price Range	Percent of Sales
Under \$86,850	62.69%
Under \$135,000	84.67%
Over \$235,000	2.72%

The high percentage of home sales under \$86,850 reflects a ready availability of low-priced condominiums in the Anchorage market and is not typical of some other areas in Alaska (see other market analyses, following).

As noted above, some housing construction continues in Anchorage (estimated at 200 units in 1989). This construction is almost exclusively confined to higher-value homes in the \$150,000 and up price ranges. Industry sources state that most of these homes are being built for oil company executives who are transferring into Anchorage and have difficulty locating suitable housing in the higher price ranges. The following graph, illustrating this trend, shows average construction cost for homes in Alaska, Anchorage, and Fairbanks by year:

**Average New Home Construction Cost
Alaska, Anchorage, and Fairbanks, 1984-1989**

Source: Anchorage Economic Development Corporation



Note that these costs do not include land, furnishings, or profit. They are simply the basic construction cost of the house. As can be seen, the average cost of a new house in Anchorage has increased from under \$90,000 in 1984 to over \$160,000 in 1989, reflecting almost exclusively the shift away from lower-quality housing and condominiums to high-end housing.

4. Factors Affecting Future Market Activity

In the long-term, improvement in the Anchorage real estate market will depend on increases in population and employment. Meanwhile, existing vacant stock will deteriorate, leading to demand for new units. Based on current trends, either of these two processes will take some years to show an effect.

Specific events which might cause short-term improvements in the market include:

- A sharp increase in oil prices, leading to an increase in State spending
- Construction of a gas pipeline

- Exploitation of the ANWR fields, leading to increased pipeline flows and increased State spending
- Expansion of Anchorage's role as an air transportation hub, one sign of which may be Federal Express's recent decision to base worldwide distribution services in Anchorage
- Increased military presence in the Anchorage area as a result of Stateside deployment of troops presently overseas, resulting from decreased international tensions (but see below)
- Some other unforeseeable event which improves the general economic climate in Anchorage.

The probability of any of these events occurring is problematical. It is equally likely that other events may retard market recovery or even cause further depression:

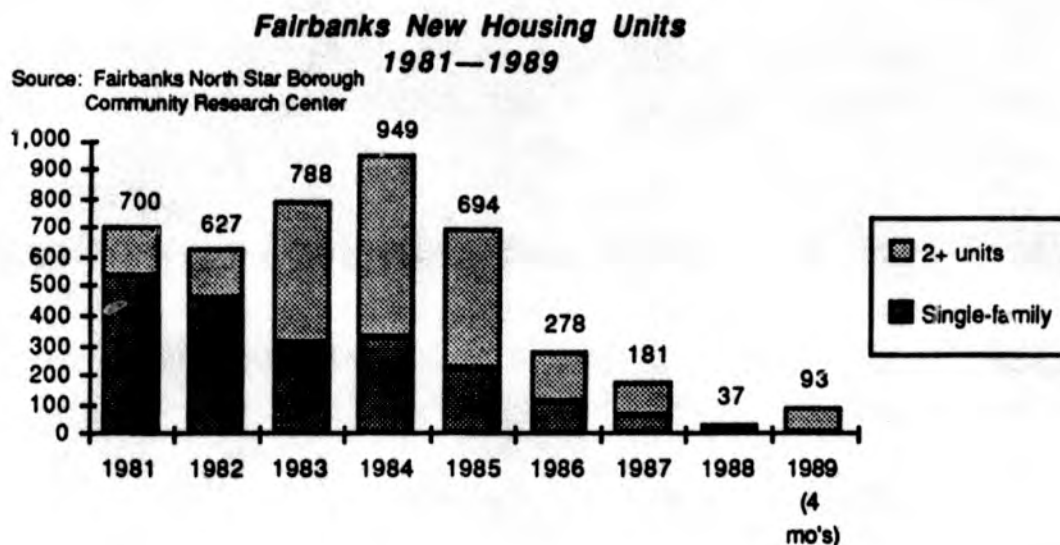
- Lowered State spending in anticipation of oil revenue decreases
- Movement of military personnel out of Alaska due to federal military spending cutbacks
- Possible new REO production as the FDIC reviews its portfolios in Anchorage for non-performing loans and increases foreclosures.

Given a very subjective view of the relative probability of these events, both positive and negative, it is difficult to feel overly optimistic about the near-term future of the housing market in Anchorage.

C. FAIRBANKS REAL ESTATE MARKET

Fairbanks represents AHFC's second largest market concentration, accounting for 13.15 percent of AHFC's total portfolio. Its delinquency rate is above Anchorage's, and above portfolio average, but its foreclosure rate is below average.

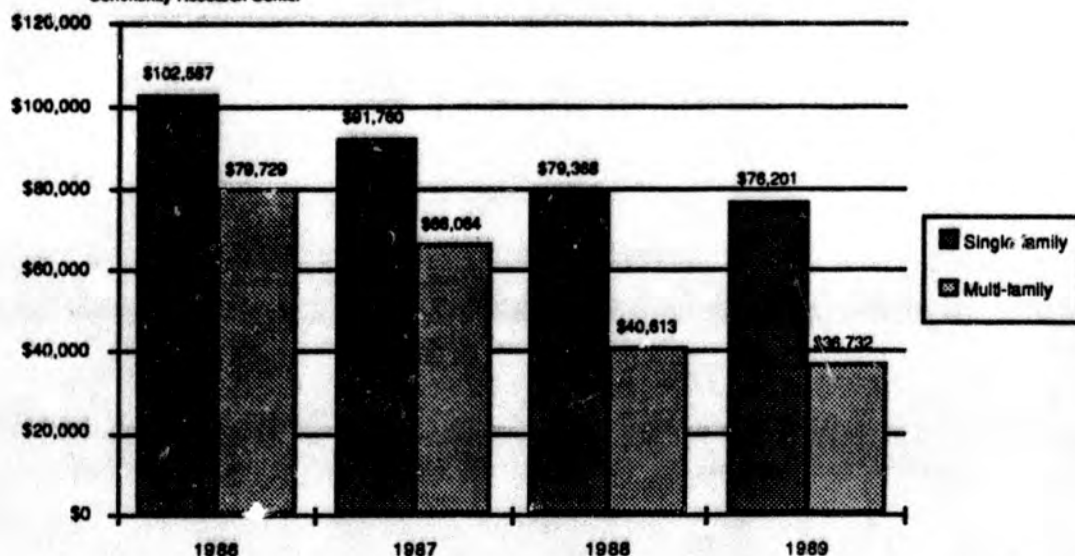
Fairbanks, like Anchorage, was hard hit by the real estate market downturn in 1986. Market supply anticipated the downturn, but not by enough. The following graph shows new units supplied to the Fairbanks market annually:



Since 1984 was the peak supply year (one year after Anchorage's peak of 1983), the oversupply situation in 1986 and years following was serious. This oversupply, combined with the economic downturn in Alaska generally, contributed to a continuing trend of lowered housing prices:

