ALASKA STATE LEGISLATURE
LEGISLATIVE BUDGET AND AUDIT COMMITTEE
Division of Legislative Audit

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SUMMARY OF: A Special Report on the Department of Community and Economic Development, Division of Investments, Commercial Fishing Revolving Loan Fund, March 18, 2003.

PURPOSE OF THE REPORT

In accordance with Title 24 of the Alaska Statutes and a special request by the Legislative Budget and Audit Committee, we conducted a performance and financial audit of the Commercial Fishing Revolving Loan Fund (CFRLF). Our specific objectives were to:

- Perform an audit of the fund's financial statements
- Evaluate administration of the loan fund and related loan program for compliance with Alaska Statutes and regulations.
- Ascertain the effect that Division of Investments (DOI) lending and collecting practices have on the financial position of the loan fund.
- Determine whether DOI is competing with private or public lenders when making commercial fishing loans and whether such competition is in accordance with the purpose of the program.

REPORT CONCLUSIONS

We have audited the FY 02 financial statements of CFRLF and concluded that, in our opinion, the statements were free of material misstatement. The statements, notes, and the accompanying auditor opinions are included in this report.

Generally, we concluded the financial position of the CFRLF has declined due to its loan concentration in the troubled salmon fishing industry. In spite of the large number of borrowers that are not making their CFRLF principal and interest payments, the CFRLF continues to receive more cash than it loans to fishermen resulting in positive cash flow into the fund.

DOI is charged with accomplishing two competing and sometimes opposing public policy goals: managing the state's financial investment in the commercial fishery and assisting Alaska residents that do not qualify for alternate financing to enter or remain in the fishery. DOI has acted within its legal authority when responding to the salmon disasters, however, in the long-term their actions may not meet the intent of the program. DOI's temporary policies are at risk of becoming standards of operation to the detriment of the fund's financial position. DOI's actions have far-reaching, economic implications that warrant input and direction from both the legislature and the governor.

In general, we found DOI administers the commercial fishing loan program in compliance with statutes and regulations. However, we have noted instances where loan practices could be improved. We have also noted that DOI collection practices are limited by the agency's failure to report CFRLF debt-to-credit reporting agencies. Further, due to its loan practices, the state has become the preferred lender for most types of commercial fishing loans.

CFRLF lending patterns have changed significantly over the past 11 years. Quota share loans and refinancing vessel loans, originally financed with other financial institutions, have become increasingly important while the demand for permit loans has substantially decreased. Refinancing of other lenders' vessel loans has increased the default risk borne by the state.

The value of limited entry permits, which serve as the primary collateral of the CFRLF, has declined significantly. The decrease in value has several implications. In the event of a default, DOI's ability to mitigate losses declines, collection efforts are hampered, and DOI's inventory of repossessed permits will grow significantly. This may lead to the further devaluation of permits as DOI repossessed permits are "promptly" put up for sale as required by statute.

To help limit the State's exposure to loss due to default, DOI has accepted the assignment of Exxon Valdez Oil Spill (EVOS) settlements. In the event EVOS settlements are approved by the courts, DOI is slated to receive $8.3 million to be applied to CFRLF borrowers' indebtedness.

FINDINGS AND RECOMMENDATIONS

1. We recommend the commissioner of the Department of Community and Economic Development coordinate with the governor's office to ensure that the CFRLF policy's and regulations remain consistent with overall public policy goals.
2. We recommend the director of DOI reevaluate the benefits provided by the pay-on-time program in light of the substantial administrative inefficiencies of the program.
3. We recommend the director of DOI takes steps necessary to ensure EVOS assignments are not accepted when alternative collateral is available.
4. The director of DOI should change its current policy to ensure EVOS settlements are applied to interest first.
5. We recommend the director of DOI coordinate with other state agencies when replacing the current loan subsystem.
6. The director of DOI should change several loan serving policies to improve administration of the program.
7. The director of DOI should ensure that the availability of other financing is thoroughly documented and considered during the loan application process.

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In general, we found DOI administers the commercial fishing loan program in compliance with statutes and regulations. However, we have noted instances where loan practices could be improved. We have also noted that DOI collection practices are limited by the agency's failure to report CFRLF debt-to-credit reporting agencies. Further, due to its loan practices, the state has become the preferred lender for most types of commercial fishing loans.

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March 25, 2003

Members of the Legislative Budget
and Audit Committee:

In accordance with the provisions of Title 24 of the Alaska Statutes, the attached report is submitted for your review.

DEPARTMENT OF COMMUNITY AND
ECONOMIC DEVELOPMENT
DIVISION OF INVESTMENTS
COMMERCIAL FISHING REVOLVING LOAN FUND

March 18, 2003

Audit Control Number

08-30022-03

The objectives of this audit were to (1) conduct a financial audit of the loan fund's financial statements, (2) evaluate administration of the fund for compliance with state law, (3) ascertain the effect of state loan policies and practices of the financial position of the fund, and (4) determine whether the state is competing with private or other public lenders when making commercial fishing loans and whether such competition is in line with the purpose of the loan program.

The audit was conducted in accordance with generally accepted government auditing standards. Fieldwork procedures utilized in the course of developing the findings and discussion presented in this report are discussed in the Objectives, Scope, and Methodology section.

Pat Davidson, CPA
Legislative Auditor

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OBJECTIVES, SCOPE, AND METHODOLOGY

In accordance with Title 24 of the Alaska Statutes and a special request by the Legislative Budget and Audit Committee, we conducted an audit of the Commercial Fishing Revolving Loan Fund (CFRLF) administered by the Division of Investments (DOI), Department of Community and Economic Development (DCED).

Objectives

The specific objectives of the audit were to:

- Perform an audit of the CFRLF financial statements

- Evaluate administration of the loan fund and related loan program for compliance with Alaska statutes and regulations.

- Ascertain the effect that DOI lending and collecting practices have had on the financial position of the loan fund.

- Determine whether DOI is competing with private or public lenders when making commercial fishing loans and whether such competition is in accordance with the purpose of the program.

Scope

We obtained an understanding of CFRLF since the program's creation in FY 73, and focused our performance review on the six-year period FY 97 through FY 02. We performed a financial audit for the fiscal year ended June 30, 2002.

Methodology

Our evaluation of CFRLF involved reviewing, analyzing, and/or testing the following:

- Financial documentation supporting CFRLF financial activity

- CFRLF financial data regarding loan delinquencies, modifications, and deferred interest accounts

- State statutes, regulations, and policies and procedures including subsequent changes as they relate to both CFRLF and CFAB

- DCED reading files pertaining to CFRLF

- DOI's contract with outreach contractor Alaska Business Development Center (ABDC)

- CFRLF loan files

- Attorney General's opinions and memorandums of advice as they relate to CFRLF and the Commercial Fishing and Agriculture Bank (CFAB).

- Commercial Fisheries Limited Entry Commission (CFEC) permit information

- CFRLF financial statements for FYs 90 through 01

Additionally, we interviewed the following individuals:

- CFRLF management, collection, lending, and litigation staff

- DCED's Chief Bank Examiner

- CFAB's president and senior vice president

- ABDC's president and staff member

- Attorney General's staff member

- Fishery economist with the Institute of Social and Economic Research

- DCED's fishery economist

- CFEC management staff

- National Marine Fisheries Service staff member in charge of the individual fishing quota loan program

ORGANIZATION AND FUNCTION

The Department of Community and Economic Development

Under the provisions of Title 44 of the Alaska Statutes, the Department of Community and Economic Development (DCED) provides a wide range of services to private businesses and aids in protecting the public by regulating certain industries. Development services provide general assistance and access to capital markets for businesses, coordinate numerous state loan programs, and manage programs aimed at key economic sectors such as electric power generation, tourism, aerospace, mining, and fishing.

Division of Investments

The Division of Investments (DOI) is organizationally located within DCED. DOI's mission is to promote economic development through direct state lending within those industries that are not adequately serviced by the private sector; and provide interagency and interdepartmental loan servicing of other loan portfolios.

Currently, DOI administers four active loan programs: Commercial Fishing, Fisheries Enhancement, Small Business Economic Development, and the Rural Development Initiative Fund Loan Program. These programs provide financing in industries and areas for which loans are not readily available from the private sector. The Division also services loans for nine inactive loan programs, as well as another six portfolios for the Alaska Industrial Development and Export Authority, the Departments of Health and Social Services, Environmental Conservation, and Military and Veterans Affairs.

Commercial Fishing Revolving Loan Fund (CFRLF)

CFRLF has been in existence since 1973. The statutory purpose of the program is to help Alaska residents enter or remain in commercial fisheries through long-term, low-interest loans. The loan fund is administered by DOI.

The fund makes loans for the purchase of limited entry permits, vessels, gear, and individual fishing quotas. The loan fund may also make loans to pay IRS obligations, improve quality, and to refinance vessels originally financed through other institutions.

Alaska Commercial Fishing and Agriculture Bank (CFAB)

CFAB was established in 1978 by the enactment of AS 44.8. CFAB is a cooperative bank. Borrowers, as members of the cooperative bank, must purchase one share of Class A stock that has a par value of $10. In addition, borrowers must purchase shares of Class B stock with a $100 par value in an amount equal to 5% of the loan amount. The purchase costs of the Class B stock may be included in the loan amount.

CFAB makes loans for most fishing or farming related purposes. The most common purposes are the purchase, modification, or refinancing of a vessel; purchase of a limited entry fishing permit; gear, engine, or equipment replacement or upgrade; general operating capital; and fish processing. An individual applicant must be an Alaska resident, and a partnership must have majority ownership by Alaska residents. When the applicant is a corporation, the majority ownership and control must rest with Alaska residents.

BACKGROUND INFORMATION

Alaska's commercial fishing industry

Many people consider the right to harvest fish a basic human right and an important way of life. Alaska's commercial fisheries are vital to Alaska's economy. Each year the industry provides thousands of jobs and hundreds of millions of dollars to the state's economy. Alaska's fishing industry leads the state in providing 47% of private sector jobs and is second only to the oil industry in providing revenue to the state's economy.[1] The ex-vessel value for commercial fish and shellfish exceeds $1 billion annually. Various species are harvested including: salmon, shellfish, herring, and groundfish/halibut.

Harvesting of commercial fish is managed by the state through a limited entry permit system. The total number of available permits for each fishery is strictly limited. Generally, fishermen may not own more than one permit for the same fishery (defined by species, gear type and area). Last year, Alaska Statute 16.43.140(c)(5) was changed to allow a permit holder to buy a second permit in the same fishery solely for the purpose of fleet consolidation (and not to fish the second permit). This creates a fishery made up of many individuals and families who have a direct personal stake in conservation, upon which the industry depends.

Historically, no fishery has been more important than Alaska's commercial salmon fishery. Five species of salmon are found and harvested in Alaska waters: king, sockeye, coho, chum, and pink. According to the State's Department of Fish and Game, the majority of these salmon are harvested in coastal waters between June 1st and September 15th. Three main gear types catch Alaska salmon: trolling, gillnetting, and purse seining. Recent averages indicate the number of salmon harvested is 71% by purse seiners, 27% by gillnetters, and 2% by trollers. All commercial salmon fishing boats are relatively small vessels; averaging 30 to 50 feet.

