RURAL TELEPHONE BANK PRIVATIZATION STUDY
EXECUTIVE SUMMARIES
AND RECOMMENDATIONS

January 2003

EXECUTIVE SUMMARIES AND RECOMMENDATIONS

Table of Contents

Description **Page**

Executive Summary 1
1.0 Introduction 1
2.0 Financial Model 3
3.0 Asset Liability Management 5
4.0 Regulatory Review 7
5.0 Legislative Assessment 9
6.0 Market Assessment 13
7.0 Organizational Review 15
8.0 Transition Plan 17

Sections

Tab 2 - Financial Model
Tab 3 - Asset and Liability Management Report
Tab 4 - Regulatory Review
Tab 5 - Legislative Assessment
Tab 6 - Market Assessment
Tab 7 - Organizational Review
Tab 8 - Transition Plan

EXECUTIVE SUMMARIES AND RECOMMENDATIONS

Executive Summary

In 1971, the Rural Electrification Act (RE Act) was amended to create the Rural Telephone Bank (RTB) for the purpose of providing supplemental financing for rural telecommunications companies and cooperatives eligible to borrow under the RE Act's telephone loan program. To provide "seed" money to start the Bank, annual Federal Government appropriations of approximately $30 million were made in return for RTB Class A stock. The total Government investment was just over $592 million.

The Bank has been retiring Class A stock on an annual basis since 1996 and, as of September 30, 2002, has retired approximately 27 percent. The RE Act states that at the point at which 51 percent of the Class A stock has been retired, the Bank is no longer a Government agency and control of the Board shifts to the publicly elected members. The Administration is proposing to privatize the Bank as soon as possible.[1] To help prepare for a privatization option, early in fiscal year 2002, the RTB Board of Directors and Bank management initiated a study of the effect of privatization on the continuing operation and long-term viability of the Bank.

The study included a number of topical reports and has gained insight from extensive discussions with the RTB Board, RTB management, and other RTB stakeholders. These reports included an asset and liability management (ALM) report, a regulatory concerns report, a market assessment, a legislative assessment, an organizational review, and a transition plan. In addition, a financial model of the Bank was developed to support analyses related to different privatization scenarios. Based on this work, the following considerations are presented to the RTB Board for its review:

1. Legislative changes are needed to the RE Act to ensure that the private Bank has the freedom it needs to compete in the private sector. Without changes to the RE Act or continued Government support, it is unlikely that the private Bank would be financially viable over the long-term.

2. A transition period of 18 months is proposed to facilitate an orderly transition of the Bank's operations from those of a Government agency to a fully operational private Bank. A Transition Team, consisting of employees on assignment from the Rural Utilities Service (RUS) with private sector support, would be needed to implement the proposed plan. The completion of transition-related activities within the proposed 18-month period will require an extensive amount of time and cooperation on the part of the Bank's Board, RUS and other parts of the Department of Agriculture (USDA), the Office of Management and Budget (OMB), and the Department of Treasury (Treasury).

[1] The President's Fiscal Year 2003 budget request included no additional funding for new loans and stated that the Bank was financially able to privatize by the end of 2003.

3. An understanding will need to be reached between the Bank and USDA, OMB, and/or Treasury regarding the transfer of the Bank's assets and liabilities to the private Bank. This understanding will need to address the transfer of all of the Bank's assets including intellectual property to the private Bank. It will also need to address any Government continuing liability for commitments entered into prior to the Bank's privatization. For example, continued access to Treasury debt may be required to finance unadvanced commitments on loans that were authorized by the Government prior to privatization and then transferred to the private Bank.

4. The private Bank could be financially viable structured as either a finance corporation or a cooperative. Employing a ranking process for the unique attributes of each structure will assist the Board in identifying the optimal organization structure for the private Bank during the proposed transition.

5. Given that the Bank has expressed its desire to continue to focus on serving the rural telecommunications market, the Bank's ability to leverage its assets to the levels typical of a commercial bank or finance company (e.g., a debt-to-equity ratio of 90:10) will be limited by competition and the number of new loans or other offerings the Bank may be able to make each year without unduly increasing its risks. Therefore, shareholders will need to understand that the Bank's initial returns may be low in comparison with other commercial banks or finance companies for a number of years until the Bank can fully leverage its assets.