**Fairbanks Home Sales Prices
By Year, 1986-1989**

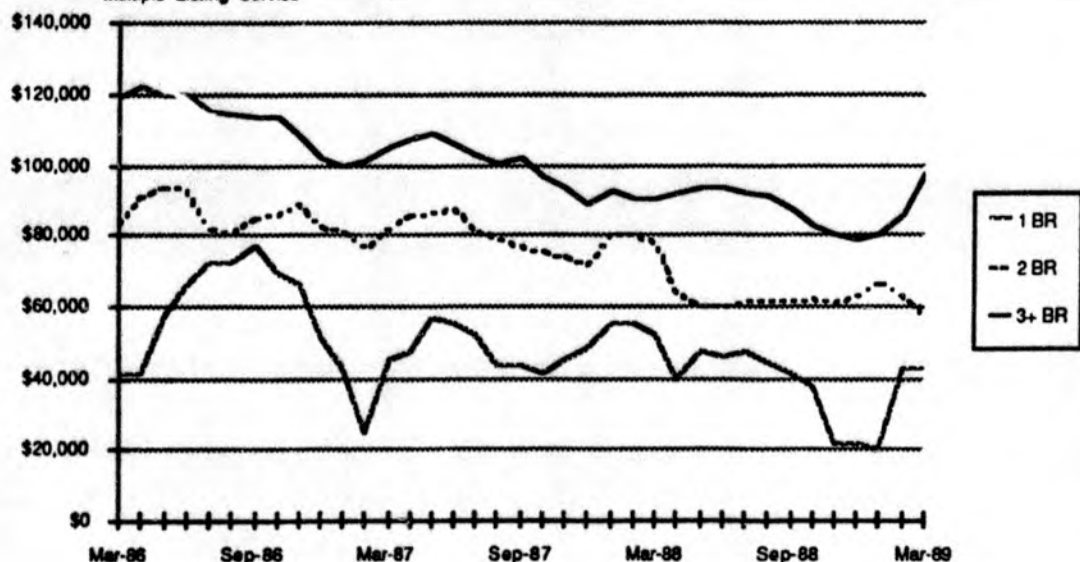
Source: Fairbanks North Star Borough
Community Research Center



Detached single family home prices also may be viewed on a monthly basis. Although the accompanying chart only shows prices through March 1989, the average annual prices per the chart above, which show 1989 prices through December 4, confirm a continuing downward trend in 1989:

**Fairbanks Average Sales Prices
MLS Sales, 1986-1989**

Source: Greater Fairbanks Board of Realtors
Multiple Listing Service



Mobile home sales are also tracked by industry sources in Fairbanks, who offer an estimate of \$18,880 as an average price in 1989.

Activity levels in the Fairbanks market remain reasonably high. The Greater Fairbanks MLS, which accounts for about 80 percent of all Fairbanks housing sales, showed the following closing counts for 1989 through December 4 in Table 3, below.

Table 3
Sales by Housing Type in Fairbanks

Housing Type	Number of Closings
Single-family	515
Townhouse/Condominium	104
Mobile home	20
Total closings	639

Demand for housing by price range is reflected by sales in the current market. Based on MLS closing price data for 358 sales in 1989, demand is stratified in Table 4, below, as follows:

Table 4
Price Stratification of Housing Sales in Fairbanks

Price Range	Percent of Sales
Under \$86,850	59.22%
Under \$135,000	91.62%
Over \$235,000	1.12%

These data are partly confirmed by industry estimates in Fairbanks that of about 200 sales in the past six months, one was at \$235,000, one at \$215,000, and the remainder at \$155,200 and below.

D. MATENUSKA-SUSITNA VALLEY REAL ESTATE MARKET

The Mat-Su Valley is AHFC's third largest market concentration, at 7.68 percent of AHFC's total portfolio. Of all areas in Alaska where AHFC maintains a substantial portfolio of loans, the Mat-Su Valley has been the hardest hit by the real estate market downturn. As of October 31, 1989, it had the highest delinquency and foreclosure rates of all AHFC geographic concentrations.

Local sources state that the reasons are twofold:

- The Valley is largely a bedroom community for Anchorage, and was thus directly affected by Anchorage's problems. This problem was exacerbated when Anchorage prices fell and deep vacancies occurred: Many Valley residents moved into Anchorage under the new, more affordable, conditions, and Anchorage's vacancies were to some extent "exported" to the Valley
- The Valley was home to many North Slope oil workers. As cutbacks occurred in the oil industry, the Valley felt the pinch harder than most.

In any event, prices have reflected the state of the market. Because the Valley MLS was part of the Anchorage MLS until relatively recently, a documented summary of historical price movements is difficult to compile. But industry sources estimate that housing prices fell violently in 1987, and are only now starting to recover as shown in Table 5, below:

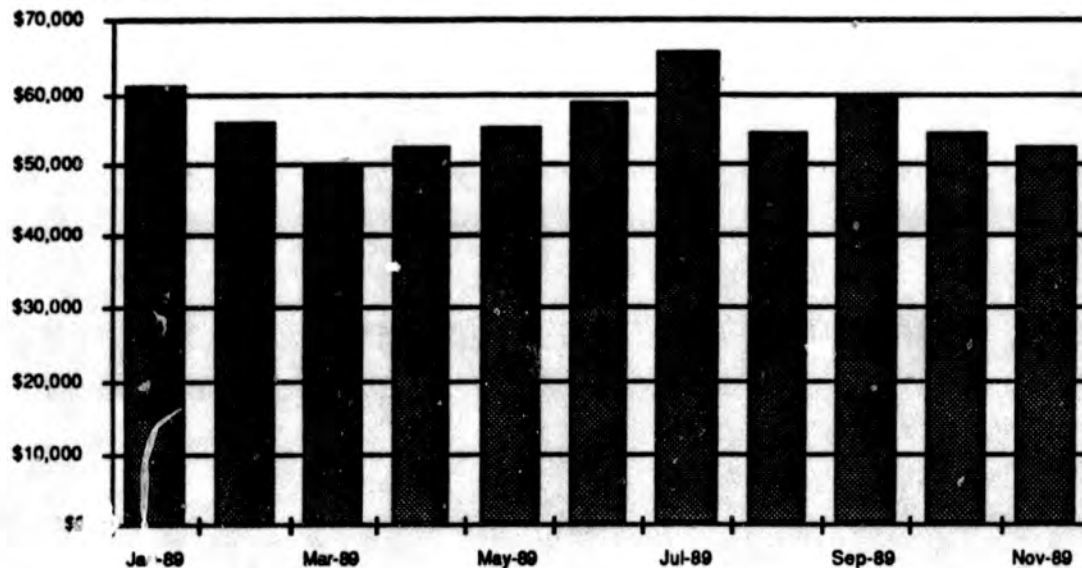
Table 5
Price Movements in Mat-Su Valley

Year	"Typical" 3-Bedroom Home
1985	\$110,000
1986	\$110,000
1987	\$55-60,000
1988	\$55-60,000
1989	\$60-65,000

Price movements in 1989 are shown in the following graph:

**Mat-Su Valley Residential Prices
All MLS Sales, 1989**

Source: Valley Board of Realtors

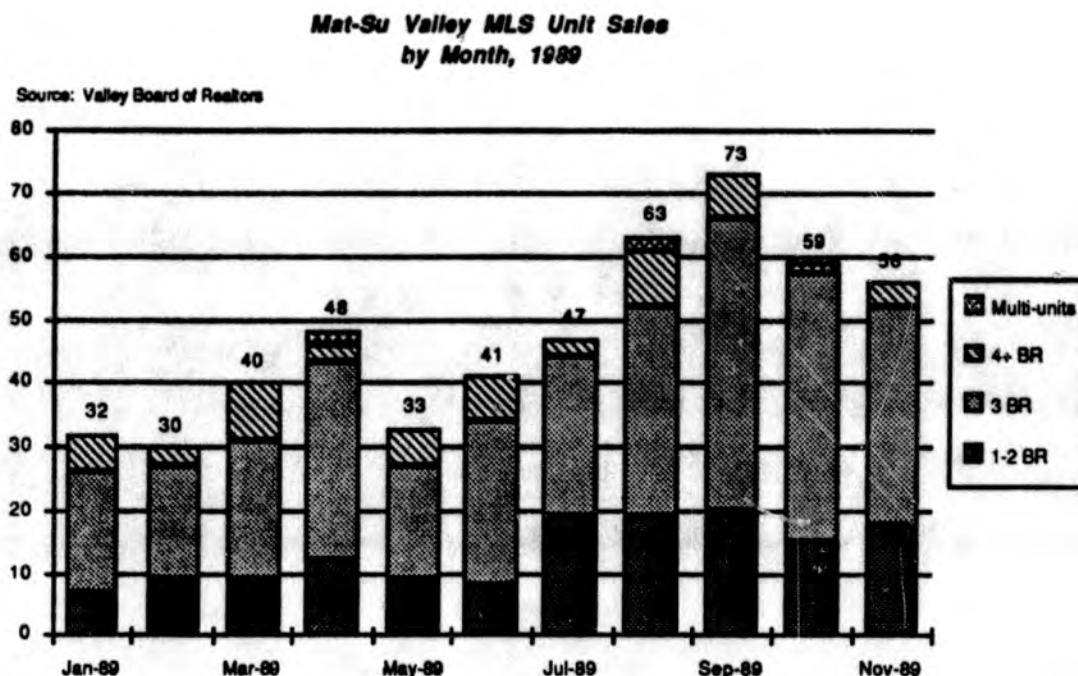


As can be seen, the average price of a home is in the high \$50,000's, and has not shown a strong recovery through the year. Some industry sources, however, feel prices should recover about 5 percent during 1990.

These sources state that school enrollment and telephone hookups are up a bit in 1989, possibly portending a further improvement in the market. Rentals are also tight, but quite a few 2-4 plexes are "off the market" and could loosen up rentals when marketed.

MLS volumes in the Valley market are running about 50 sales per month, of which most are single-family residences. Condominium sales account for only about 1.5 percent of total sales. In general, the Valley marketplace is not condominium-heavy like Anchorage's.

The following graph shows market activity for 1989:



This graph appears to show market activity picking up somewhat as the year progresses, but it would be premature to announce a trend from these data.

Market stratification, based on all MLS sales for the first eleven months of 1989, is shown in Table 6, below, as follows:

Table 6
Price Stratification of Housing Sales in Mat-Su Borough

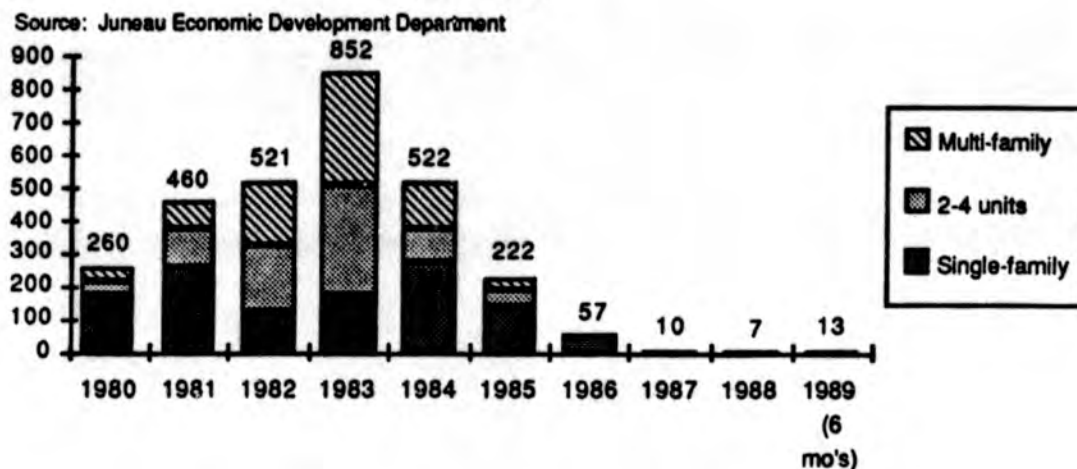
Price Range	Percent of Sales
Under \$86,850	89.45%
Under \$135,000	97.70%
Over \$235,000	0.00%

E. JUNEAU REAL ESTATE MARKET

Juneau represents 7.11 percent of AHFC's portfolio by dollar amount. Its delinquency and foreclosure rates are well below the average for AHFC's portfolio.

To a certain extent, the history of the Juneau housing market parallels the cycle of overbuilding and then oversupply experienced in Anchorage:

**Juneau New Housing Units
1980—1989**



As in Anchorage, construction peaked in 1983 and has since practically ceased altogether.

But in contrast to the Anchorage, Fairbanks, and Mat-Su Valley markets, Juneau real estate is showing a strong recovery from the downturn. Local industry sources state that prices are up, inventories are tight, and that above-list offers must often be made in order to buy desirable properties. These sources also state that local appraisers are applying inflationary factors to older comparables when valuing properties as shown in Table 7, below.