Creation and evolution of the Commercial Fishing Revolving Loan Fund (CFRLF)

In the early 1970s, the legislature identified a need to provide Alaska residents additional financing opportunities for the purchase and/or maintenance of commercial fishing vessels. CFRLF was created in 1973 for this purpose. In 1978, the statutes were amended to allow CFRLF to make and foreclose on limited entry permit loans. The intent of this amendment was to place more limited entry permits in the hands of Alaskans.

The mission of CFRLF as stated in Alaska Statute 16.10.300 is as follows:

> *It is the policy of the state, under AS 16.10.300 – 16.10.370, to promote the rehabilitation of the state's fisheries, the developing of a predominantly*

[1] This information was obtained from the Department of Fish and Game web site, and data is for calendar year 2000.

resident fishery, and the continued maintenance of commercial fishing gear and vessels through out the state by means of long-term low interest loans.

CFRLF was capitalized with just over $60 million dollars from FY 73 through FY 86. Since the fund was created, $27.8 million has been appropriated out of CFRLF into the general fund. Additionally, $19.6 million has been appropriated from CFRLF to fund various projects. (See Appendix C)

In FY 95, the use of the fund was significantly expanded. Until that point, CFRLF was mainly utilized for the financing of limited entry permits and the purchase and/or maintenance of vessels and gear. In FY 95, statutes were changed to allow CFRLF to finance the purchase of individual fishing quota shares. A temporary lending program was authorized which allowed CFRLF to make loans up to $30,000 for payment of IRS obligations.[2] Further, statutes were changed to allow the fund to refinance vessel loans originally financed by private or other public lending institutions. In FY 98, the purpose of the fund was again expanded to allow quality improvement loans.

Eligibility for the State's commercial fishing loan program requires applicants to be Alaska residents. Additionally, applicants must have fished commercially for a certain number of years. The required level of fishing experience varies by type of loan. Vessel loans cannot exceed $100,000 and permit loans cannot exceed $300,000. A borrower's total CFRLF loans, excluding quota share loans, may not exceed $300,000. When adding the maximum allowable quota share loan, borrowers may be loaned up to $600,000 from CFRLF.

Creation of the Alaska Commercial Fishing Agriculture Bank (CFAB)

CFAB was established in 1978 by the enactment of AS 44.81. Alaska Statute 44.81.010(a) reads as follows:

> *There is established the Alaska Commercial Fishing and Agriculture Bank. The exercise by the bank of the powers conferred by this chapter is considered to be for a public purpose. The bank is exempt from the provisions of AS 06.05 (Alaska Banking Code) and AS 10.15 (Alaska Cooperative Corporation Act) in the exercise of powers granted by this chapter.*

Exhibit 1

Financing Options for Commercial Fishing Loans is Limited

CFRLF and CFAB are the only two entities allowed by statute to hold limited entry permits as collateral. In effect, the state and CFAB are the only two entities that can finance the purchase of limited entry permits. Further, if a borrower wants to use the permit for additional collateral when applying for another type of commercial fishing loan, such as the purchase of a vessel or gear, CFRLF and CFAB are the only two financing options.

Division of Investments' (DOI) mission is, in part, to *"promote economic development through direct state lending within those industries that are not adequately serviced by the private sector."* DOI's regulations require the agency ensure that other financing is unavailable before approving a loan request for specific loans such as vessel loans, quota share loans, and certain permit loans.

[2] This program was created in an effort to keep the IRS from foreclosing on limited entry permits. There was concern that the IRS would sell permits at far below market value, thereby decreasing permit value.

CFAB's policies and directions are established, within its statutory authority, by a seven person board of directors that hires professional management and staff to operate the bank. CFAB makes loans for most fishing or farming related purposes. In order to be eligible as a CFAB borrower, an applicant must be engaged in the commercial fishing or farming industries. As discussed in Exhibit 1, CFAB and CFRLF are the only entities permitted to finance the purchase of limited entry permits.

Eligibility is only the first step of the lending process. To obtain a CFAB loan, an applicant must be found by CFAB to be capable and creditworthy within the context of the specific loan request. The standards used by CFAB are essentially the same as those of private lenders. However, CFAB's specialized purposes, and their experience, has allowed them to consider a broader range of applicant qualifications than most other lenders.

Borrowers, as members of the cooperative bank, must purchase one share of Class A stock that has a par value of $10. In addition, borrowers must purchase shares of Class B stock with a $100 par value in an amount equal to 5% of the loan amount. The purchase costs of the Class B stock may be included in the loan amount.

Challenges experienced by salmon fishery

The value of Alaska's salmon fishery has dropped drastically since the mid 1990s. Salmon prices have declined significantly, many salmon returns have been extremely low, and labor disputes have plagued the industry. Wild salmon has lost its strong presence in the export market and also struggles in the domestic market which has begun to favor the quality, dependability, and availability of farmed salmon. Quality and transportation challenges associated with the harvesting of wild salmon prevent it from regaining its ranking as the preferred product.

Fishery economists do not anticipate improvement for Alaska's salmon fishery without significant changes. Many entities are pursuing changes to improve salmon's marketability.[3] Exhibit 2 discusses the recent formation of the Legislative salmon task force.

Since FY 97, natural and economic disasters have

Exhibit 2

Salmon Task Force

A Joint Legislative Salmon Industry Task Force was formed in FY 03 to "*evaluate the State of Alaska's statutory framework for Alaska's wild salmon industry as well as current industry practices and to make recommendations for statutory, regulatory and structural changes that will improve the industry while recognizing Alaska's coastal economy*."

The task force provides a means to facilitate communication and the exchange of information. Public hearings were held to help identify the needs of each regional area. Subcommittees addressed such topics as marketing, quality, governance, finance and production. While the task force is still relatively new, legislation recommended by the task force has already been introduced.

[3] For example, the Bristol Bay Economic Development Corporation is sponsoring a project which includes creating special marketing programs to promote all species of Bristol Bay salmon. Further, the Alaska Sea Grant Initiative sponsored a statewide workshop focusing on enhancing the quality and marketing of Alaskan salmon products.

been declared in several salmon fishing areas. The years of disastrous fishing seasons have left many fishermen unable to pay their debts. Exhibit 3 shows the communities impacted by the disasters. These communities encompass a large number of CFRLF borrowers.

Exhibit 3

Communities Impacted by Disasters

Date	*Impacted Communities*	*Comments*
Summer/Fall 1998	Yukon and Kuskokwim Rivers, and Bristol Bay, Stebbins, St. Michael, Minto and Manley Hot Springs, False Pass, Nelson Lagoon, and Tyonek	Declared a natural disaster due to low salmon returns.
Summer 2000	Yukon River Drainage including tributaries and Kuskokwim River drainage including, and Norton Sound	Declared a natural disaster due to low salmon returns.
Summer 2001	Norton Sound, main stem of the Yukon River downstream from Rampart, Kuskokwim Bay and the Kuskokwim River downstream from Chuathbaluk, Dillingham census area, Bristol Bay, Lake and Peninsula Boroughs and the Aleutians East Borough east of Cape Sarichef.	An economic disaster was declared for Bristol Bay and the Alaska Peninsula. A natural disaster was declared for Kuskokwim and Yukon.

Credit risk concentration of CFRLF

CFRLF was not intended to hold a diversified loan portfolio. The loan fund serves only one industry; commercial fishing. Therefore, cash flow into CFRLF depends upon the economic viability of the commercial fishing industry.

The CFRLF loan portfolio is further concentrated in the salmon market which has performed poorly over the past five years. In an effort to determine the ability of CFRLF borrowers to repay loans, we attempted to ascertain the viability of specific salmon fisheries. Our intent was to determine the degree to which CFRLF loans are concentrated in fisheries that experienced biological and economic disasters.

In order to categorize each loan by species and area, a detailed analysis of each loan would have been necessary. We determined a more efficient way to stratify loans was to evaluate the permits and individual fishing quotas (IFQs) that serve as collateral for the portfolio.

Permits and IFQs collateralize most of the commercial fishing loans and are easily linked to specific species and fishing areas.[4]

[4] DOI management estimated that ninety percent of the loan portfolio is collateralized by permits or IFQs.

Exhibit 4 stratifies total permits and IFQs that secure the CFRLF portfolio by species.[5] Approximately 76% of the permits and IFQs are concentrated in the salmon fishing industry. Salmon permits are further stratified by area in Exhibit 5. Exhibit 5 shows that the largest concentration of permits is in the Bristol Bay Area with almost 25% of total salmon permits. Prince William Sound has the second highest concentration with 15% of total salmon permits.

Exhibit 4

Permit and IFQ Collateral[5]
Stratified by Species

Species	*Number*	*Percent*
Salmon Permit	1,470	75.85%
Halibut IFQ	159	8.20%
Herring Permit	107	5.52%
Dungeness Permit	72	3.72%
Shrimp Permit	36	1.86%
Herring Spawn Permit	27	1.39%
Sablefish Permit	16	0.83%
Red/Blue King Permit	12	0.62%
Sea Cucumber Permit	9	0.46%
Sablefish IFQ	27	1.39%
Tanner Crab Permit	3	0.15%
Total	1,938	100.00%

Exhibit 5 also indicates whether the permit area was impacted by a fishery disaster. Over 50% of the salmon permits are for areas that have declared fishery disasters (this percentage includes the Exxon Valdez Oil Spill disaster that impacted Prince William Sound). Many people who fish in a disaster area do not have the financial resources to pay their debts, including their CFRLF annual loan payment.

Exhibit 5

Salmon Permit Collateral
Stratified by Area

Area	*Number of Permits*	*% of Total*	*Disaster Area*
Bristol Bay	360	24.5%	Yes
Prince William Sound	227	15.4%	Yes
Northern Southeast	202	13.7%	No
Statewide	198	13.5%	No
Cook Inlet	152	10.3%	No
Kodiak	121	8.2%	No
Peninsula/ Aleutians	88	6.0%	Yes
Lower Yukon	53	3.6%	Yes
Chignik	39	2.7%	No
Yakutat	18	1.2%	Yes
Kuskokwim	9	0.6%	Yes
Kotzebue	1	0.1%	No
Norton Sound	1	0.1%	Yes
Upper Yukon	1	0.1%	Yes
Total	1,470	100.0%	

<u>Division of Investments (DOI) responds to fishing industry hardships</u>

DOI was encouraged to do whatever possible to assist the large number of fishermen in financial need. Interested parties routinely contact the agency and request that it help borrowers who cannot make their loan payment. DOI travels to impacted communities to provide information on the options available through the agency, including the ability to apply for a loan extension or modification and defer interest. The agency also contracts with an organization to assist fishermen with financial counseling, loan application, and collection issues.

DOI's loan servicing procedures changed

[5] A permit or IFQ may serve as collateral for more than one loan. Our analysis counted a permit or IFQ each time it was used as collateral for a loan. For example, if a Bristol Bay Salmon permit worth $100,000 collateralized a $50,000 permit loan, a $10,000 quality improvement loan, and a $30,000 vessel loan, our analysis would have counted this permit three times.

as more fishermen requested assistance from the agency. The agency encouraged borrowers who could not make their loan payments to apply for interest deferral and loan term extensions.[6] Payment plans were implemented when possible. After statutes were changed to allow refinancing, DOI changed their regulations so that the CFRLF interest rate would fluctuate with the prime rate. This significantly lowered interest rates. Borrowers took advantage of the lower interest rates by refinancing their CFRLF loan. All borrowers not in default or delinquent, including those with approved extension/modification applications, were eligible for the lower interest rates under DOI's refinance program. Beginning in FY 00, DOI implemented a pay-on-time program that lowered the interest rate an additional percent if payment was received in a timely manner.