6. The financial model developed for the Bank using a reasonable set of assumptions reflecting the privatization scenarios reviewed indicates that the Government's Class A stock could be repaid in full during the Bank's transition from a Government agency to a private Bank without adversely impacting the Bank's long-term viability. However, the more capital that remains in the bank at privatization, the more resources would be available for support to the rural telecommunications industry.

7. It is estimated that the rural telecommunications market has capital needs of nearly $5 billion per year, 50 percent of which is projected to be the Bank's primary target market. There is a continuing need for low cost financing and the private Bank will be able to help fill a part of this demand with loans similar to those already being offered by RUS and RTB, and through new offerings that could be considered by the private Bank (e.g., variable rate loans, loan guarantees). If the Bank were able to capture between 10 and 25 percent of the target market this would amount to new loans of $240 million to $600 million per year.

8. For the private Bank to continue to be a low-cost supplier to the rural market, it will need to maintain a very high credit rating. Instituting an ALM and risk management process, with similar performance measures as those used for commercial banking institutions (e.g., CAMELS: Capital, Asset Quality, Management, Earnings, Liquidity, Sensitivity), will assist the Bank in maintaining a level of portfolio risk that is consistent with the risk strategy of the RTB Board. This will also assist the Bank in

meeting the requirements that are likely to be set forth by the credit rating agencies. The rating agencies' determination of the privatized Bank's strength, operational credit and capital considerations will be a vital component in the Bank's long-term success.

9. During and following the transition, an outreach program to the Bank's shareholders and other stakeholders is needed to keep all interested parties informed of the Bank's movement towards privatization, retain the Bank's customer base, and gather input that needs to be considered during the transition.

10. The scope of this study did not allow for a legal analysis of the issues surrounding the Bank's privatization. Legal considerations associated with the privatization will need to be reviewed in detail before and during the transition.

(This page intentionally left blank.)

1.0 Introduction

In support of the privatization of the Rural Telephone Bank (RTB), the RTB Bank management engaged a team led by Science Applications International Corporation (SAIC) and including BearingPoint (formerly KPMG Consulting) to review a number of issues related to the Bank's privatization. This paper will discuss the issues that were studied and present a summary of the findings associated with each. The following deliverables are summarized in this report and presented in their entirety in the Appendixes:

- a financial model for use in analyzing various privatization scenarios and their projected effect on the Bank's financial condition
- a report on asset liability management (ALM) policies, issues, and concerns
- a summary of the impact of regulatory considerations and issues on how the private Bank could be established and organized
- a legislative assessment of changes to the RE Act that need to be considered to assure long-term financial viability of the private Bank
- a market assessment of rural telecommunications financing needs
- an organizational review
- a Government agency to privately-owned Bank transition plan

(This page intentionally left blank.)

2.0 Financial Model

A financial model was created of the RTB, as both a Government agency and a privatized entity. The financial model is a tool that uses algorithms to produce a statistically distributed range of results based on a large number of input variables. The output of the model includes standard accounting pro forma financial statements and the particular business scenario selected by the user. In addition, the model allows the user to understand which variables have the greatest impact on the estimated profitability of the privatized Bank using Monte Carlo simulation and sensitivity analysis. (See Appendix A for a more detailed description of the financial model.)

The financial statements output by the model present operating results for three years before privatization and several years following privatization. At privatization, several changes occur to the RTB's assets, liabilities, equity, income, and expense accounts that are reflected in the model's output.

Some of the most significant input variables of the model include the timing and method of retiring Class A stock, lending rates, and lending volumes.

The model allows for three methods of retiring A stock:

1. retire with cash
2. retire with cash and issue debt
3. the Government abrogates the remaining outstanding Class A stock

With Class A stock, if method 1 is chosen all of the Class A stock will be retired with cash in a single year or over a multi-year period. If method 2 is selected, debt is issued and interest payments are made on the new debt. Method 3 simply eliminates the balance of Class A stock (or Treasury debt) and reports the change on the Bank's income statement as extraordinary income.

Lending rates is another set of major variables allowed by the model. The model allows the user to input a spread above the RTB's cost of money, which is based on the one-year risk-free rate and the twenty-year risk-free rate, for a number of different variables. Spreads on cash, Treasury debt and private debt reference the one-year risk-free rate and the twenty-year risk-free rate directly. By referencing the risk-free rates, the model takes into account prevailing market interest rates, which are designated by the user and may be easily found in the *Wall Street Journal*. Spreads above the Bank's cost of money are used to determine borrower rates on new loans.