Table 7
Appraisal Escalation Factors in Juneau

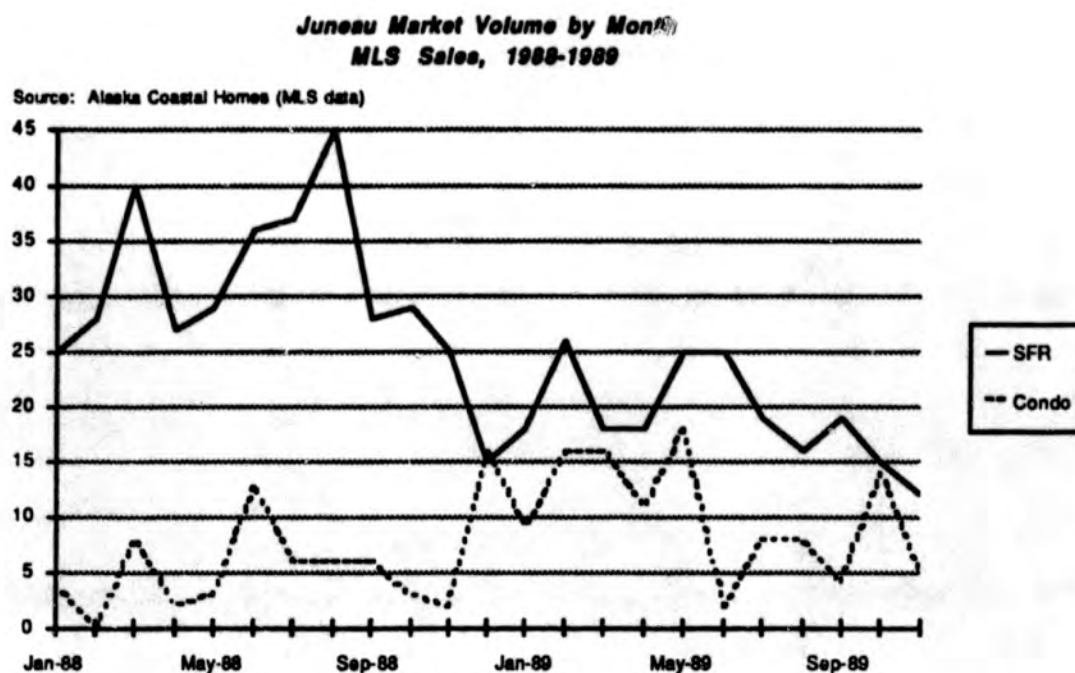
Type of Property	Escalation Factor
Single-family	1%/month
Zero lot line	3%/month
In-city condo	1/2%-1%/month

Volumes of sales handled through the Juneau MLS in recent years are summarized in Table 8, as follows:

Table 8
Volume of Sales in Juneau

Year	Number of Sales
1986	256
1987	299
1988	459
1989	400

The drop-off in 1989 is not due to a worsening market, but to fewer properties listed and higher prices. The pattern of housing sales over the past two years is shown below:



Dependable price information in Juneau is hard to obtain because of lack of MLS statistical reporting. Industry sources estimate the following trend of prices since 1986 as shown in Table 9:

Table 9
Housing Price Movements in Juneau

Type of Home	1986	1987	1988	1989
Single-family detached	\$105,000	\$78,500	\$85,000	\$105,000
Zero lot line	\$80,000	\$59,500	\$59,500	\$68,000
Condominium	\$56,000	\$23,000	\$28,000	\$35,000

The same industry sources estimate price stratification within the Juneau market as presented in **Table 10**, as follows:

Table 10
Price Stratification of Housing Sales in Juneau

Price Range	Percent of Sales
Under \$86,850	65-70%
Under \$135,000	80%
Over \$235,000	1/4%

F. KENAI PENINSULA REAL ESTATE MARKET

The Kenai Peninsula market consists mainly of Kenai, Soldotna, and vicinity areas. This market represents 5.91 percent of AHFC's portfolio by dollar volume. It has experienced below-average delinquency and foreclosure rates.

Activity in this market has shown some improvement, although average time-on-market figures indicate slow sales as noted in Table 11:

Table 11
Market History in Kenai Peninsula

Year	Sales per Month	Days on Market
1987	16.25	162
1988	27.33	190
1989 (11 months)	23.45	223

Average sales prices for all classes of homes declined about 12 percent from 1987 to 1988, and an additional 4 percent in 1989, described in Table 12, following:

Table 12
Housing Price Movements in Kenai Peninsula

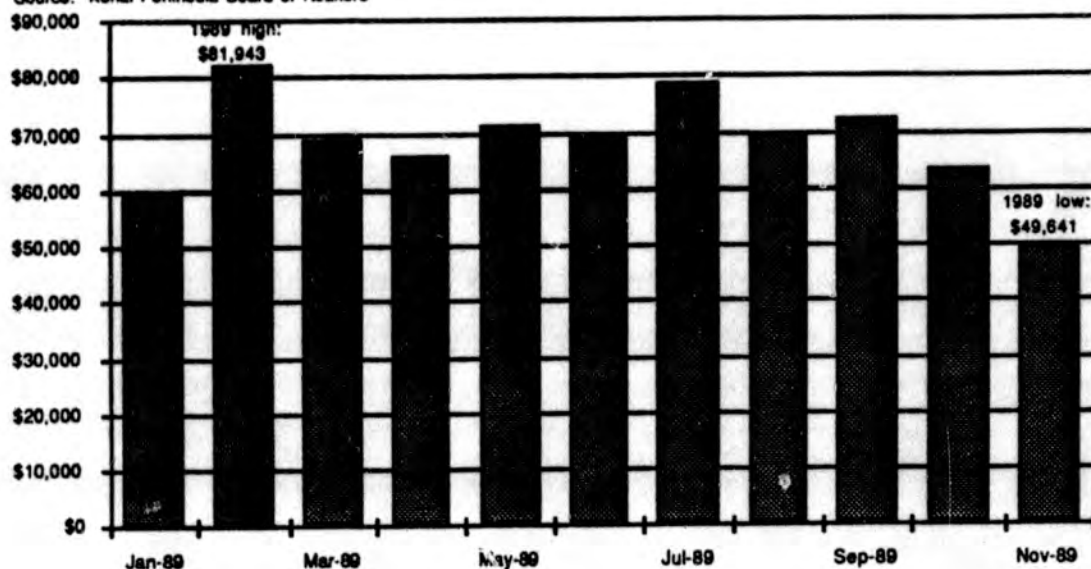
Year	Average Home Price
1985	\$105,000 (1)
1986	\$105,000 (1)
1987	\$80,852 (2)
1988	\$70,556 (2)
1989	\$67,889 (2)

Notes: (1) Industry estimates. Home prices did not drop generally in 1986, but sales slowed down dramatically.
(2) MLS averages of closings. Drop in 1989 is said to be due to the mix of homes sold, not to generally lower prices.

Movements in home sales prices can be seen in the following chart:

**Kenai Peninsula Average Sales Prices
MLS Sales, 1989**

Source: Kenai Peninsula Board of Realtors



An analysis of 258 MLS sales over the first eleven months of 1989 gives the following demand stratification presented in Table 13, below:

**Table 13
Price Stratification of Housing Sales in Kenai Peninsula**

Price Range	Percent of Sales
Under \$86,850	78.29%
Under \$135,000	96.51%
Over \$235,000	0.00%

G. KETCHIKAN REAL ESTATE MARKET

Ketchikan represents 2.36 percent of AHFC's portfolio. It has a below-average delinquency rate and the lowest foreclosure rate of any specific geographic concentration tracked by AHFC.

The Ketchikan real estate market was not hit badly by the economic downturn, at least when compared with Anchorage, Fairbanks, and Juneau. Overbuilding was largely prevented by unavailability of land and difficult terrain, and builders tended to bypass Ketchikan in 1983-4 for the greener pastures of Anchorage and Mat-Su Valley. As a result, the "overhang" of properties when demand slackened was not great. Also, Ketchikan lost only about 1 percent of its population in the downturn (as opposed to about 15 percent in Anchorage), limiting the damage.