Potential Exxon Valdez Oil Spill (EVOS) settlements play important role in CFRLF

Many past and current participants in the fishing industry are parties to a class action lawsuit seeking damages resulting from EVOS. A settlement awarding $5 billion in punitive damages was appealed. The appellate court remanded the case back to the lower courts under the direction that the amount of punitive damages was too high. At the date of this report, the amount of punitive damages had been revised to $4 billion. However, the case is still in the appeal process.

If and/or when a court decision is reached regarding the punitive damages, past and current participants in the fishing industry will benefit through the distribution of the settlement monies. Many of CFRLF borrowers are slated to receive EVOS settlements.

Generally, DOI requires that a loan be fully collateralized prior to approving a request to modify or extend a loan. As permit and vessel values dropped, borrowers had difficulty providing additional collateral during the extension/modification process. DOI began to look to EVOS settlements as a way to protect CFRLF from collateral devaluation. DOI has not allowed potential EVOS settlements to serve as collateral for an initial loan. But, DOI has accepted assignment of EVOS settlements in the event borrowers cannot provide adequate collateral during the extension/modification of existing CFRLF loans. Assignment of EVOS settlements has also been accepted as part of default settlement agreements.

The practice of accepting EVOS settlements began in the mid 1990s. Initially, DOI staff would take an assignment of an EVOS settlement in the amount of a borrower's collateral deficit. In April 1997, the courts approved a distribution plan for the $5 billion dollar settlement. By the late 1990s, DOI staff had developed a method of estimating a borrower's EVOS settlement distribution. To recognize the uncertainty in the receipt and amount of the settlement, DOI will not accept more than 25% of the agency's estimate of a borrower's settlement, less attorney fees.

[6] See Exhibit 7 on page17 for extension/modification application statistics for FY 92 through FY 02.

Salmon disasters have been declared almost every year since FY 97

Salmon disasters are termed natural or economic. There is no official definition of a natural fishing disaster. The following is the statutory definition of an economic disaster,

> *"economic disaster means that the annual income to workers in the designated area dropped below the average annual income for the base period for workers in the designated area and the drop in income is of such magnitude that the average family income of all residents of the designated area as determined by the department is below the poverty guidelines issued by the federal Department of Health and Human Services, adjusted by the department to reflect subsistence economic patterns and appropriate cost-of-living differentials; the availability of alternate employment shall be considered in determining whether an economic disaster has occurred under this paragraph."*

Exhibit 3 on page 8 shows the communities impacted by the fishery disasters.

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REPORT CONCLUSIONS

We were asked to conduct a financial and performance audit of the Commercial Fishing Revolving Loan Fund (CFRLF). This audit was requested, in part, because of concerns regarding the health of the loan fund, in light of the hardships experienced by the fishing industry. Our objectives include examining administration of the commercial fishing program by the Division of Investments (DOI) and ascertaining the impact of certain loan and credit practices on the financial position of the loan fund.

Generally, we concluded that the financial position of CFRLF has declined due to its loan concentration in the troubled salmon fishing industry. In spite of the large number of nonperforming loans, CFRLF continues to receive more cash than it loans to fishermen resulting in positive cash flow into the fund. DOI staff has altered loan servicing and collection procedures to provide the maximum assistance possible to fishermen. These actions may not have been prudent in regards to the financial position of the loan fund. However, DOI staff contends that their assistance was necessary to avoid further economic devastation to fishermen and fishing communities.

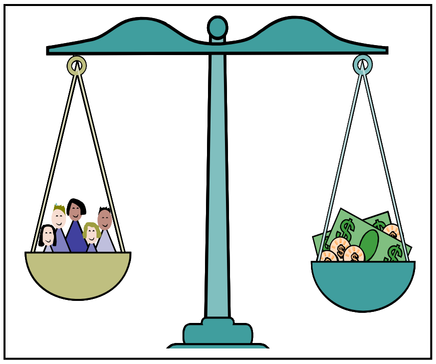
In general, we found DOI administers the commercial fishing loan program in compliance with statutes and regulations. However, we have noted instances where loan practices could be improved. We have also determined that, due to its loan practices, the state has become the preferred lender for most types of commercial fishing loans. Our specific conclusions are discussed below.

CFRLF's competing purposes make managing loan program difficult

Maintaining a revolving loan fund requires the state to differentiate between applicants. In order to be revolving, a fund must receive enough principal and interest payments to provide resources to meet the lending needs. This requires the state to differentiate between applicants, accepting only those that will be able to repay the debt. Otherwise, the outflows of cash would quickly outpace inflows and the fund could not be considered revolving.

The task of differentiating between applicants is straight forward for a private lender. Acceptable levels of debt-to-income and credit scores have been established to determine who would or would not be approved and the appropriate interest rate. Private lenders have, over time, determined the level of risk they are willing to take to maximize their profits. The process is more complicated for the State's loan program.

CFRLF statutes are designed so that lack of credit does not prohibit an applicant from receiving a loan. The loan fund was created, in part, to provide borrowing opportunities to Alaskan fishermen that would not qualify for financing from other lenders. Hence, many CFRLF applicants lack credit history, have poor credit, or have high debt-to-income ratios.



Prudent management of the state's financial investment versus helping typically higher risk Alaska residents enter, or remain, in the fishery are competing and sometimes opposing public policy goals. As demonstrated to the left, DOI must strike a precarious balance between the two different goals in order to effectively manage the commercial fishing loan program. During times that the salmon fishery flourished, this balance was easy to maintain. Delinquency and default rates were low and collection efforts were routine. The loan portfolio grew and cash flow was good. Financing at reasonable interest rates was available to Alaskan fishermen. During the years that the salmon fishery has struggled, a balance has been difficult to maintain.

DOI would benefit from formal guidance from the legislature and governor regarding their loan policies and practices. DOI has acted within its legal authority when responding to the salmon disasters; however, in the long-term their actions may not meet the intent of the program. The practices of routinely deferring interest and postponing collection efforts were intended to be temporary responses in light of the agency's statutory mandate of assisting fishermen. As the disasters continue and the financial positions of fishermen fail to rebound, DOI's temporary policies are at risk of becoming standards of operation to the detriment of the fund's financial position. DOI's actions have far reaching, economic implications that warrant input and direction from both the legislature and the governor. There is a need to reevaluate the purpose of CFRLF, and incorporate management of CFRLF, into public policy decisions.

<u>The financial position of CFRLF has declined in response to the salmon disasters</u>

During the preparation of the FY 02 CFRLF financial statements, DOI management changed its methodology for estimating uncollectible loans. During the 1990s, DOI management set the amount of uncollectible loans at 6% of loans receivable and 12% of deferred interest receivable. This estimate did not fully recognize the increased risk of default by many CFRLF borrowers. Further, the estimate did not recognize the increased exposure to loss caused by the decrease in collateral values. Management changed their methodology, taking into consideration additional data, regarding the number of times each loan had been modified and the drop in values of limited entry permits and vessels. Consequently, CFRLF allowance for uncollectible loans receivable and deferred interest receivable was increased and the fund recognized $13.2 million loan and interest losses in FY 02.

Although a large number of CFRLF loans are routinely extended/modified and the fund has a high rate of delinquency and default, cash flow into the fund has been resilient. CFRLF was capitalized by general fund contributions and set up to be a revolving fund. It does not have the cost of borrowing funds and the target rate of return that other financial institutions must meet. The expenses of the fund are mainly limited to the costs of running the program (such as wages, benefits, supplies, travel).

In spite of increasing loan extensions/modifications and a high rate of delinquency/default, the repayment of principal and interest has outpaced new lending and created a large cash balance in the fund. During FY 02, DOI received \$8.3 million of principal repayments and \$5.3 million of interest payments, yet it made new loans for only \$6.2 million. The fund has \$25.2 million in cash and investments as of June 30, 2002.

New lending in FY 02 was at its lowest in the past 12 years. This decrease has occurred even though the purpose of the fund was significantly expanded in FY 95. The number of new loans and the average loan amount has substantially decreased.

<u>DOI lending and collecting policies have financial impact on fund</u>

In response to the fish disasters, Exhibit 6 on the next page outlines how DOI minimized collection efforts and maximized its efforts to extend and modify loans. DOI favored postponing swift foreclosure action with the hopes that the fishing industry would rebound. Beginning in FY 94, DOI allowed resident borrowers to defer interest without incurring additional interest charges. Deferred interest receivable accounts were usually due at the end of a loan's term. This policy kept interest from accruing on interest and gave borrowers time to recuperate from financial hardship.

Loan servicing changed as more fishermen requested assistance from the agency. Interest deferral and term extensions have become routine. After statutes were changed to allow refinancing, DOI developed new regulations that based the interest rate on the prime rate. This effectively lowered the interest rate and many borrowers refinanced their loan. All CFRLF resident borrowers not in default or delinquent, including those with an approved extension/modification applications, were eligible for the lower interest rates under DOI's refinance program. Beginning in FY 00, DOI implemented a pay-on-time program that lowered the interest rate an additional one percent if payment was received timely.

As discussed previously, DOI must balance the goal of assisting high risk Alaskans, entering or remaining in the fishery, with the goal of maintaining the loan fund at a level that will meet future lending needs. In light of the disasters occurring in the fishing industry, DOI shifted this balance towards helping fishermen in financial need. An unintended consequence has been the unchecked growth of borrowers' deferred interest indebtedness. Further, postponing collection in a declining market reduced DOI's ability to mitigate the loss in the event of a default. Collateral values have declined sharply during the last five years. In hindsight, reaching a settlement agreement rather than postponing default would have been a better financial choice for some borrowers. Personal bankruptcies may become more likely under the mounting deferred interest debt and the inability to sell collateral at a decent price.

DOI's management explained that the decision to apply for an extension/modification is made by the borrower. Based on discussions with DOI collection officers, we question whether borrowers are fully aware that routinely deferring interest creates a large indebtedness, often due in a balloon type payment at the end of a loan term. Further, we question borrowers' ability to make these payments at the end of the loan term.

Exhibit 6

DOI Creative Collection Practices

As fishermen's financial situations worsened and collateral values dropped, DOI became creative in finding ways to work with borrowers. Below are some unique DOI collection techniques:

Super Modifications: This action is DOI's final effort to avoid foreclosure. Borrowers are given five years to improve financial condition. Reduced payments are required during the five-year period; interest is automatically deferred each year. Any payments received are credited to the principal. As of June 30, 2002 there were 24 CFRLF loans in super modification status.

Bifurcation: A loan is split into a performing loan and a nonperforming loan. Collateral is liquidated to mitigate losses on the nonperforming loan and a settlement is reached for the deficiency. A payment schedule is established for the performing loan.