Lending volume (loan advances) is another set of key variables. Annual loan advances for liquidating, financing, and other private loans may be input into the model by the user. For liquidating loans, the amount represents loan advances on liquidating loans before privatization, and loan advances on private liquidating loans after privatization. The same is true for financing loans. For new, private loans, a starting volume can be input as well as a targeted volume after 10 years of private operations to show how the Bank could build up its loan portfolio over time.

The user can vary the Bank's administrative costs, corporate tax rate, and targeted debt to book value ratio. Additional variables influence the results of the model, with several included for designating asset, liability and equity balances at the beginning of the first year of the model run so that the model can be easily updated, allowing the Bank's latest internal financial information to serve as the starting point.

The output of the model includes a statement of operations or income statement, a balance sheet, a sources and uses of cash statement, and a statement of net interest spreads as some of the primary reports. Of course there are several limitations in running a forward looking model and any such review comes with qualifications.[1] The primary objective is to provide working model that will support a wide range of analyses to allow the Board to understand various options the Bank may want to consider as it moves towards privatization.

[1] SAIC does not endorse or guarantee the Bank's financial results, the financial model was designed to allow the user to study operations of the privatized institution through the selection of values for a number of different variables that could affect the Bank's profitability. Actual results are dependent on these variables playing out as forecast including, for example, the Bank's ability to increase its loan advances and control its operating expenses.

3.0 Asset Liability Management

ALM concerns that would pertain to the RTB after it privatized were reviewed. (See Appendix B for the ALM report.) The results of this review identified a number of considerations for the RTB Board to address as it develops an ALM strategy and process to be used by the private Bank.

1. Instituting an ALM process would assist the RTB in managing its portfolio risk so that it is consistent with the risk and return goals established by the RTB Board. Such a process would include:
   - Procedures and practices that control the interest rate risk taken
   - Adequate systems for identifying and measuring interest rate risk
   - A system for monitoring and reporting risk exposures on a timely basis
   - A system of internal review and audit to ensure the integrity of the process

2. Rating agency and capital preservation considerations will drive the cost of funds available to the RTB after privatization including the following key items that the Bank's ALM strategy will need to address:
   - Adequacy of Loan Loss Reserves
   - Loan collateral, diversification of the portfolio, and concentration within a single industry (e.g., the rural telecommunications industry)
   - Adequate capital to absorb the risk associated with RTB's limited business focus (i.e., rural telecommunications)
   - Loan terms and conditions that include prepayment constraints and lending commitments tied to the changing interest rate markets

3. A viable ALM process assumes consistency with the risk strategy of the Bank's Board, comprehensive information is available to make decisions, consistent measurements that can be translated into protective actions are made, and reasonable trade-offs between timeliness and precision exist.

4. To control risk exposure, the ALM process should reflect sensitivity to interest rate changes and their impact on interest income, earnings, net portfolio value, and capital. Interest rate sensitivity risk comprises repricing risk, yield curve risk, basis risk, and options risk. Management will likely be the most important issue during the transition to a private institution. Asset quality and earnings of the bank will prove as important in the initial phases of operation after the transition. Ultimately, capital and liquidity may become critical issues depending on how and when the Government's interest in Class A stock is repaid

5. Gap analyses, sensitivity analyses, and simulations should be instituted for all interest-rate sensitive assets and liabilities.

6. Although the commercial bank structure was eliminated from the alternative structures under consideration, the RTB should adopt the key performance measures included in the commercial bank rating system as a means of judging the Bank's performance (i.e., CAMELS - Capital, Asset Quality, Management, Earnings, Liquidity and Sensitivity).

4.0 Regulatory Review

The regulatory review identified the attributes of the Cooperative and the Finance Company structures being considered for the private Bank.[2,3] (See Appendix C for the full regulatory review.) A decision process that ranks the attributes as to their importance to the RTB Board and the stakeholders will assist in making the final decision on the optimal structure for the private Bank.