It must also be noted that the real estate market in Ketchikan (as in Sitka, which follows) is driven not so much by financing considerations as by relatively small changes in population or jobs. A new enterprise employing twenty people may cause a considerable change in vacancies and prices in these markets, while a similar occurrence in Anchorage would have little or no effect on the market.

While exact numbers are not available, industry sources state that housing prices are already slightly above their peak levels of 1985, and that appreciation of good properties is currently about 1/2 percent per month. Rentals are difficult to obtain. Lot sales, which had been extremely depressed, are now beginning to pick up, and new rental housing is expected to come on the market as a result.

The market is predominantly single family detached housing. Some condominiums exist; perhaps 100 units are "real" condominiums, while there are about 200 additional units converted from apartments which are of lower quality and not generally susceptible to FHA or AHFC financing. Less than 10 percent of property sales are condominiums.

Activity levels in the market have been as shown in Table 14:

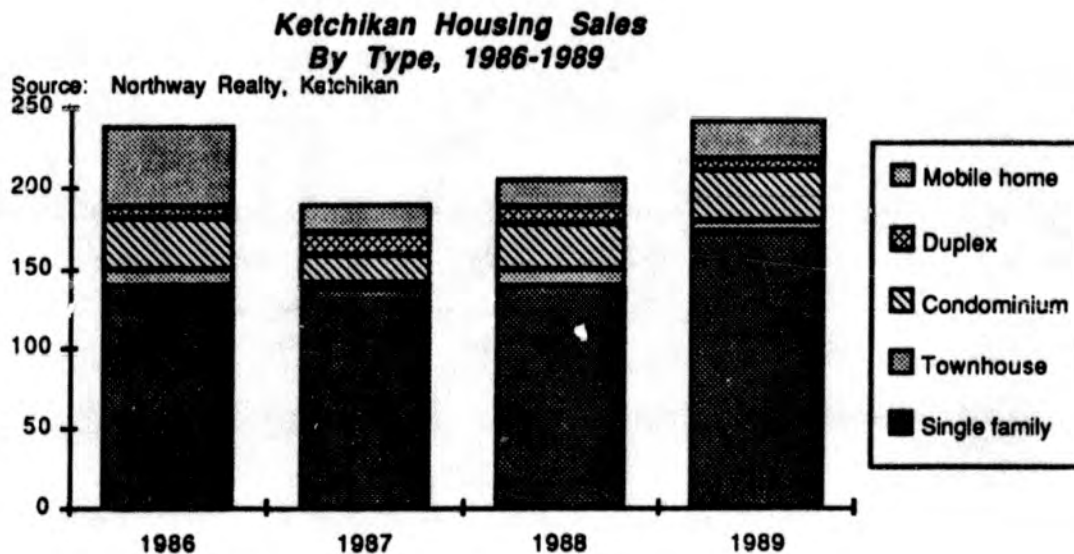
Table 14
Annual Housing Sales in Ketchikan

Year	Annual Sales
1984	250 (1)
1985	225 (1)
1986	236 (2)
1987	188 (2)
1988	204 (2)
1989	241 (2)

Notes: (1) Industry estimates.

(2) Figures per Northway Realty, Ketchikan.

Distribution of sales by housing type over the past four years is shown in the graph following:



Industry sources estimate that historical movement in prices, based on a hypothetical 3-bedroom house in two neighborhoods, is presented in Table 15, as follows:

Table 15
Price Movements in Ketchikan

Year	"Desirable" Area	"Less Desirable" Area
1985	\$100,000	\$100,000
1986	98,000	90,000
1987	98,000	90,000
1988	100,000	96,000
1989	110,000	105,000

The same sources estimate the stratification of the market as shown in Table 16, as follows:

Table 16
Price Stratification of Housing Sales in Ketchikan

Price Range	Percent of Sales
Under \$86,850	45%
Under \$135,000	90%
Over \$235,000	0%

H. SITKA REAL ESTATE MARKET

The Sitka market represents one of the smallest geographic concentrations of AHFC activity, making up 1.57 percent of AHFC's total portfolio. It has the lowest delinquency rate of AHFC concentrations, and the second lowest foreclosure rate.

Unlike many other areas in Alaska, Sitka maintained a stable real estate market through the last half of the 1980's. It had experienced an earlier downturn, however. Industry sources estimate that a home which would have cost \$180,000 in 1982 had declined in value to about \$150,000 by 1985. Home prices remained stable at 1985 levels through 1988, and have increased in value approximately 6 percent during 1989.

This recent increase in prices is laid to lack of available stock on the market. Of Sitka's approximately 2,000 housing units, 160 were on the market in Spring 1988; by Fall on 1989, only about 60 were available for sale. Current sales rates are estimated at 35-50 properties per year, with little change from 1988.

The lack of available stock is affecting lot sales in anticipation of new construction. Land values have been increasing at 3-4 percent per year for the past three years, and 6-12,000 square foot lots now sell for between \$35,000 and \$50,000.

One problem with the Sitka market is quality of housing. Many units were built in a haphazard fashion and some are now showing foundation and other defects which preclude them from FHA-insured financing. Since private mortgage insurance is largely unavailable in Sitka (and elsewhere in Alaska), FHA/AHFC financing is the preferred and often the only financing method for buyers unable to make a down payment of at least 20 percent. As a result, these units are difficult to finance, limiting sales.

Industry sources estimate stratification of the housing market as depicted in Table 17, as follows:

Table 17
Price Stratification of Housing Sales in Sitka

Price Range	Percent of Sales
Under \$86,850	10%
Under \$135,000	65%
Over \$235,000	1%

The lack of units under the tax-exempt limit is laid to the predominance of detached homes in the area and the scarcity of condominium units. If mobile homes were included in this category, approximately 15 percent of demand would be under the tax-exempt limit.

APPENDIX D

**EVALUATION OF HOUSING
ASSISTANCE FUND
MORTGAGE LOAN PURCHASE
BY AHFC**

Ernst & Young

APPENDIX D
EVALUATION OF HOUSING ASSISTANCE FUND
MORTGAGE LOAN PURCHASE BY AHFC

Legislation was introduced in 1989 (Senate Bill 245) which would require the AHFC to purchase at par value home mortgage loans from the Housing Assistance Division (HAD). These loans are primarily for homes in rural Alaska, and have interest rates which are set by law at one percent less than AHFC rates. The Housing Finance Task Force requested an evaluation of this proposal, including its impact on AHFC loan programs, and whether the purchase should be at par value or market value.

Our analysis and conclusions regarding the SB 245 proposal is presented in the following subsections:

- *Description of HAD Purchase Proposal*
- *Impact on AHFC of Purchasing HAD Loans*
- *Conclusions Concerning Purchase of HAD Loans.*

A. DESCRIPTION OF HAD PURCHASE PROPOSAL

Senate Bill 245 was introduced by the Senate Finance Committee in 1989, and would require the AHFC to purchase at par value (i.e., the outstanding principal balance) at least \$80 million of mortgage loans from the Housing Assistance Loan Fund. The bill did not set a ceiling on the dollar amount or number of loans to be purchased.