Principal First: Under this practice, DOI applies any payments received entirely to principal. Principal will eventually be repaid and payments can then be applied to deferred interest. This practice is favored by DOI because interest accrues at a declining rate and will eventually stop accruing once principal is paid.

Cannery Assignments: DOI works with canneries so that a borrower's income is remitted directly to the agency.

PFD Assignments: Borrowers agree to assign future permanent fund dividends to DOI as part of a settlement agreement or payment plan. During FY 02 DOI received $262,019 in dividend assignments.

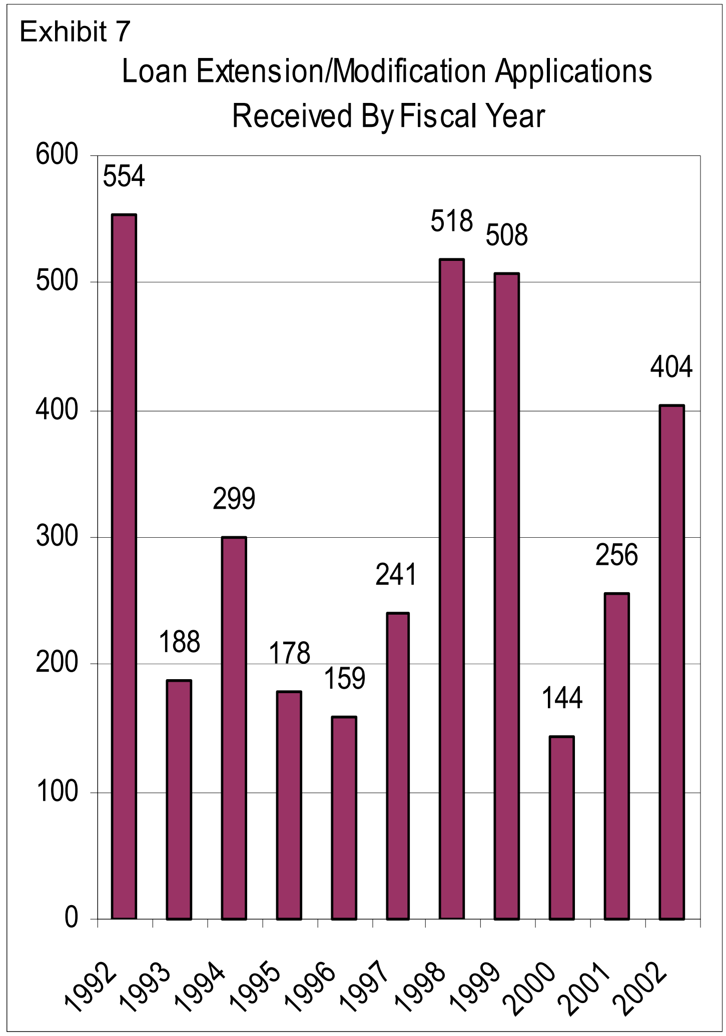
EVOS Assignments: DOI utilizes EVOS settlements whenever possible in settlement agreement and in cases where borrowers want to modify/extend their loan, but cannot provide the required collateral. EVOS Assignments are registered with the designated EVOS attorneys. As of June 30, 2002 DOI held $8.3 million in EVOS assignments.

Increasing number of borrowers are not making principal and interest payments

DOI has responded to the fish disasters by allowing borrowers to delay the payment of principal and interest by filing the appropriate application. In FY 02, DOI approved 315[7] applications for extension/modification (17% of total CFRLF loans as of June 30, 2002). This practice is anticipated to continue.

[7] Exhibit 7 shows that 404 extension/modification applications were received by DOI in FY 02. A total of 315, or 78%, were approved. The approval rate may be understated because not all applications received by DOI had been reviewed by June 30, 2002. In FY 01, 239 of the 256 applications received, or 93%, were approved. Approval statistics were only available for FY 01 and FY 02.

Exhibit 7 summarizes the number of extension/modification applications received by DOI during the period FY 92 through FY 02.



When DOI approves a borrower's application to defer interest, they create a deferred interest receivable account which is reported as an asset on the fund's statement of net assets (also referred to as a balance sheet). CFRLF's statement of net assets is found on page 33 of this report. Accounting standards require that the total amount reported in this account be reduced for the amount management estimates will not be collected. Total deferred interest owed to DOI as of June 30, 2002 was $8.5 million. The allowance for uncollectible accounts was estimated by management to be $4.8 million.

In addition to the borrowers who applied for and received approval to postpone payment of principal and interest, 20.3% of outstanding loans receivable were reported as either delinquent or in default.

We reviewed default rates as of June 30, 2002 by type of loan. IRS obligation loans were the worst performing type of loan. Default rates for IRS loans were approximately 40%. Permit loans had a default/delinquency rate of approximately 26%. Vessel refinance default/delinquency rate was approximately 19%.

<u>CFRLF lending patterns have changed significantly over the past 11 years</u>

Historically, the main emphasis of the CFRLF loan program has been to finance the purchase of permits and, to a lesser extent, the purchase of vessels. Major changes were made to the program in FY 95. Statutes were changed to allow CFRLF to finance the purchase of quota shares. A temporary lending program was authorized which allowed CFRLF to make loans up to $30,000 for payment of IRS obligations. Further, statutes were changed to allow the fund to refinance vessel loans originally financed by private or other public lending institutions.

The new statutory provisions significantly changed CFRLF's lending patterns. In FY 95, quota share loans added 15 loans and a total of $1.1 million in principal. IRS loans totaled 101 for approximately $2.2 million. The largest impact on the fund was the vessel refinancing. In FY 95, CFRLF refinanced 41 vessel loans for a total of $5 million. These types of loans are typically much larger than other DOI vessel loans because statutes permit the refinance of vessel loans up to $300,000. However, if a vessel loan originates at DOI, it is statutorily capped at $100,000.

The change in the lending patterns is evidenced in Exhibit 8. This exhibit compares the total number, type, amount, and average loan amount of CFRLF loans for the three year period ending FY 94 to the three year period ending FY 02.

Exhibit 8

Comparison of CFRLF Loan Activity
Three Year Period FY 00 through 02 Compared to FY 92 through 94

	FY 92 through FY 94			FY 00 through FY 02		
Type of Loan	Average Loan Amount	Number of Loans	Total Amount Loaned	Average Loan Amount	Number of Loans	Total Amount Loaned
Permit	$82,416	244	$20,109,538	$40,618	170	$6,905,116
Vessel	58,774	56	3,291,322	50,601	114	5,768,484
Gear	7,104	2	14,208	9,247	19	175,702
Quality Improvement	n/a	n/a	n/a	48,567	40	1,942,691
IRS Obligation	n/a	n/a	n/a	20,516	20	410,328
Quota Loan	n/a	n/a	n/a	98,958	57	5,640,584
Vessel Refinance	n/a	n/a	n/a	75,480	62	4,679,764
		302	$23,415,068		482	$25,522,668

A total of 302 loans were issued by CFRLF during the three year period ending FY 94. Out of the 302 loans, 244, or 81%, were for permits. In contrast, 170 permit loans were issued during the three year period ending FY 02. This represents only 35% of total loans during the period. The significance of quota share lending and vessel refinancing is also evidenced in Exhibit 8. In the three year period ending FY 02, quota share loans made up approximately 12% of total loans and vessel refinancing made up 13%.

The decline in the demand for permits and the decline in the average permit loan amount have increased the significance of vessel refinancing and quota share lending. Permit lending has become a smaller percentage of CFRLF lending when compared to large dollar vessel refinance loans. Quota share loans have also dropped in regards to average loan amount. However, the drop in value has been much less severe than the drop experienced by permits.

Values of CFRLF collateral have fallen substantially

Commercial fishing permits are CFRLF's main source of collateral. Consequently, a significant change in the value of permits affects the degree to which CFRLF is secured.

We performed an analysis of the permits that serve as collateral for CFRLF to determine how the value of the permits has changed. We used historical permit value information provided by the Commercial Fisheries Limited Entry Commission to compare the value of each permit at the point of loan origination to the value as of June 30, 2002.

Exhibit 9 summarizes the decrease in permit values by species. A total of 1,752 permits serve as collateral for loans receivable. This number cannot be related to loans receivable on a one-to-one basis because permits may serve as collateral for more than one loan. However, an overall evaluation of the decline in permit values provides an understanding of the degree to which the loan portfolio is secured.

Exhibit 9

Analysis of CFRLF Collateral
Limited Entry Permits

Species	Number of Permits	Permit Value at loan date	Permit value at 6/30/02	Dollar Change	Percent Change
Salmon	1,470	$121,298,538	$37,641,400	$(83,657,138)	-69%
Herring	107	9,297,463	4,965,400	(4,332,063)	-47%
Herring Spawn	27	951,166	544,700	(406,466)	-43%
Dungeness	72	2,892,100	2,054,800	(837,300)	-29%
Sea Cucumber	9	89,000	75,600	(13,400)	-15%
Shrimp	36	527,900	471,300	(56,600)	-11%
Sablefish	16	3,114,600	2,942,500	(172,100)	-5%
Red/Blue King Crab	12	1,174,800	1,474,500	299,700	25%
Tanner Crab	3	351,900	359,400	7,500	2%
Totals	1,752	$139,697,467	$50,529,600	$(89,167,867)	-64%

Vessels are also important sources of collateral for CFRLF. According to DOI staff, vessel values have decreased in a manner similar to permit values.

The decrease in value of collateral has several implications to the fund. In the event of a default, DOI's ability to mitigate losses declines. Collection efforts are hampered due to the complexities of seizing vessels which are costly to maintain and difficult to dispose of. Further, DOI's inventory of repossessed permits has grown and is expected to continue to increase significantly. This may lead to the further devaluation of permits as DOI repossessed permits are "promptly" put up for sale as required by statute.[8]

[8] AS 16.10.337(b) requires DOI to promptly advertise and sell permits after foreclosure.

EVOS settlements could potentially provide \$8.3 million to CFRLF

As discussed during the Background Information section of this report, EVOS settlements have been accepted as part of default agreements and in instances borrowers want to modify or extend loans that were not adequately collateralized. EVOS settlement assignments are registered with the court designated attorneys. At the date of this report, DOI held \$8.3 million of EVOS settlements. DOI contends that when a settlement is approved, \$8.3 million will be applied to borrowers' indebtedness.

We believe DOI should change its policy that directs the application of EVOS settlement monies (see Recommendation No. 4 in the Findings and Recommendation section of this report). Borrowers that assign part of their EVOS settlements to DOI often owe the state both deferred interest and loan principal. Under DOI's current policy, DOI will apply settlement monies to principal first in order to slow the growth of borrower interest indebtedness (once principal is done, interest stops accruing).

DOI does not report CFRLF debt and collection data to credit agencies

Several organizations compile credit data and provide the information to financial institutions and other interested parties for a fee. A credit report generally includes facts about a person's identity, where they work, live, a person's bill-paying habits, and public record information. Lending institutions use credit reports to determine whether or not to extend credit.

While DOI routinely uses credit reports when evaluating an applicant's credit worthiness, DOI does not report commercial fishing loan indebtedness or default/delinquency information to credit reporting agencies. According to DOI staff, the loan subsystem is not compatible with credit agencies' computer systems and manual reporting would be too cumbersome for the agency to conduct.