1. A cooperative association organization structure would typically have the following attributes:
   - Capital contributions can be required of members
   - Offers the ability to avoid or significantly reduce income taxes
   - Limited return on capital (could be put in the bylaws)
   - Vast majority of business is typically done within the required membership
   - Members are generally seeking the same benefits from the cooperative
   - One vote per member governance
   - Ability to issue multiple classes of stock
   - Subject to certain guiding principles established by the cooperative
   - Allowed to issue certificates of indebtedness
   - Patronage dividends distribution at the end of the year after certain amounts have been set aside for reserves
   - Each state has its own laws and regulations, some states restrict operations or ownership
   - Possible restrictions on earnings may limit capital market or outside investor attractiveness
   - Cooperative education or special contingency requirements may require some funds be set aside

   RTB currently operates as a hybrid. It is a corporation but it operates similar to a cooperative in many ways. For example, shareholders currently have only one vote regardless of how many shares of the Bank's stock they may own[4], borrowers are required to purchase stock and become shareholders of the Bank whenever they take out a loan, and patronage dividends are allocated to shareholders at the end of every

---

[2] The Privatization Committee of the RTB Board eliminated the Commercial Banking option during an early working session primarily due to the Board's desire to continue to serve rural communities as a source of financing for rural telecommunications. Additional considerations include loan portfolio constraints over concentration and diversification, and regulation burdens focused at carrying deposits; which were not objectives for the privatized institution.

[3] RTB management stated early in the study that the Administration would not support transition of the Bank to a Government-sponsored enterprise so this option was eliminated from consideration.

[4] Per Section 406 (b) of the Rural Electrification Act of 1936.

year. Several of the attributes listed above could lower the Bank's cost of funds and help interest rate offerings but may also limit the opportunities open to the private Bank.

2. A finance company organization structure would typically have the following attributes:
   - Most often organized as Corporations, governed by general corporate law and primarily the Corporate Charter
   - Customary to allow one vote per share, although could be restricted by charter
   - No guiding principles/restrictions
   - Ability to issue multiple classes of stock
   - No restrictions on income or return on capital
   - Able to declare dividends at the discretion of the Board
   - No restrictions on ownership
   - No restrictions on customers and or lines of business
   - Able to make riskier investments
   - Each state has its own corporate laws and regulations, and some states have capital requirements for finance companies
   - Board make-up usually determined by largest shareholders
   - Subject to state consumer protection and usury laws
   - Subject to income taxes
   - Generally higher loan default rates than those seen by a cooperative
   - Higher expectations on the part of investors in terms of return on equity

   RTB is currently chartered as a corporation under the RE Act. A corporate structure similar to the current RTB could be established in the corporate bylaws and articles of incorporation. Several of the attributes cited above could challenge the Bank's ability to keep down its cost of funds and interest rate offerings, but a corporate structure would offer the private Bank the most freedom and flexibility.

5.0 Legislative Assessment

Legislation governing the RTB operations (mainly the RE Act) would be restrictive to private bank operations. If the legislation and associated implementing regulations are not amended in a manner such those suggested herein, the private Bank would be unable to compete on an even footing in the private sector and would be unlikely to have any long-term financial viability. Therefore, it is recommended that legislative changes such as those described below be considered by the RTB Board of Directors and be pursued in a manner that would allow the changes to be made before the Bank is privatized. (See Appendix D for the full legislative assessment.)

1. *Change the manner in which interest rates are determined for new loans.* The interest rates charged on RTB loans are set using a formula set forth in Section 408 of the RE Act. This formula does not allow for the inclusion of administrative costs, profit, the marginal cost of money, or the costs of equity beyond dividends paid on outstanding stock. Also, under normal circumstances, a private bank would offer borrowers different interest rate loans depending on the perceived risks associated with the project being financed and the overall financial stability of the borrower. The RE Act does not allow for such differentiation. Without the ability to recover these normal costs of doing business, the Bank will not sustain long-term financial viability.

2. *Allow the Bank the ability to offer other products.* Sections of the RE Act now limit the Bank's ability to offer any loans other than "cost of money" loans. In addition, the legislation limits the purposes for which loans can be made. All RTB loans are secured loans with collateral being offered by the borrower. The RE Act also limits the size of the communities that the Bank may serve. As a private Bank there may be opportunities to expand the services provided by the Bank to the rural telecommunications community through the offering of other products such as variable rate loans, unsecured or subordinated debt, loan guarantees, etc.