The loans in question are primarily for homes in rural areas of the State, and were financed by State funds appropriated to the Housing Assistance Division (HAD) of the Department of Community and Regional Affairs (DCRA). None of the loans are insured. The loans were originated by HAD and are serviced by various financial institutions.

There were 1,566 HAD loans as of September 30, 1989, with a principal balance owing of \$154.5 million. In fiscal year 1988/89, HAD originated 167 new loans. For the three months ending September 30, 1989, only two new loans were made by HAD.

All loans made by HAD are State funded. Total appropriations by the State for the HAD loan program have been \$191.5 million since fiscal year 1980/81, the year HAD was created by the Legislature. Because all the loans are funded by the State it is difficult to determine if the HAD loan program has broke even. The financial statements prepared for the program do not include the opportunity costs, or the imputed interest costs, of the State funds. This is different from AHFC practices which impute a cost of funds for all bond proceeds and State funds used to purchase loans.

B. IMPACT ON AHFC OF PURCHASING HAD LOANS

The proposal is effectively a removal of assets from AHFC because it allows the State to take monies from AHFC. The loans would be transferred from DCRA to AHFC in return for cash (equal to the purchase price) given from AHFC to DCRA. The State could then have the option of appropriating the monies from DCRA.

Such an extraction of Corporation assets could affect AHFC's ability to raise new capital and keep existing loan programs functioning. The AHFC raises capital through "general obligation" bond sales, with the bonds backed by the financial strength of the Corporation. Because of this "general obligation" of AHFC behind each bond, the bonds receive the highest credit rating and a lower interest rate. An extraction of assets such as proposed would damage AHFC's financial health, weaken the security for existing bonds, and raise concerns about the vulnerability of AHFC to future withdrawals. This kind of environment will make investors uneasy and cause concern for the rating agencies, both of which could translate to higher interest costs and difficulty in maintaining existing AHFC loan programs.

The financial impact on AHFC would be greatest if the loans were purchased at the face amount of the outstanding principal owed (par value). The current par value of the loans is estimated by DCRA to be \$154 million. The market value of the properties securing many of the loans may be less than the loan balance, according to DCRA, especially in light of recent declines in real estate prices statewide. In its own internal analysis of the potential purchase, AHFC estimated that the HAD portfolio of loans is worth 76 percent of the principal balance of the loans.

Senate Bill 245 does not consider market value, but would require AHFC to purchase at least \$80 million in HAD loans, regardless of the actual, or market value of the loans. This would mean an additional premium paid to the State by AHFC. The rural home owners would not receive any financial benefit from the proposed purchase.

These loans are uninsured which means AHFC would be 100 percent at risk for any delinquent payments, interest lost from late payments, and, if the property were foreclosed on, the loss in value of the property. In addition, there would be attorney fees,

taxes, insurance, and other holding costs for any foreclosed property, all of which would have to be paid by AHFC if it owned the loans. This again would only weaken further the current financial position of AHFC and damage its ability to raise additional capital at a reasonable cost.

Earlier, in Section III of this report, we presented estimates of net unrestricted assets of the Corporation. Given that AHFC may only have \$10 million of liquid assets which are not restricted by existing bond covenants or short-term borrowing agreements, there are not sufficient funds to purchase the HAD loans, unless AHFC issues new debt.

If the purchase of HAD loans is funded through the sale of bonds by AHFC, the net effect on AHFC assets would be less, although not necessarily zero. Proceeds from a bond sale could be used to purchase the loans, and the loans could be used as collateral for the bonds. This was done in fiscal year 1986/87 when AHFC made a similar purchase, at par value, of \$70 million in HAD loans, financing this purchase with the sale of floating and fixed rate bonds.¹ If the cash flow from the loans, net of servicing fees, is sufficient to repay the bonds,² then the impact on AHFC assets could be minimal. If delinquencies and foreclosures occurred, or if the interest received from the loans was less than the interest costs of the bonds, then any shortfall in funds available for debt service would have to be provided by the Corporation.

The financing bond covenants for the first purchase of \$70 million in HAD loans required that AHFC replace any delinquent loan used as security for the bonds with a "good" loan from AHFC's own portfolio (i.e., a loan which is not delinquent). Approximately 80 of the original HAD loans have gone into delinquency, and AHFC has had to replace approximately \$4 million in delinquent HAD loans with \$4 million in non-delinquent AHFC loans.

¹ All of the HAD loans purchased by AHFC were loans for homes in urban areas, and are still owned and managed by AHFC.

² The annual cash flow from the loans may or may not exactly match the required annual debt service payments on the bonds issued. However, total loan cash flows, prepayments, and reinvestment income over the life of the loans, when discounted back to today's dollars, could theoretically equal the present value of all payments on the debt issued to purchase the loans.

It is unclear at this time how the cash flow from the HAD loans can be used if purchased by AHFC. In 1988, the Legislature passed, and the Governor signed into law, House Bill 555 which contained the following provision:

"(10) Purchase loans from the Housing Assistance Loan Fund (AS 44.47.380) if and only if:

- (A) the payments of principal and interest on the loans are deposited in a separate fund of the Corporation to be used for the purposes, and subject to the standards and criteria, of AS 44.47.360 -- 44.47.560 as those statutes provided on June 10, 1988; and
- (B) the Corporation has established a source of mortgage insurance for new loans subject to the provisions of AS 44.47.360 -- 44.47.560."

It appears that the cash flow from the HAD loans can only be used to make more HAD-type loans. It cannot be used to repay bonds, to collateralize new bonds, to make new AHFC loans, or for any other activities of AHFC. Under our interpretation of HB 555, the cash flow from the HAD loans is restricted to making only loans and the loans made must meet HAD criteria.

A final point should be made regarding servicing the loans. The DCRA is organized to service home buyers in rural Alaska, with satellite offices in seven locations. The DCRA makes money available to home buyers which might not otherwise be able to obtain financing. The DCRA has less stringent requirements for its loans than does AHFC. The DCRA does not require mortgage insurance on loans, nor is approval required by the Department of Environmental Conservation, both of which are required for AHFC loans. Also, the interest rate provided by DCRA is one percent below AHFC interest rates. In order for AHFC to provide the same level of service, significant changes would need to be made to AHFC operations and underwriting criteria, which could impact AHFC high credit rating and ability to raise money to continue its loan programs.

C. CONCLUSIONS CONCERNING PURCHASE OF HAD LOANS

Because of concerns identified previously regarding the potential purchase, we conclude that AHFC should not be required to purchase the HAD loans. Such a transaction could weaken AHFC's ability to continue its loan programs because the direct extraction of assets from the Corporation would make it difficult for AHFC to raise funds for its existing bond-financed programs. In addition, existing State law may limit or prevent the use of the loans for current AHFC activities. Existing law should be clarified and possibly amended if the purchase of HAD loans by AHFC were actually made. Finally, a purchase by AHFC of HAD loans would diminish the attention rural Alaskan homebuyers now receive from the Department of Regional and Community Affairs. Even if AHFC were to purchase only the urban HAD loans (as was done in the first, \$70 million purchase two years ago), there may not be enough urban loans in the HAD portfolio to meet the \$80 million minimum established by SB 245.