In our view, not reporting to credit agencies is not a prudent lending practice. Typically, CFRLF borrowers do not have the credit history necessary to qualify for other financing and often have high debt-to-income ratios. These factors make it important that the state do what is possible to limit a borrower's ability to incur additional debt that would prevent them from making their commercial fishing loan payments. Currently, potential creditors become aware of CFRLF indebtedness only when borrowers voluntarily disclose the debt.

Additionally, not reporting to credit agencies limits DOI's effectiveness as a collection agency. Negative credit information remains on an individual's credit report for up to seven years and will follow an individual if they move out of Alaska. Without the ability to impact a borrower's credit history, the effectiveness of DOI's collection procedures is weakened.

In general, DOI has administered the loan program in compliance with state law

In general, DOI has administered the commercial fishing loan program in compliance with state statutes and regulations. However, DOI failed to document their determination that applicants were not eligible for alternative sources of financing.

Statutes/regulations require the state to be the lender of last resort for vessels, fishing gear, quota shares, and certain permit loans. However, our testing found that loan officers were not routinely documenting an applicant's eligibility for financing from other financing sources. Therefore, it was unclear whether such a determination took place. Further, management does not have the ability to review a loan committee's determination without adequate documentation. This finding is addressed in Recommendation No. 7 in the Findings and Recommendation section of this report.

Additionally, several loan practices were identified that could be improved to strengthen CFRLF performance. Improvements include alternative payment schedules; considering living expenses when evaluating applicants' ability to service debt; and considering an applicant's inability to meet current CFRLF loan payment prior to making a new loan. These suggestions for improvement are described in detail in Recommendation No. 6 in the Findings and Recommendations section of this report.

DOI loan practices make the state the preferred lender for commercial fishing loans

DOI loan terms and practices make the state the preferred lender for most commercial fishing loans. DOI's interest rates are competitive with private lending institutions. Further, DOI offers a 1% interest rate reduction if payments are made on time and the agency allows borrowers to defer payment of interest and principal by showing just cause. The agency does not increase interest rates in the event of a default which is standard for other financial institutions. Further, the agency is reluctant to foreclose on collateral. These characteristics make DOI the preferred lender.

As discussed in the Background Information section of this report, the only sources of financing for limited entry permits are CFRLF and CFAB. Alaska statutes do not require the state to be the lender of last resort when it comes to certain types of permit loans.[9] Hence, CFRLF and the CFAB are the only active competitors in this area lending. Because limited entry permits are used extensively to cross-collateralize other commercial fishing loans, CFRLF is also CFAB's main competitor for vessel and gear loans. Appendix A to this report compares the two entities loan balances, loan originations, delinquency rates and interest rates over the past five years. In FY 2002, interest rates were much lower at CFRLF. This combined with the DOI's loan collection and servicing practices make it the preferred lender for most loans.

[9] Eligibility for CFRLF is broken down into three sections. Each section requires a different level of experience and covers specific types of loans. Permit loans are available under both Section A and Section B. The main difference in eligibility between Section A and Section B is experience in the fishery. Section A loans may be obtained without showing that the state is the lender of last resort. Section B loans are only available if the applicant is not eligible for alternate financing. Note: Vessel loans are only available under Section B.

Private financing institutions are willing to make commercial fishing loans as long as an applicant can show an acceptable level of profitability, demonstrate good credit history, and provide adequate collateral. Given the financial hardships and poor profitability of the salmon industry, competition between CFRLF and private financial institutions is currently not a concern.

CFRLF is one of several lenders that make quota share loans. The federal Individual Fishing Quota Loan Program, administered by the National Marine Fisheries Service, is considered to be the preferred lender for these types of loans because of the low interest rate. In FY 02 the federal program offered loans for 6%. CFRLF interest rates were 7% for quota share loans.

<u>Refinancing of other lenders' vessel loans has increased the default risk borne by the state</u>

In FY 95, the purpose of CFRLF was significantly expanded to include, in part, the refinancing of vessels originally financed through some other lender. At the time of the change, DOI was encountering situations where a borrower held a permit loan from DOI and a vessel loan from a private lending institution. If the private lender foreclosed on the vessel, the borrower would be unable to generate income to service their permit loan. By allowing CFRLF to refinance the troubled vessel loan, typically with lower interest rates and longer terms, fishermen would be capable of making payments on both their vessel and permit loans.

Troubled times for the fishing industry made refinancing vessel loans with DOI very popular. In addition to lower interest rates and longer terms, DOI's collection policies further enticed people to refinance.

Vessel refinancing has become a large part of CFRLF's loan portfolio. At June 30, 2002 these loans made up $13.4 million (16.5%) of total loans receivable. CFRLF vessel loans are statutorily capped at $100,000, yet the refinance of other lenders vessel loans is permitted for up to $300,000. Consequently, the increased demand for vessel refinancing has contributed significantly to loans receivable.

Refinancing other lenders vessel loans does not appear to be in line with the legislative intent that CFRLF be the lender of last resort. However, if the goal of the refinance program was to consciously shift the risk of default from private and other public lenders to the state, then the program is accomplishing this goal.

FINDINGS AND RECOMMENDATIONS

Recommendation No. 1

We recommend the commissioner of the Department of Community and Economic Development (DCED) coordinate with the governor's office to ensure that CFRLF's policies and regulations remain consistent with overall public policy goals.

Changes in the salmon industry have necessitated the reevaluation and realignment of state law. The legislative salmon task force was created to facilitate communication and the exchange of information in an effort to identify ways to reclaim the lost market share and to foster an environment that encourages expansion into new markets. The State's statutory framework for the wild salmon industry and current industry practices were reviewed to identify changes to statutes and regulations that may serve to improve the industry and recognize the State's coastal economy. This process has led to the introduction of several bills this legislative session.

It is important that CFRLF policies and regulations reflect overall decisions by policy makers. The loan and collection practices of Division of Investments (DOI), instituted in response to economic conditions they expected to be temporary, have become standard modes of operation. These policies and related regulations should be reevaluated and realigned as policy decisions are made regarding the State's role in the salmon industry.

We recommend the commissioner of DCED coordinate with the governor's office to ensure that CFRLF policies and regulations remain consistent with overall public policy goals.

Recommendation No. 2

We recommend the director of DOI reevaluate the benefits provided by the pay-on-time program in light of the substantial administrative inefficiencies of the program.

During FY 00, DOI instituted a pay-on-time program that reduces borrowers' interest rate by 1% if the borrower made their loan payment on-time the previous year. DOI envisioned the program would give borrowers incentive to make their loan payment timely rather than applying for an extension/modification. Less extension/modification applications and fewer delinquencies would save staff time.

When discussing the program with DOI staff, we found that DOI's loan subsystem does not handle interest rate changes efficiently. To ensure interest rate changes are made accurately, the new payment schedule for all loans that qualify for the pay-on-time program must be manually processed. According to DOI's director, the only evidence that the program is successful at encouraging timely payments has been verbal feedback from borrowers.

Given the pay-on-time program is labor intensive to administer, we recommend the director of DOI reevaluate the program to ensure the costs of the program are justified.

Recommendation No. 3

We recommend the director of DOI takes steps necessary to ensure EVOS assignments are not accepted when alternative collateral is available.

Alaska statutes require CFRLF loans be sufficiently collateralized. DOI requests additional collateral during the loan extension/modification process if the value of original collateral has declined to a point the outstanding balance is not adequately secured. EVOS settlements are accepted by DOI even though a borrower may have other collateral, such as real property, available. DOI regards EVOS assignments as adequate replacements for collateral deficits.

Assignments of EVOS settlements are less desirable than traditional types of collateral because the assignments cannot be liquidated to mitigate losses in the event of a default. Further, the amount and timing of EVOS settlements are unknown. We recommend the director of DOI accept the assignments of EVOS settlements only after all other collateral have been exhausted.

Recommendation No. 4

The director of DOI should change its current policy to ensure EVOS settlements are applied to interest first.

EVOS settlement assignments have been obtained by DOI as part of settlement agreements and in exchange for approval to extend loan terms and defer interest when original collateral dropped in value. DOI held approximately $8.3 million in EVOS settlement assignments as of June 30, 2002.

DOI has a policy that directs the application of EVOS settlement monies based on the status of a loan. For example, if a loan is delinquent, any EVOS monies received will first be applied to any payments that are past due. If EVOS settlement assignments were accepted as part of a settlement agreement, the monies will be applied in accordance with the settlement agreement. In loans that are considered by DOI to be current, EVOS assignments will be applied to outstanding principal regardless of whether the borrower also owes the state deferred interest.

Standard lending practice requires the application of loan payments to interest first. In contrast, DOI has, in certain circumstances, permitted the application of payments to principal first. DOI has begun to apply payments to principal to slow the growth of borrowers' interest indebtedness. The agency intends to continue with this practice when it receives EVOS settlement monies.

DOI's policy to apply payments to principal first may be justified, for a limited time, during periods of extreme financial hardship. However, in the event that CFRLF borrowers receive EVOS settlements, this practice is no longer justified. We recommend that DOI's director change its policy to ensure that EVOS settlements are first applied to borrowers' deferred interest indebtedness.

Recommendation No. 5

We recommend the director of DOI coordinate with other state agencies when replacing the current loan subsystem.

During our financial audit of CFRLF, we noted the subsystem was antiquated and difficult to maintain. The system requires laborious manual reconciliations to ensure that the information is accurately reflected in the state accounting system. The system cannot decipher partial payments, late fees, overpayments and cannot efficiently process interest rate changes. Additionally, the system was not set up to track extension/modification information. These system problems increase personal service costs, restrict the availability of information, slow down the production of data and increase the risk of misinformation.

In FY 02, DOI received a capital appropriation for the design and solicitation of a new loan processing computer system. We recommend the director of DOI coordinate with the Department of Administration, Division of Finance to ensure that the new subsystem is capable of interfacing financial data into the state accounting system. Further, we recommend the director of DOI coordinate with the Department of Administration, Division of Information Services, to ensure the loan system has adequate security capabilities. Both of these entities have expertise that would benefit DOI significantly as they pursue replacing the current loan subsystem. We further recommend the new system be designed to produce the information necessary for proper financial reporting and be capable of sharing loan data with credit reporting agencies.

Recommendation No. 6

The director of DOI should change several loan serving policies to improve administration of the program.

During review of DOI loan servicing procedures, we found the following practices could be improved to strengthen CFRLF performance.

Accelerate Payments: Commercial fishing loans are set up on an annual payment schedule. This payment schedule was established because fishing income was generated during the summer months. Typically, fishermen would not have the resources available to service the debt during other periods. Annual principal and interest payments are very large. For example, the annual principal and interest payment on a $100,000 ten year loan at 8% is $18,000.

In response to the hardships experienced by the fishing industry, many borrowers have obtained other means of employment that provide income throughout the year. Further, many borrowers are expanding into other species and/or areas in order to lengthen the period in which they can generate income.

We recommend DOI consider implementing quarterly or monthly payment schedules for those borrowers that have income available at other times during the year. When determined appropriate, smaller principal and interest payments paid quarterly or monthly should increase overall payments into the fund. Collection officers stated that it is not uncommon to encounter a borrower who does not have the discipline to set aside the money necessary to meet their annual loan payment. Quarter/monthly payments would also help make the payments more manageable for many individuals. Further, borrowers will pay a lower total amount of interest under a monthly or quarterly payment schedule because the outstanding principal balance declines at a faster rate.