3. *Provide the Bank with the ability to earn a reasonable servicing fee on the Financing Account loans since the interest charged on these loans does not currently cover the cost of administration.* Upon privatization, the Bank will be responsible for administering approximately $400 million of financing account loans (i.e., direct loans obligated after FY 1991) and the potential for over $500 million of loans that will have been committed by the Government but are unadvanced on the privatization date. The costs associated with servicing these loans are currently funded through appropriations and are not included in the interest rate formula set forth in Section 408 of the RE Act. Once the Bank is privatized, it is assumed that appropriations will no longer be available to cover these costs so it is imperative that language be included in legislation to allow the Bank to keep some percentage of the interest being collected on these loans to cover, at a minimum, its administrative costs. Otherwise, the Bank will have to operate at a loss on these loans and its probability of success over the long-term will be diminished.

4. *Provide the Bank with continued access to Treasury debt after privatization that is tied to prior Government commitments.* Transfer of the Bank's unadvanced loan commitments to the private Bank will cause it to have to advance funds, as requested, on a large number of loans made by the Bank prior to privatization. It is estimated that there will be approximately $1 billion of unadvanced loan commitments transferred to the private Bank.[5] These loans will require the private Bank to continue to abide by the interest rate formula set forth in the loans themselves. Borrowers may not exercise these commitments if their calculated interest costs are no longer based on the Treasury rate, but on higher private debt rates. This could result in a significant loss of income to the private Bank. In order to maintain the existing loan portfolio and customer base, language should be included in legislation to, at a minimum, allow the private Bank continued access to Treasury debt as long as the Bank continues to advance funds on loans made by the Government prior to the Bank's privatization.

5. *Clarify the timing and method of retirement for the remaining Class A stock after the privatization point has been reached.* There is no discussion in the RE Act on the timing or method of retiring the remaining Class A stock after 51% of the stock has been retired other than to state that the stock should be retired as quickly as possible "but not to the extent that, the Telephone bank Board determines that such retirement will impair the operations of the telephone bank." There is a concern that if the Bank were required to retire all of the Class A stock upon privatization, the resulting reduction in the Bank's cash reserves would weaken its position with financial rating agencies and could be perceived as a loss of support on the part of the Government. The RE Act also refers to a requirement that at least as much Class A stock must be retired each year as Class B stock is sold but after privatization there may no longer be Class B stock since it could be converted to some other type of stock such as common stock. To place the Bank in the best position to continue to support the rural telecommunications community over the long-term, language should be included in legislation to allow the Bank the option of paying off the Class A stock through a loan from Treasury. This would allow the Bank to immediately pay off the Class A stock, increasing the Government's return on these funds from the 2 percent dividend currently received to the interest rate for long-term Treasury notes, currently approximately 5 percent. In addition, it would consolidate the Government's interest in the Bank as a creditor of the Bank, improving the Government's standing in the unlikely event of a bankruptcy.

6. *Support a transition period to allow the Bank to transition from a Government agency to a private entity.* To enhance the probability of continued success for the private Bank, it will be necessary to undertake an orderly transition from a Government agency to a private Bank. During this transition period, steps must be taken to position the private Bank to serve the rural telecommunications community and operate efficiently without delay at privatization. For this transition to be successful, it will need to be supported by a transition team made up of employees at

[5] As of September 30, 2002, RTB's unadvanced loan commitments totaled $1,186,000,000. (Report of the Treasurer, Rural Telephone Bank Shareholders' Meeting, November 15, 2002, page 6.)

RUS that are currently involved with the Bank and others. This transition team will need continued access to USDA facilities and personnel to collect information on the assets (including systems, policies, and procedures) and liabilities that will be transferred to the private Bank. Finally, the transition will require funding beyond that normally appropriated to the Bank for administrative costs. Language should be included in legislation to specify how the cost of the transition will be shared between the Government and the Bank, that Bank funds can be used to support transition-related activities, and to encourage an orderly transition period and transfer of assets to the private Bank.