If SB 245 were signed into law, and AHFC were to purchase HAD loans, it would make more sense to purchase all HAD loans, and not try to split the portfolio into HAD administered loans and AHFC administered loans. Splitting the portfolio would weaken the attention rural Alaskans now have, duplicate State services, and create inefficiencies. If the purchase were made, all the loans should be purchased.

If all the loans were purchased, the price paid should be based on the market value of the properties and not the par value (or unpaid principal balance) of the loans. The market value is the only fair price for the loans and should reflect delinquencies, potential foreclosures, and net realizable value from the sale of the property.

Determination of market value can be performed by a number of underwriters, mortgage bankers, or independent consulting firms, some of whom AHFC already uses for structuring bond sales. Generally, these firms require a magnetic tape containing the history, type, and performance of every loan in question. Although the methodologies used by each firm may differ, the actual purchase price can be determined based on factors such as prepayment characteristics, interest rates, loan-to-value ratios, delinquency rates, foreclosures, and net losses on loans which default. These firms also can evaluate the quality of the original loan origination and underwriting, and the ability of the loan

servicers to collect payments and pursue foreclosures. Finally, interest rates at the time of the purchase are considered in establishing an appropriate discount or premium on an individual group (pool) of loans with similar fixed interest rates.

APPENDIX E

**LEGAL REVIEW BY DELANEY,
WILES, HAYES, REITMAN
& BRUBAKER, INC.**

Ernst & Young

DELANEY, WILES, HAYES, REITMAN & BRUBAKER, INC.

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January 11, 1990

James A. Gibson
Project Director
Ernst & Young

Dear Mr. Gibson:

You have requested our opinion as to certain matters pertaining to your consulting contract with the Alaska Housing Finance Corporation ("AHFC").

In responding to your queries, we have performed extensive legal research including a thorough review of relevant provisions of the United States and Alaska Constitutions, provisions of the Alaska Statutes, together with numerous cases interpreting such constitutions and statutes, other judicial authorities and commentaries. We find that most of the issues raised in your queries have not been ruled upon by either the Alaska Supreme Court or other courts of last resort.

We have endeavored to provide you with our best legal analysis of the issues presented by your queries and with our view of the likely outcome if the issues were presented to the Alaska Supreme Court.

The attached format follows the organization of the queries which you presented.

STATEMENT OF QUERIES PRESENTED

I. GENERAL

1. Define AHFC. Is it unique from other Alaska state agencies (e.g., Alaska Railroad Corporation)? Is AHFC different from a private corporation?
2. Under the existing statutes, does AHFC have the power and authority to issue revenue bonds as to a specifically identified group of mortgages?

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3. Are there any legal constraints to establishing a new agency to implement only the original legislative intent programs of AHFC?
4. Can the legislature by appropriate legislative enactment exempt AHFC from the provisions of the Executive Budget Act?
5.
 - (a) Can the legislature by appropriate legislative enactment terminate the AHFC taxable bond program?
 - (b) Can the legislature by appropriate legislative enactment terminate the AHFC tax-exempt bond program?
 - (c) Can the legislature by appropriate legislative enactment terminate the tax-exempt veterans mortgage bond program?
6. Can specific AHFC programs be removed from AHFC and incorporated into a new entity?
7. What legal constraints are there to modifying the public corporation status of AHFC so that it functions like a private corporation, but still is a state organization?

II. TRANSFER OF ASSETS

1. Can the state legally expropriate funds from AHFC?
2. Does AHFC have any legal responsibility to provide a return on capital to the state?
3. Can the legislature direct AHFC to purchase specific assets?
4.
 - (a) Will an extraction of any, but not substantially all, unrestricted or unpledged assets from AHFC by the state give rise to a valid claim by bondholders against the state?
 - (b) Will an extraction of any, but not substantially all, restricted or pledged assets from AHFC by the state give rise to a valid claim by bondholders against the state?

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- (c) Will an extraction of substantially all the assets from AHFC by the state give rise to a valid claim by bondholders against the state?
- 5. Are there any legal grounds for AHFC to compel the state to appropriate or transfer funds to AHFC?
- 6. If AHFC, pursuant to legislative enactment, purchases loans from the HAD program, is the application of payments of principal and interest received on such loans restricted to making future HAD loans?

III. SUBSIDY

- 1. If the interest reduction subsidy is legislatively eliminated as of June 30, 1990, can the proceeds of bonds sold prior to this date be used to finance loans under the new legislation?
- 2. Can AHFC change the eligibility requirements for loans made from bond proceeds, if the bonds are already sold?
- 3. Are there legal constraints to discontinuing or diminishing the interest rate subsidy by appropriate legislative enactment?
- 4. What legally needs to be done to implement a change in the interest rate subsidy?
- 5. Is AHFC an unlawful monopoly in restraint of trade because of its market position?

IV. CHANGE OF OWNERSHIP

- 1. Are there any legal constraints to:
 - (a) AHFC issuing and selling common stock in AHFC, thereby transferring 100% of ownership and control of AHFC to a private party?
 - (b) AHFC selling all assets?
 - (c) AHFC selling its REO disposition operation to a private party?
 - (d) AHFC selling loans within a bond program, i.e., where loans have been pledged as collateral?

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- (e) AHFC selling a loan not used as collateral for a specific loan program?
- 2. Are there legal constraints to AHFC entering into a partnership?

ANALYSIS

I. GENERAL

- 1. Define AHFC. Is it unique from other Alaska state agencies (e.g., Alaska Railroad Corporation)? Is AHFC different from a private corporation?

AHFC is a public corporation created pursuant to statute as opposed to a private corporation which is created by the issuance of a certificate of incorporation by the State of Alaska upon the filing of articles of incorporation. AHFC has neither articles of incorporation nor a certificate of incorporation.

AHFC is a separate legal entity; however, this separate legal existence serves only to accommodate a centralized business-type of corporate management and the isolation of certain state activities within a functioning unit. The essential test to determine whether an entity such as AHFC is a state agency is the financial nexus between the entity and the State of Alaska and the actual control or lack of control of the entity by the State of Alaska. Various factors are applied in determining the actuality of financial nexus or dependency and control. "An administrative agency may be called a commission, board, authority, bureau, office, officer, administrator, department, corporation, administration, division or agency. Nothing of substance hinges in the choice of name. . . ." Alaska State Housing Authority v. Dixon, 496 P.2d 649, 651 (Alaska 1972) quoting 1 K. Davis, Administrative Law, § 1.01, at 1 (1958) (emphasis added). The Alaska Supreme Court has expressly stated that independent corporate status does not prevent a finding of state agency. Alaska Commercial Fishing & Agriculture Bank v. O/S Alaska Coast, 715 P.2d 707, 711 (Alaska 1986). Rather, the court considers a state agency's separate corporate status as a neutral factor. Id. at 710.