Borrowers' ability to meet their current loan payments should be considered when evaluating an application for a new CFRLF loan: Through interviews with DOI loan officers, we became aware that DOI policies and procedures do not require that an applicant's CFRLF loan payment history be considered when determining whether an applicant qualifies for a new CFRLF loan. Prudent lending practice would certainly take into consideration an applicant's ability to meet their current CFRLF loan obligations. We recommend DOI require all past DOI payment history, including number of times borrowers extend/modify loans, be considered in any new lending decision. This requirement will help reduce the risk of lending funds to individuals that ultimately default on their obligation.

Consider living expenses when evaluating applicants' ability to service debt: We became aware that DOI policies and procedures do not require loan officers to consider applicants' living expenses when evaluating their ability to service debt. We believe this is important when evaluating CFRLF applicants because of the large debt-to-income ratios that are permitted. Living expenses, such as rent, heating, and food can be quite high in many areas of Alaska. By failing to consider such information, DOI may be making loans to applicants who cannot service the debt. We recommend DOI consider living expenses when evaluating an applicant's ability to meet their loan payments.

The changes recommended should improve performance of CFRLF and can be accomplished by altering policies and procedures.

Recommendation No. 7

The director of DOI should ensure that the availability of other financing is thoroughly documented and considered during the loan application process.

We determined that loan officers were not routinely documenting an applicant's ineligibility for financing from other financing sources. One of the eligibility requirements under AS 16.10.300(a)(1)(C)(iv) is that applicants "*are not eligible for financing from other recognized commercial lending institutions to purchase quota shares.*"

In addition, regulation 3 AAC 80.055(b), that governs DOI lending practices, states

> "*An applicant will be considered eligible for a loan to purchase a limited entry permit, vessel, or gear under AS 16.10.310 (a)(1)(B) or purchase quota shares under AS 16.10.310 (a)(1)(C) if the department determines that the applicant is not eligible for an alternative source of financing.*"

In a majority of the loan files reviewed, there was no documentation by loan officers concerning applicants' ineligibility for alternative financing sources. DOI management's ability to review loan officers' conclusions regarding applicants' ineligibility for alternative financing is restricted without adequate documentation.

We recommend the director of DOI ensure the availability of other financing sources is thoroughly documented and considered during the loan application process.

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AUDITOR'S REPORTS AND FINANCIAL STATEMENTS

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Independent Auditor's Report

Members of the Legislative Budget
and Audit Committee:

We have audited the accompanying financial statements of the Commercial Fishing Revolving Loan Fund administered by the Division of Investments, Department of Community and Economic Development, State of Alaska, as of and for the year ending June 30, 2002 as listed in the table of contents. These financial statements are the responsibility of the Division of Investments' management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States. Those standards require that we plan and perform audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as the overall financial statement presentation. We believe our audit provides a reasonable basis for our opinion.

As discussed in Note A, the financial statements present only the Commercial Fishing Revolving Loan Fund and are not intended to present fairly the financial position of the State of Alaska and the results of its operations and cash flows of its propriety funds in conformity with accounting principles generally accepted in the United States of America.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Commercial Fishing Revolving Loan Fund of the Division of Investments, Department of Community and Economic Development, State of Alaska, as of June 30, 2002, and the results of its operations and cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued our report dated November 15, 2002 on our consideration of the Division of Investments' internal control over financial reporting and on our tests of compliance with certain provisions of laws, regulations and policies.

Pat Davidson, CPA
Legislative Auditor

November 15, 2002

Independent Auditor's Report on Compliance and on Internal Control Over Financial Reporting Based on an Audit of Financial Statements Performed In Accordance with *Government Auditing Standards*

Members of the Legislative Budget
and Audit Committee:

We have audited the accompanying financial statements of the Commercial Fishing Revolving Loan Fund of the Division of Investments, Department of Community and Economic Development, State of Alaska, as of and for the year ended June 30, 2002, and have issued our report thereon dated November 15, 2002. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Compliance

As part of obtaining reasonable assurance about whether the Division of Investments' financial statements mentioned above are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations and policies, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed instances of noncompliance which are discussed in the Report Conclusions and Findings and Recommendations sections of this report.

Internal Control Reporting Over Financial Reporting

In planning and performing our audit, we considered the Division of Investments, Department of Community and Economic Development, State of Alaska's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements identified above and not to provide assurance on the internal control over financial reporting. However, we noted a certain matter involving the internal control over financial reporting and its operation that we consider to be a reportable condition. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect the Division of Investments' ability to record, process, summarize and report financial data consistent with the assertions of management in the financial statements. The reportable condition is described in Note G in the Notes to the Financial Statements and, further in Recommendation No. 5 in the Findings and Recommendations section of this report.

A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be reportable conditions and accordingly, would not necessarily disclose all reportable conditions that are considered to be material weaknesses. However, we do not believe the reportable condition identified above is a material weakness.

This report is intended for the information of the State's management and members of the Alaska Legislature. However, this report is a matter of public record and its distribution is not limited.

Pat Davidson, CPA
Legislative Auditor

November 15, 2002

State of Alaska
Department of Community and Economic Development
Division of Investments
Statement of Net Assets
Commercial Fishing Revolving Loan Fund
June 30, 2002

ASSETS		
Current Assets:		
Cash and Investments	$	25,238,983
Accounts Receivable - Net		802,369
Interest and Dividends Receivable		3,194,450
Deferred Interest Receivable		413,474
Loans, Notes, and Bonds Receivable		5,593,043
Total Current Assets		35,242,319
Noncurrent Assets:		
Deferred Interest Receivable		3,222,848
Loans, Notes, and Bonds Receivable		59,511,143
Repossessed Property		377,777
Total Noncurrent Assets		63,111,768
Total Assets		98,354,087
LIABILITIES		
Current Liabilities:		
Accounts Payable and Accrued Liabilities		35,132
Due to Other Funds		181,319
Other Current Liabilities		81,671
Total Current Liabilities		298,122
Total Noncurrent Liabilities		0
Total Liabilities		298,122
NET ASSETS		
Unrestricted		98,055,965
Total Net Assets	$	98,055,965

State of Alaska
Department of Community and Economic Development
Division of Investments
Statement of Revenues, Expenses, and Changes in Fund Net Assets
Commercial Fishing Revolving Loan Fund
For the Year Ended June 30, 2002

OPERATING REVENUES		
Charges for Goods and Services	$	402,289
Interest and Investment Income		5,117,999
Allowance for Uncollectible Interest		(1,384,843)
Fines and Forfeitures		109,921
Total Operating Revenues		4,245,366
OPERATING EXPENSES		
Operating		2,688,403
Provision for Loan Losses and Forgiveness		11,794,763
Total Operating Expenses		14,483,166
Operating Income (Loss)		(10,237,800)
NONOPERATING REVENUES (EXPENSES)		
Total Nonoperating Revenues (Expenses)		0
Income Before Transfers		(10,237,800)
Transfers (Out to) Other Funds		(175,000)
Change in Net Assets		(10,412,800)
Total Net Assets - Beginning of Year		108,468,765
Total Net Assets - End of Year	$	98,055,965

State of Alaska
Department of Community and Economic Development
Division of Investments
Commercial Fishing Revolving Loan Fund
Statement of Cash Flows
For the Year Ended June 30, 2002

CASH FLOWS FROM OPERATING ACTIVITIES		
Receipts of Principal from Loan Recipients	$	8,249,512
Receipt of Interest and Fees from Loan Recipients		5,279,566
Payments to Loan Recipients		(6,234,630)
Interfund Services Used		(2,639,463)
Other Receipts		67,871
Other Payments		(370,107)
Net Cash Provided (Used) by Operating Activities		4,352,749
CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES		
Operating Subsidies and Transfers (Out to) Other Funds		(175,000)
Net Cash Provided (Used) by Noncapital Financing Activities		(175,000)
Net Increase (Decrease) in Cash		4,177,749
Cash and Cash Equivalents - Beginning of Year		21,061,234
Cash and Cash Equivalents - End of Year	$	25,238,983
Reconciliation of Operating Income (Loss) to Net Cash Provided (Used) by Operating Activities:		
Operating Income (Loss)	$	(10,237,800)
Adjustments to Reconcile Operating Income to Net Cash		
Net Changes in Assets and Liabilities:		
Accounts Receivable - Net		(169,398)
Loans, Notes and Bonds Receivable - Net		13,531,447
Interest and Dividends Receivable - Net		630,167
Deferred Interest Receivable		783,325
Other Assets		(192,115)
Due to Other Funds		181,319
Accounts Payable and Accrued Liabilities		(174,196)
Net Cash Provided (Used) by Operating Activities	$	4,352,749

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Notes to Financial Statements

Note 1 -- Summary of Significant Accounting Policies

The accompanying financial statements of the State of Alaska, Department of Community and Economic Development, for the Commercial Fishing Revolving Loan Fund (CFRLF) have been prepared in conformity with generally accepted accounting principles (GAAP) as prescribed by the Governmental Accounting Standards Board (GASB). GASB is the accepted standard-setting body for governmental accounting and financial reporting principles which are primarily set forth in the GASB's *Codification of Governmental Accounting and Financial Reporting Standards.* The State does not apply Financial Accounting Standards Board pronouncements issued after November 30, 1989 for enterprise funds, unless GASB amends its pronouncements to specifically adopt FASB pronouncements issued after that date.

A. Measurement Focus and Basis of Accounting

CFRLF is reported as an enterprise fund as prescribed by GAAP. Enterprise funds are used to report any activity for which a fee is charged to external users for goods and services. CFRLF uses the flow of economic resources measurement focus and accrual basis of accounting. This is the same basis of accounting used for private-sector business enterprises and nonprofit organizations. Revenues are reported in the fiscal year in which they are earned and expenses are reported in the fiscal year in which the liabilities for goods and services are incurred.

CFRLF distinguishes operating revenues and expenses from nonoperating items. Operating revenues and expenses generally result from providing services and producing and delivering goods in connection with an enterprise fund's principal ongoing operations. All other revenues and expenses are reported as nonoperating.

Further, CFRLF classifies assets and liabilities as current and long term. Current assets are those assets expected to be converted to cash within one year. Current liabilities are the obligations that are reasonably expected to be liquidated either through the use of current assets or the creation of other current liabilities.

B. Fiscal Year

CFRLF's fiscal year begins on July 1 and ends June 30, consistent with the State's fiscal year.

C. Management Estimates

In preparing the financial statements in accordance with GAAP, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities as of the date of the statement of net assets and the reported amounts of revenues and expenses for the year. Actual amounts could differ from those estimates. The more significant accounting and reporting policies applied in the preparation of the accompanying financial statements are discussed within the notes below.

D. Cash and Investments, Cash and Cash Equivalents

The amounts shown on the statement of net assets as Cash and Investments represent cash on deposit in banks, petty cash, cash invested in various short-term instruments, and other investments of the State.