7. *Provide guidance on the transfer of the Bank's assets including intellectual property.* There is not currently any clarifying language in the RE Act as to the assets beyond those listed on the Bank's balance sheet that will transfer to the private Bank upon privatization. Besides the obvious assets that will need to transfer to the private Bank such as cash and loans receivable, there are other assets in the form of intellectual property that will need to transfer as well. For example, this intellectual property may include the systems, books, and spreadsheets used currently to keep track of loan payments, estimated interest receivable, amortization schedules for outstanding loans, loan activity, histories and data, etc. Language should be included in legislation clarifying that all assets, including any intellectual property associated with RTB, will transfer to the private Bank upon privatization.

8. *Provide guidance on the transfer of the Bank's liabilities including the Government's continuing responsibility for decisions made prior to the Bank's privatization.* In addition to all liabilities on the balance sheet that will transfer to the private Bank upon privatization, there are other potential liabilities and considerations that may not be reflected in the Bank's financial statements that need to be considered prior to privatization. For example, one concern is possible financial, default, and/or environmental liabilities associated with collateral security interests being transferred to the privatized bank associated with loans approved by the Government prior to privatization. Language should be included in legislation clarifying that the private Bank shall be liable for any liabilities arising out of its operations after the privatization date and that the Government will continue to be responsible for any liabilities and contingent liabilities associated with bank operations or commitments made by the Government prior to privatization.

9. *Clarify the Bank's relationship with other Government or RUS telecommunications-related programs after privatization.* After privatization, the Bank will be subject to the competitive pressures of the marketplace. Included in these competitive pressures are the other telecommunications programs of RUS. Under normal business practices, when a subsidiary is spun off from the parent corporation or sold to another company, it is common for the parent corporation to enter into a non-compete or exclusivity clause for some period of time. Because the private Bank will continue to serve the rural telecommunications community, some accommodation should be allowed for a reasonable period of time that would lessen the competitive pressures placed on the private Bank from Government programs. This may include offering

the private Bank the right of first refusal to act as a concurrent lender on RUS telecommunication loans for a period of time. Language should be included in legislation to offer the private Bank some protection from direct Government competition to increase its likelihood of long-term success.

10. *General Duties and Prohibitions.* Under Section 206(a) of the RE Act, the RTB is required to publish "all rules, regulations, bulletins, and other written policy standards governing the operations of the telephone loan and loan guarantee programs" in accordance with the Government's standard rulemaking requirements as set forth in Section 553 of Title 5, United States Code. As a private Bank, RTB will face the competitive pressures of the marketplace. It is expected that it will need to significantly change its policies and procedures to be successful in this venue and these changes cannot be subject to Government rulemaking. Legislation should be amended to clarify that restrictions such as those stated in Section 206 do not apply to the private Bank and/or the loans it issues. Otherwise, the private Bank will be operating on a different set of rules than other private businesses and such differences could adversely affect the Bank's ability to be successful and offer competitive products to its customers.

11. The Bank should require a financial audit as of the effective date of the transition from a public entity to a privately owned entity.

6.0 Market Assessment

The Market Assessment identifies ten key issues for consideration in the privatization plans for the RTB. This study estimated the total capital expenditure (CAPEX) needs of rural carriers and the allocation of their CAPEX needs to specific telecommunications business and technology initiatives. The study's results are based on extrapolating the results from a series of interviews with rural carriers that were considered representative of a population of over 1,300 carriers using a stratified sampling approach. Included in the total population in the survey frame were over 700 RTB borrowers. (See Appendix E for the entire market assessment report.)

1. The telecommunications industry in the U.S. has never been through a more turbulent time in history. The ongoing announcements of bankruptcies and financial instability of even the largest telecommunication firms are tarnishing the industry and impacting stock values, thus negatively impacting sources of capital.

2. Similar to larger carriers, revenues have declined for rural local exchange carriers (RLECs) as a result of a loss of access lines due to the recession and subsequent weak recovery, and a loss of access minutes due to the substitution and use of mobile phones.

3. In order for RLECs to mitigate the revenue downturn for wireline services projected in the coming years, carriers must reduce expenses, introduce new services into their portfolios, institute capital savings plans by capping investment in circuit switched based service infrastructure and equipment, and/or invest in more cost effective technologies.

4. Annual rural telecommunications capital spending is estimated at $4.8 billion. Internal funding by rural carriers is estimated to serve roughly 50 percent of this demand. The remaining 50 percent (about $2.4 billion) is considered open to the traditional rural loan market. Financing by other lending institutions such as RTFC or CoBank, and leasing arrangements serve to reduce RTB's addressable market share in this traditional market.