While the Alaska Supreme Court has repeatedly stated that a determination of whether an entity is a state agency depends on the

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particular facts and circumstances presented and the purpose of the inquiry, certain factors have been consistently applied by the Alaska Supreme Court in determining status. These factors, referred to as the "DeArmond factors", balance an entity's authority against the state's retained control. The factors considered include: (a) whether the creation and funding of the agency fulfilled a public purpose, (b) whether the statute expressly locates the agency within a department, (c) the submission of annual reports to the state, (d) certified copies of minutes sent to the governor, (e) appointment by the governor of at least some of the board of directors, (f) financial contributions by the legislature to the annual budget, and (g) any additional controls retained by the state. Alaska Commercial Fishing & Agriculture Bank ["CFAB"], supra at 709-712 citing DeArmond v. Alaska State Development Corp., 376 P.2d 717 (Alaska 1962), Walker v. Alaska State Mortgage Ass'n, 416 P.2d 245 (Alaska 1966), Alaska State Housing Authority v. Dixon, supra, Alaska State Operated School System v. Mueller, 536 P.2d 99 (Alaska 1975).

AHFC has characteristics similar to other public corporations which have previously been determined to be "state agencies" in other contexts in the aforementioned cases. See also University of Alaska v. National Aircraft Leasing, Ltd., 536 P.2d 121 (Alaska 1975).

In addition to state controls over AHFC, constitutional concerns also weigh in favor of the status of AHFC as an agency rather than an entity with complete autonomy from the state. The Alaska Constitution requires substantial ties between a public corporation and the executive branch. The Alaska Constitution provides that all executive and administrative functions shall be placed within not more than 20 principal departments and that each department shall be under the supervision of the governor. Alaska Const., article III, sections 22 and 24. If AHFC is regarded as an entity with complete autonomy entirely independent from the State of Alaska, as opposed to an agency, a constitutional challenge would foreseeably be mounted against the statute creating AHFC on the basis that it attempts to create an overly independent agency in violation of article III, sections 22 and 24, of the Alaska Constitution. Article III, section 22 states:

All executive and administrative offices, departments, and agencies of the state government and their respective functions, powers, and duties shall be allocated by law among and within not more than twenty principal departments, so as to group them as far as practicable according to major purposes. Regulatory, quasi-judicial, and temporary agencies may be established by

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law and need not be allocated within a principal department.

Article III, section 24 states:

Each principal department shall be under the supervision of the governor.

Pursuant to statute, AHFC is expressly located within the Department of Revenue. AS 18.56.020. Executive controls over AHFC are present which were also found to exist in the above-referenced cases. The express classification of AHFC within the Department of Revenue weighs in favor of a determination that AHFC is an instrumentality or agency of the state as opposed to being an entity which is "independent" of the state. Further, AHFC does not appear to fall within one of the three exceptions to the constitutional requirement that all agencies of the state be allocated within twenty principal departments. See Walker, supra, at 249, n. 11, wherein the Alaska Supreme Court affirmed the determination that Alaska State Mortgage Association (ASMA) was not an agency independent of the state and that ASMA was not a regulatory, quasi-judicial, or temporary agency of the state within the exceptions provided under article III, section 22 of the Alaska Constitution.

AHFC is unique from other state agencies in the sense that it is performing unique public purposes in the provision of housing to residents of the state through mortgage loan subsidies.

AHFC is significantly different from a private corporation in that:

- (a) A private corporation has shareholders, AHFC has no issued or outstanding stock. However, the courts generally state that the "interests" in public corporations are held by the state. The term "interests" being used in place of references to the rights of shareholders.
- (b) The board of directors of a private corporation are elected by the shareholders. The board of directors of AHFC consist of five members who all are, in effect, appointed by the governor.
- (c) The board of directors of a private corporation generally have a duty to apply the assets and funds of the corporation with a view towards earning a profit and providing a return to the shareholders. The board of

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directors of AHFC, on the other hand, has a duty to apply the funds and assets of AHFC in fulfillment of the public purposes for which the entity was created and to specific programs adopted by legislative enactment.

AHFC would seem to be different from the Alaska Railroad. While the Alaska Railroad is also a public corporation, its purpose is generally to provide a reliable, safe and efficient means of transportation throughout the railbelt, and also to be self-sustaining (AS 42.40.100) and presumably generate a profit if possible.

2. Under existing statutes, does AHFC have the power and authority to issue revenue bonds as to a specifically identified group of mortgages?

It would seem that under the presently existing statutes AHFC does have the authority to issue limited purpose obligations in the form of revenue bonds as to a specifically identified group of mortgages.

Alaska Statute 18.56.110(f) provides that AHFC has the power to pledge to any payment or purpose all or any part of its revenues to which its right then exists or may thereafter come into existence. Under such provision AHFC could determine to pledge the revenues from a specifically identified group of mortgages as a source of payment of limited purpose obligations or "revenue bonds".

We have considered AS 18.56.110(b) which provides:

The principal and interest on these bonds or notes, except state guaranteed bonds, is payable from corporation funds, excluding funds in the housing development fund. (emphasis added);

and AS 18.56.170 which provides:

Obligations issued under the provisions of this chapter other than state guaranteed obligations do not constitute a debt, liability or obligation of the state or of any political subdivision of the state or a pledge of the faith and credit of the state or of a political subdivision but are payable solely from the revenue or assets of the corporation. (Emphasis added.)

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It would seem that the provisions of AS 18.56.170 and 18.56.110(b) are provisions of liability limitation in the sense that they seek to limit the recourse of bondholders to AHFC funds, revenues, or assets as opposed to limiting the power of AHFC to issue limited purpose obligations which appears to be generally granted in the statute.

As a practical matter, we would recommend specific enabling legislation as to limited purpose obligations to remove any doubt as to the authority to issue such bonds and enhance the marketability of such bonds.

It appears that revenue bond funds are not subject to expropriation and are therefore an exception to the constitutional prohibition against dedicated funds.

3. Are there any legal constraints to establishing a new agency to implement only the original legislative intent programs of AHFC?

Focusing only on the transfer of "original legislative intent programs" presently administered by AHFC to a new agency, we find no constitutional impediments under either the United States or the Alaska Constitutions. By appropriate legislative enactment a new state agency could be created and the implementation and administration of the "original legislative intent programs" could be transferred to such agency. AHFC, being a state agency (see discussion under I.1 above), could not itself create such a new state agency and transfer to it the "original legislative intent programs". While a private corporation might create a subsidiary corporation and spin-off a division or branch into such a new corporate entity, such action is not within the power or authority of AHFC because while it is a public corporation it remains a state agency.

It would also seem that the governor would have the power by executive order to create a new state agency to implement the "original legislative intent programs" of AHFC. However, because AHFC was originally charged with the implementation and administration of such programs by legislative enactment, such changes would "require the force of law" and pursuant to article III, section 23, of the Alaska Constitution be subject to legislative approval. The case of Suber v. Alaska State Bond Committee, 414 P.2d 546 (Alaska 1966) would seem to so indicate.

The rights of bondholders must also be considered in regard to such restructuring. While legislative enactment would effect