CFRLF's statement of cash flows shows changes in cash and cash equivalents. For the purpose of the statement of cash flows, all highly liquid debt instruments with original maturities of three months or less are considered cash and cash equivalents. In addition, because the State's short-term fixed income pool operates as a demand deposit account, amounts invested in the pool are classified as cash and cash equivalents. At June 30, 2002 the assets of the pool were comprised of U.S. Treasuries, U.S. Government agency debt, and other U.S. dollar-denominated bonds with residual cash invested in short-term money market instruments.

E. Loans Receivable

There are five sections of statutes that authorize commercial fishing loans to two-year Alaska residents. Each section has specific loan eligibility requirements and loan maximums. With the exception of AS 16.103.310 (B), the maximum single loan amount is $300,000. The maximum under section B is $100,000. A potential maximum of $600,000 to any individual at a given time from CFRLF exists due to the combination of various eligibility criteria. Types of loans include the purchase of limited entry permits, vessels, gear, and quota shares; the upgrade of vessels and gear to improve the quality of catch; the refinancing of existing CFRLF loans; and the refinancing of non-CFRLF loans for the purchase of vessels or gear. A sixth authorizing section of statute, for retirement of past due federal tax obligations, expired according to legislation effective August 1, 2002. Loans must be fully collateralized and are assumable by qualified Alaska residents. The Division of Investments is one of two entities allowed by statute to secure loans using limited entry permits. Loan applicants may not have past due child support obligations. Statutes governing CFRLF are contained in AS 16.10.300-370.

Interest rates are fixed at the time of loan closing. The rate is based on the bank prime rate listed in the *Wall Street Journal* during the preceding three-month period. The maximum term for new loans is 15 years, although terms may be extended for poor fishing seasons or adverse market conditions for Alaska products. A recurring interest rate reduction of one percent is applied if full loan payments are made timely. A one percent loan origination fee is charged on all new loan applications, including non-CFRLF refinance loans. A one-half (½) percent refinance fee is charged on CFRLF refinance applications. A $100 application fee is charged for all new loan and modification applications.

F. <u>Interest on Loans</u>

The accrual of interest income is suspended on loans considered by management to be impaired. Management considers loans to be impaired if they are delinquent or in foreclosure status. Loans are considered delinquent when payment of interest is contractually past-due more than 30 days.

G. <u>Troubled Debt Restructurings</u>

A troubled debt restructuring occurs when management, for economic or legal reasons related to a debtor's financial difficulties, grants a concession that it would not otherwise consider. CFRLF troubled debt restructurings mainly consist of one or both of the following modification of loan terms:

- Extension of the maturity date of the face amount of the loan
- Deferral of accrued interest

CFRLF accounts for its troubled debt restructurings in accordance with *FASB Statement No. 15*. Due to the inefficiencies in the subsidiary loans receivable system, the aggregate investment in loans with extended maturity dates could not be obtained. As of June 30, 2002 CFRLF had an aggregate investment in loans receivable for which interest had been deferred of $8,477,238. As discussed above, troubled debt restructurings may include extending the maturity date, deferring interest, or both types of modifications. Therefore, the aggregate invested in loans with deferred interest is a subset of the total aggregate investment in loans with troubled debt restructurings.

In accordance with an accrual basis of accounting, it is management's policy to recognize interest and record a receivable during the first or second fiscal year that interest is deferred through a troubled debt restructuring. The third time a loan is modified and interest deferred, the collectibility of revenue becomes suspect and interest is not recognized until payment is received. Under this policy, a total of $854,366 of deferred interest was recognized during FY 02 and $855,243 of deferred interest was not recognized.

H. <u>Allowance for Loan Losses</u>

The allowance for uncollectible loans is maintained at an amount management considers adequate to provide for estimated loan losses inherent in the loan portfolio. The allowance is based upon review and evaluation of the loan portfolio which considers many factors including: collateral, industry conditions, prior loan loss experience, trends in delinquency and foreclosure rates, and management's estimate of future losses. Allowances for loan losses are subjective and may be adjusted in the future depending on economic conditions.

I. Allowance for Deferred Interest Losses

The allowance for deferred interest receivable losses is maintained at an amount that management considers adequate to provide for estimated losses inherent in the receivable account. The allowance is based upon review and evaluation of the related loan portfolio, which considers many factors including: collateral, prior loan loss experience, loan restructurings, economic conditions, historic trend, and management's estimate of future losses and repayments. Allowances for deferred interest losses are subjective and may be adjusted in the future depending on trade and industry conditions.

J. Policy for Capitalizing Assets

The Division of Investments follows guidance in *Alaska Administrative Manual No. 55* when establishing a threshold for capitalizing equipment and software for the enterprise funds. In accordance with this policy, machinery, equipment, and software with a unit cost (including ancillary costs) of $100,000 or greater is capitalized. CFRLF had no capital assets as of June 30, 2002.

Note 2 – Loans Receivable

The total outstanding loan principal and amounts performing, delinquent, or in foreclosure are presented in the table below. In FY 02, 410 modifications were processed. This resulted in changes to existing terms and conditions of loans. Of the 410 modifications, 294 extended the maturity date of a loan which resulted in a loss of principal payments due in FY 02 and FY 03, respectively, of $197,216 and $371,815. The overall effect of these restructurings will increase total repayments over the life of a loan. In addition, 84 of these modifications took additional collateral to properly secure the loan balance due to the decrease in permit values used as collateral.

Loans Receivable Performance Measures:
As of June 30, 2002 there is $81,369,300 in total outstanding loan.

	Amounts (in thousands)	Percentage
Performing Status	$ 64,617.6	79.4%
Delinquent Status	$ 12,946.0	15.9%
Foreclosure Status	$ 3,805.7	4.7%
Total Loans Receivable	$ 81,369.3	100.0%
Less Allowance for Doubtful Accounts	$ (16,265.1)	20.0%
Net Loans Receivable Balance	$ 65,104.2	80.0%

Note 3 -- Economic Dependency

In accordance with its statutory mandate and authority, CFRLF's lending activity is limited to the Alaska commercial fishing industry. The industry is currently experiencing economic difficulties because of dramatically changed market conditions. Prices paid to harvesters have dropped dramatically and in some areas, such as Bristol Bay and Western Alaska, reduced fish returns have also adversely impacted CFRLF borrowers. Consequently, the CFRLF portfolio is subject to an increased risk of nonpayment. State officials, industry representatives and the legislature are currently working on changes that may improve the economic viability of CFRLF participants.

Note 4 -- Interfund Transfer

During FY 02, $175,000 was appropriated out of CFRLF to fund seafood inspections by the Department of Environmental Conservation.

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APPENDICES

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APPENDIX A

Comparison of CFAB and CFRLF
Specific Loan Information
For the Years 1998 through 2002

	1998		1999		2000		2001		2002	
	CFAB	CFRLF	CFAB	CFRLF	CFAB	CFRLF	CFAB	CFRLF	CFAB	CFRLF
Loan Balances ($ in millions)	31.3	80.7	29.8	77.8	28.2	77	31	78.6	28	65.1
Loan Originations ($ in millions)	4.3	12.1	5.8	4.9	4.9	7.9	8	10.3	2.5	6.2
Delinquent Loans (as a percentage of $)	24.30%	8.90%	21.60%	20.20%	11.50%	12.50%	14.90%	18.70%	21.50%	20.30%
Interest Income ($ in millions)	3.1	7.2	3.2	6	3.2	8	2.7	6.2	2.5	5.1
Interest Rate Range -- Low	8.00%	10.50%	8.00%	9.50%	8.00%	10.50%	8.00%	8.50%	8.00%	7.00%
Interest Rate Range -- High	11.00%	10.50%	11.00%	10.50%	11.00%	10.50%	11.00%	10.50%	11.00%	7.00%

APPENDIX B

Limited Entry Permit Statistics
Salmon Fisheries
By Area and Gear Type

Gear Type	Area	Permits Issued CY 2001	Permits Fished CY 2001	Permits Not Fished CY 2001	Permits serving as collateral on CFRLF loans as of 6/30/02	% of CFRLF Collateral Permits v. Permits Fished	% of CFRLF Collateral Permits v. Permits Issued
Drift Gillnet	AK Peninsula/Aleutian Island	160	137	23	33	24.09%	20.63%
Purse Seine	AK Peninsula/Aleutian Island	121	64	57	18	28.13%	14.88%
Set Gillnet	AK Peninsula/Aleutian Island	113	98	15	23	23.47%	20.35%
		394	299	95	74	24.75%	18.78%
Drift Gillnet	Bristol Bay	1,885	1,566	319	273	17.43%	14.48%
Set Gillnet	Bristol Bay	1,010	834	176	59	7.07%	5.84%
		2,895	2,400	495	332	13.83%	11.47%
Purse Seine	Chignik	98	92	6	27	29.35%	27.55%
Drift Gillnet	Cook Inlet	574	467	107	97	20.77%	16.90%
Purse Seine	Cook Inlet	83	25	58	10	40.00%	12.05%
Set Gillnet	Cook Inlet	744	505	239	36	7.13%	4.84%
		1,401	997	404	143	14.34%	10.21%
Beach Seine	Kodiak	34	0	34	2	0.00%	5.88%
Purse Seine	Kodiak	384	182	202	88	48.35%	22.92%
Set Gillnet	Kodiak	188	172	16	11	6.40%	5.85%
		606	354	252	101	28.53%	16.67%
Set Gillnet	Kotzebue	190	65	125	1	1.54%	0.53%
Set Gillnet	Kuskokwim	818	514	304	9	1.75%	1.10%

APPENDIX B
Continued
Limited Entry Permit Statistics
Salmon Fisheries
By Area and Gear Type

Gear Type	Area	Permits Issued CY 2001	Permits Fished CY 2001	Permits Not Fished CY 2001	Permits serving as collateral on CFRLF loans as of 6/30/02	% of CFRLF Collateral Permits v. Permits Fished	% of CFRLF Collateral Permits v. Permits Issued
Set Gillnet	Lower Yukon	701	0	701	51	0.00%	7.28%
Set Gillnet	Norton Sound	190	51	139	1	1.96%	0.53%
Drift Gillnet	Prince William Sound	541	522	19	145	27.78%	26.80%
Purse Seine	Prince William Sound	268	147	121	36	24.49%	13.43%
Set Gillnet	Prince William Sound	30	30	0	4	13.33%	13.33%
		839	699	140	185	26.47%	22.05%
Drift Gillnet	Southeast	482	433	49	106	24.48%	21.99%
Purse Seine	Southeast	415	345	70	57	16.52%	13.73%
		897	778	119	163	20.95%	18.17%
Hand Troll	Statewide	1,295	306	989	115	37.58%	8.88%
Power Gurdy Troll	Statewide	965	701	264	159	22.68%	16.48%
		2,260	1,007	1,253	274	27.21%	12.12%
Fish Wheel	Upper Yukon	157	0	157	1	0.00%	0.64%
Set Gillnet	Upper Yukon	72	0	72	0	0.00%	0.00%
		229	0	229	1	0.00%	0.44%
Set Gillnet	Yakutat	169	114	55	18	15.79%	10.65%
	Totals	11,687	7,370	4,317	1,380	18.72%	11.81%