5. The RTB addressable rural loan market is estimated to range from 10 to 25 percent of the traditional rural loan market depending on RUS's continued support of the telecommunications program, leaving the private Bank's annual market share potential ranging from $240 million to $600 million.[6]

6. Our survey results shows annual CAPEX spending allocation is estimated to breakdown as follows:

    - Approximately 33% for Plant Construction & Upgrades

[6] RUS and RTB were authorized to enter into cost of money loans and issued commitments for $475 million in 2002.

- Approximately 25% for Switches and Switch Upgrades
- Approximately 14% for Overbuild/CLEC Operations
- Approximately 12% for DSL Equipment
- Approximately 10% for Mobil Services
- Approximately 6% for Long Haul Connections

7. Many survey respondents indicated a need for capital funding or loans in the area of cable/video plant, mobile infrastructure and CLEC/overbuilding ventures -- areas not traditionally served by RTB or with heavy limitations. Others are providing loans for these areas and RTB may be able to further enhance its competitive position by providing more flexible financing arrangements after the Bank is privatized.

8. Additional market analysis is needed to further explore RTB's position in the rural telephony financial marketplace. A larger survey sample with more product focused information on how and where RTB could meet the CAPEX spending demand would substantiate final product development and provide emphasis, direction and plans for marketing privatized offerings.

9. RTB needs to continually understand the significant market and technological trends affecting the telecommunications industry and their impact on RLECs. It is also necessary to understand the key business directions that the rural telephone carriers are undertaking in terms of capital and operational investments for sustaining and growing their businesses.

10. Survey respondents confirmed their requirements for RTB to continue to provide low interest funding to the rural telephone communities, and stressed the importance of efficiency and effectiveness of loan application requirements and processes. They see some of RTB's current lending requirements as overly burdensome, and the process often slow in meeting their required capital commitments in a rapidly changing environment.

7.0 Organizational Review

The Organizational Review highlights key findings for consideration as the Bank pursues privatization alternatives and strategies. This study is an initial effort to craft an organizational blueprint and identify operational costs and considerations. (See Appendix G for the full organizational review.) The areas that need to be considered as part of a successful privatization are summarized below:

1. The Privatization Committee agreed that the following mission statement reflected the Bank's continuing mission even after privatization:

   The Rural Telephone Bank mission is to provide quick turn-around, low cost and specialized lending to the rural telecommunications community; we accomplish this through a commitment to quality professionals and protecting our growing capital investment, while expanding the interests we serve.

2. The stakeholder outreach program confirmed the mission and some of the key Bank's success factors for privatization; the results are built into the analysis and design of the Bank's operations. The top items included: asset and shareholder value protection, continued commitment to financing the needs of the rural telephone marketplace, a sound business plan, expanding the product offerings and streamlining the Bank's requirements.

3. To continue to create value for its customers and shareholders, the Bank's proposed organization requires staff who understand the rural telephone market, product and business development, service through the loan life-cycle, low cost sources of capital, sound asset liability management, and well documented planning, risk and legal protections. Two organizations have been proposed that should allow the Bank to accomplish its privatized mission. It is estimated that the Bank will require a staff between 35 and 52 employees and start with a number of functions outsourced. As more experience is gained, the Bank might need to adjust its organization.

4. The proposed organization structure, board structure and estimated operating expenses act as a benchmark for projecting reasonable scenarios for the privatized entity. The scenarios reviewed indicate that private operations could be successful. The Bank must manage to a reasonable operating expense budget, find low cost sources of capital, and provide a mix of products and risk-based interest and fee pricing that meets asset liability management (ALM) objectives while covering the cost of capital, expenses, and returns to shareholders.

   - The scenario variables include: reasonable loan demand growth rates (about 15% per year), spreads averaging as low as 0.5% above the marginal cost of capital, paying back 100% of Class A stock through debt or cash, leveraging the Banks strong balance sheet and cash position, annual allowances for loan losses, and exploring a mix of product, services and partner offerings.

   - The projected returns meet the investment-return hurdles of those of a cooperative structure, with zero or low taxes and lower returns in the range of 4.3% to 6.1%. If the Bank elects the finance company structure it must accelerate its leveraging activity to bring rates closer to the marketplace for private investment company returns, estimated to be in the 13% to 15% range. Leveraging will prove to be difficult in the Bank's early years because it will need to increase its level of loan advances substantially from current levels to be leveraged at the same level as typical commercial banks, a process that may take many years because the Bank intends to stay focused on the rural telephone market.

- The scenarios assumed operating expenses ranging from $11 million to $21 million per annum based on a percentage of non-cash assets. The private Bank's operating expenses were independently assessed and estimated to be in the range of $8.0 to $9.7 million. It is recommended that these costs be substantiated early in the transition period with firm-fixed proposals and price quotes.

5. The rating agencies' determination of the privatized Bank's strength, operational credit and capital considerations will be a vital component in the Bank's long-term success. A high credit rating is required to drive the low cost of capital for providing exceptional loan values or guarantees to its borrowers. When considering options for paying out dividends, using cash to retire stock, or offering new products; all will need to be reviewed with maintaining a high credit rating as a key requirement. The Bank should develop working relationships with the credit agencies and engage them to provide preliminary reviews and recommendations for implementation into final transition plans and organizational designs.

6. Final considerations in the organizational design should include non-ALM risk mitigation and management, and the establishment of a strong system of internal controls.

8.0 Transition Plan

Privatization represents a major change in the Bank's operations. There is no guidance in the RE Act for how the Bank will transition from a Government agency to a private entity. Therefore, it is critical that the Board approves and implements a plan for transitioning the Bank in such a way as to minimize the impact of this change on the rural telecommunications community. (See Appendix H for the complete transition plan.)

The proposed Transition Plan includes activities that should be completed before the Bank is privatized so that it can continue to responsibly serve the rural community while at the same time increase the likelihood of the Bank's long-term success. The Transition Plan is a living document that will be modified as necessary to address issues that may arise during its implementation. This plan does not anticipate that the RTB would be operated any differently during the transition period than it currently is.

The Board of Directors is responsible for establishing the Bank privatization target date and approving the transition plan. At the start of the transition period, estimated to be 18 months, the Board would be responsible for appointing a Transition Manager, optimally a senior manager who is experienced in managing large projects on a tight schedule and is familiar with the operations of the RTB or a similar institution. The Transition Manager would report directly to the Board, providing regular progress reports and presenting information at key decision points for Board action.

In addition, the Board would need to work closely with RUS and USDA to form a Transition Team to implement the proposed transition plan. The proposed Transition Team would be comprised of personnel temporarily assigned from RUS/USDA and specialized outside support hired by the Board. The Transition Team as a whole would be responsible for the success of the transition. Six functional areas are represented on the team – finance, human resources, operations, organizational planning, legal and marketing/communications. It is critical that the transition team include professionals well versed in credit analysis related to the rural telecom market. The Functional Area Leads would be responsible for coordinating information and decisions among all the functional areas so that the Transition Team and the Board can work efficiently without duplication or gaps. The Transition Manager, Functional Area Leads and the Board would need to meet on a frequent, regular basis to discuss progress on the transition plan and to discuss issues where Board decisions will be needed. The Transition Manager would be responsible for ensuring that the meetings are planned, the decision options clearly stated for Board action, and the results of the meetings documented.

Among the key activities that would need to be completed during the transition are the following:

- Pursuing legislative changes to the RE Act;
- Developing a business plan, assessing market requirements, and determining the optimal organizational structure for the private Bank;

- Determining the location of the Bank's offices;
- Setting up private accounts for the Bank's assets to be transferred into;
- Conducting a study of insurance needs;
- Ensuring that the Bank has a clear understanding of the assets, liabilities, and the financial systems, information, and data that may transfer to the Bank;
- Meeting regularly with shareholders and other Bank stakeholders;
- Meeting with credit rating agencies and other members of the financial market;
- Hiring the private Bank's management team;
- Developing a memorandum of understanding with the Government on a number of issues since the private Bank will continue to work closely with the Government; and
- Creating the systems, policies and procedures that will need to be in place before the Bank can be privatized.

A detailed list of key decisions and activities for the RTB Board's consideration and ultimate approval are listed in the Transition Schedule. The schedule is an integral part of the Transition Plan and would be used as the tool to assess progress and performance.