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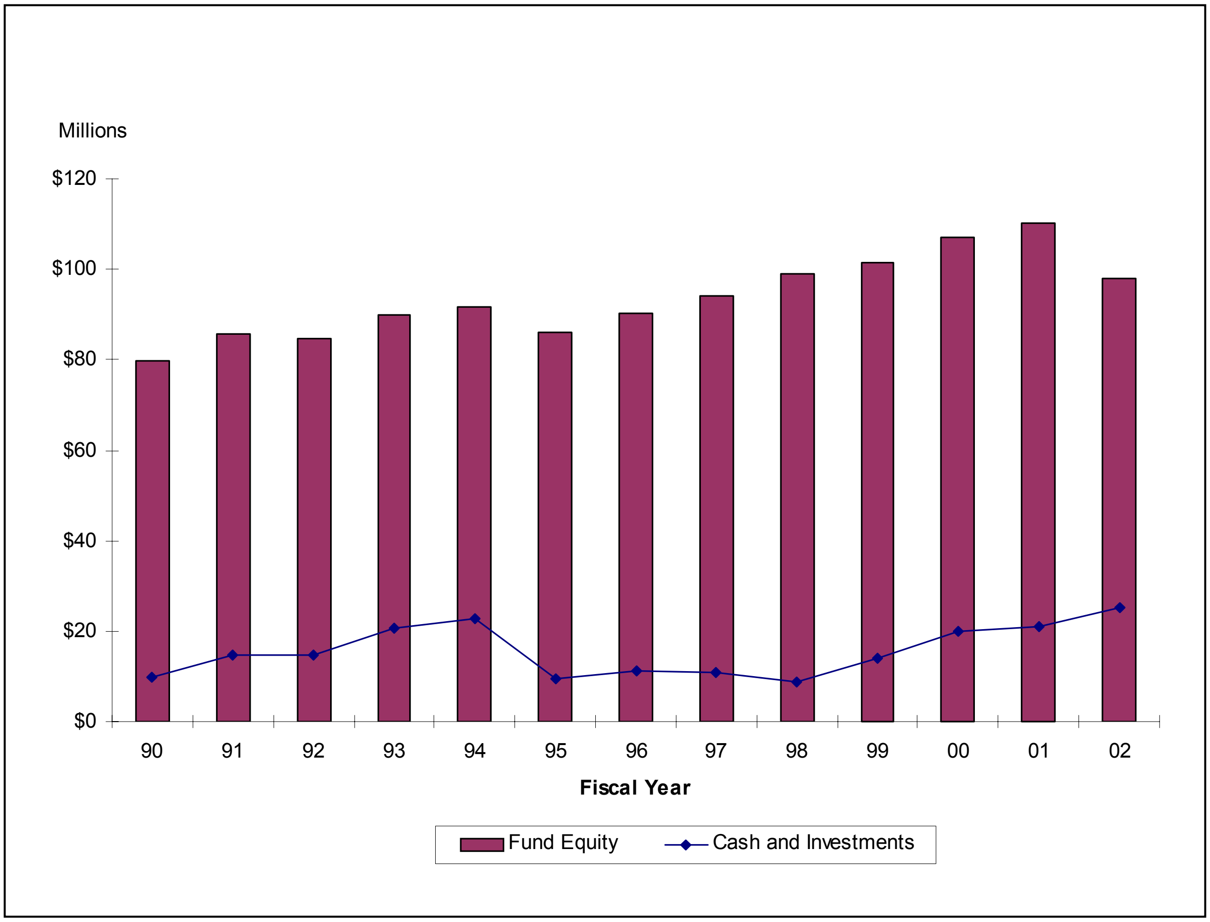
Appendix C

Cash and Investments Compared To Total Net Assets Commercial Fishing Revolving Loan Fund



The graph above illustrates the comparison of cash and investments to total net assets in the Commercial Fishing Revolving Loan Fund (CFRLF) since FY 90. As discussed in the Background Information section of this report, the fund was originally capitalized with $60 million and there have been subsequent withdrawals of cash totaling over $40 million.

The significant decrease in cash between FY 94 and FY 95 resulted from almost $10 million being transferred from CRFLF to the Fisheries Enhancement Revolving Loan Fund. The decrease in total net assets between FY 01 and FY 02 was primarily due to the revised method for estimating loan losses.

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April 16, 2003

Ms. Pat Davidson
Legislative Auditor
P.O. Box 113300
Juneau, AK 99811-3300

Dear Ms. Davidson:

RE: Preliminary Audit Report 08-30022-03

The Department of Community and Economic Development received your Preliminary Audit Report dated March 18, 2003 and very much appreciates the opportunity to provide written comments concerning the findings and recommendations contained in the report.

Recommendation No. 1

We recommend the commissioner of the Department of Community and Economic Development coordinate with the governor's office to ensure that the CFRLF's policies and regulations remain consistent with overall public policy goals.

We agree with this recommendation and will implement a process to involve the Governor's Office in CFRLF program changes that affect public policy goals.

Recommendation No. 2

We recommend the director of DOI reevaluate the benefits provided by the pay-on-time program in light of the substantial administrative inefficiencies of the program.

We agree with this recommendation. Administrative costs associated with the program are more than anticipated when the program was created. DOI is in the process of purchasing a new software program that could substantially lower these costs in the near future. We will weigh existing and estimated administrative costs for the program against the benefits provided, discuss this information with the Governor's Office and make a decision regarding the future of this program.

Recommendation No. 3

We recommend the director of DOI take steps necessary to ensure EVOS assignments are not accepted when alternative collateral is available.

EVOS assignments are only utilized when a borrower requests a loan extension and the loan is no longer adequately secured or as a part of a final settlement agreement. As a general rule, EVOS assignments are taken as a last resort, however, we will modify our existing loan extension policy (LB 12) to make it clear that EVOS assignments are only taken after other collateral options (excluding personal residences) have been exhausted. Under existing policy, we do not require borrowers to put up personal residences that would qualify for a homestead exemption under AS 09.38.010 as a condition of receiving a loan extension.

Recommendation No. 4

The director of DOI should change its current policy to ensure EVOS settlements are applied to interest first.

Current policy (SB 15) provides that funds be applied in a variety of ways depending on the status of the loan. For example, in cases where the loan is delinquent monies are first applied to past due payments to bring the loan current. If a loan is in modification or settlement status funds are applied as stipulated in the executed legal documents. In cases where the loan is current, funds are applied as directed by the borrower. If the borrower does not indicate a preference, funds will be applied first to the principal balance. Crediting the principal balance first helps borrowers deal with very difficult market conditions that exist today by lowering their debt more quickly. The tradeoff, however, is a reduced amount of interest eventually received by the fund. The department will consider amending this policy as it relates to current loans after discussing the policy ramifications with the Governor's Office as suggested in recommendation No. 1.

Recommendation No. 5

We recommend the director of DOI coordinate with other state agencies when replacing the current loan subsystem.

We agree with this recommendation and have included language in the software requirements document stipulating that the new system provide extensive financial reporting capabilities as well as the ability to interface with the state accounting system and credit reporting agencies.

Recommendation No. 6

The director of DOI should change several loan servicing policies to improve administration of the program.

Accelerate Payments

Loan officers review loan applicant's income sources prior to making decisions on payment due dates. In the majority of cases annual payments are the only viable option however other payment schedules such as monthly are utilized. DOI will amend the Lending Branch policies and procedures to encourage monthly, quarterly, or semi-annual payment schedules when appropriate.

Borrowers' ability to meet their current loan payments should be considered when evaluating an application for a new CFRLF loan.

Division policies (LB 1 (6), LB 2 (7), LB 3 (8), LB 4 (12) and LB 6 (10)) contain provisions that borrowers "should have no poor past payment record with state agencies." This includes both active and retired loans made by the division. Loan officers consider payment history as well as debt service ability when making decisions on new loans. In addition, existing policies require loan officers to review deferred interest receivable account balances when evaluating the credit history and repayment ability of the applicant.

Consider Living Expenses when evaluating applicants' ability to service debt.

Living expenses have always been considered when evaluating the ability of loan applicants to service the debt. Loan Committee memorandums include a "Living Expenses" line item in the debt service calculation and loan officers have consistently included this information as a part of their evaluation process. This requirement has also been clearly spelled out in current policies and procedures.

Recommendation No. 7

<u>**The director of DOI should ensure that the availability of other financing is thoroughly documented and considered during the loan application process.**</u>

Prior to February 2001, the division evaluated and qualified some applicants under AS 16.10.310(a)(1)(C) without requiring a denial letter if it was obvious the borrower did not meet private sector lending criteria. This allowed those applicants to avoid the additional time and expense involved in going through the application process twice. Loan officers were instructed to include the basis for their decision relating to this requirement in the loan committee memorandum. In February 2001, the policy was modified to require denial letters as a part of these applications to insure that all applicants seeking loans to purchase quota shares met this requirement. In addition, the division modified the loan committee memorandum macro to insure that Loan officers address this requirement for all applications considered under AS 16.10.310(a)(1)(B) and AS 16.10.310(a)(1)(C). Division managers will carefully review loan files during the post review process to sure that this requirement is met.

Clarifications

Page 3 of the report discusses the types of loans that can be made under the CFRLF. It should be noted that loans to pay IRS obligations are no longer available as that section of the statute sunsetted on August 1, 2002.

On pages 9 and 10 the report discusses changes that were made to the program in response to industry problems. I think it is important to note that the regulation change that tied the interest rate to the prime rate was done primarily for two reasons. First, it insured that the statutory requirement of providing "low interest" loans would be met regardless of interest rate changes taking place in the market. Secondly, it regulated the amount of subsidy associated with the program regardless of rate changes in the marketplace. The statutory change allowing CFRLF borrowers to refinance existing loans, coupled with falling interest rates in the market, allowed a large number of Alaskan harvesters to reduce their interest rates and loan payments.

In the first paragraph on page 10 it is important to note that borrowers must have maintained Alaska residency in order to refinance existing CFRLF loans.

In the last paragraph on page 15 it is important to note that borrowers are made aware of their deferred interest indebtedness at the time that a loan modification is signed. The report also questions the ability of borrowers to make the balloon payments created in cases where the deferred interest receivable is deferred to maturity. It should be noted that the division has the ability and the desire to work out a new payment schedule with these borrower at the time that the balloon payment is due.

Thank you for the opportunity to provide comments. The Department of Community and Economic Development very much appreciates the time and effort you and your organization put into this audit.

Cordially,

Edgar Blatchford
Commissioner

April 22, 2003

Members of the Legislative Budget
and Audit Committee

We have reviewed the Department of Community and Economic Development's (DCED) response to our audit report. Nothing contained in the response gives us cause to reconsider our conclusions. However, we do have the following additional comments regarding the department's response to Recommendation No. 6.

DCED indicates that living expenses are currently considered when evaluating loan applicants' ability to service a commercial fishing loan. However, our interviews with staff concluded that living expenses were not always considered during this evaluation. Further, living expenses (including rent) were excluded from the debt/income ratio which DCED uses to help evaluate repayment ability.

We agree that DCED revised policies and procedures clearly require the inclusion of living expenses during the evaluation process. This change should help assure proper evaluation in the future.

In summary, we reaffirm the findings, recommendations and conclusions contained in this report.

Pat Davidson
Legislative Auditor