RURAL TELEPHONE BANK PRIVATIZATION STUDY
ASSET AND LIABILITY MANAGEMENT

January 2003

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RURAL TELEPHONE BANK ASSET AND LIABILITY MANAGEMENT

Executive Summary

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 be the most important issue during the transition to a private institution. Asset quality and earnings of the bank will likely prove as important during the initial phases 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).

Introduction

The Board of Directors of the Rural Telephone Bank (RTB) has acknowledged the significant financial management responsibilities being assumed by them on behalf of borrowers and the public they serve. The objective of this section of the report is focused on the review of Asset/Liability Management (ALM) considerations that should be a comprehensive policy and practice regardless of the selection for alternative forms of ownership/governance as a privatized entity.

The simplest definition of ALM is the management of the net interest margin to ensure the level of portfolio risk is consistent with the risk/return goals established by the institution. ALM's primary focus is the simultaneous management of interest-rate sensitive assets and liabilities for the purpose of mitigating interest rate risk, providing liquidity, and enhancing the market value of the institution. Interest rate risk arises when the portfolio's principal and interest cash flows (including final maturities and prepayments), both on and off the balance sheet, have mismatched pricing terms and dates. The amount of this risk is a function of the magnitude and direction of interest rate changes and the size and maturity of the mismatched positions. The Office of the Comptroller of the Currency (OCC) defines interest rate risk as "the risk to earnings or capital arising from the movement of interest rates."[1] As pointed out in the more detailed ALM presentation attached hereto, ensuring the risk/return goals are met is an integrated strategy requiring simultaneous decisions regarding the types and amounts of financial assets and liabilities held by the institution, a thorough understanding of the range of financial markets in which the institution operates, how interest rates are determined, why interest rates change over time, and the impact of those changes on the value of the institution's assets and liabilities. Risk management should be a portfolio allocation process in which the RTB sets a Risk Strategy and makes a conscious decision about the risks to take and which not to take, basing this on the rewards for taking the risk and the bank's capacity to bear and manage that risk. Earnings and capital provide RTB with the cushion to absorb the consequence of risks (e.g., declining net interest margin, lower market value of investments, loan losses, more expensive borrowing costs, etc.) arising from ineffective ALM and poor asset quality.

OCC advises financial institutions in the following recommendation and we concur in this recommendation that prior to privatization the RTB adopt a risk management process; "Although the formality and sophistication of a bank's risk management process may vary, depending upon the level of the bank's risk and the complexity of its holdings and activities, the process should include:

- Procedures and practices that control the nature and amount of 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.

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[1] "Qs & As Clarify OCC Policy on Interest Rate Risk Management," OCC news release NR 95-63, June 20, 1995; Interest Rate Risk Management, OCC Bulletin 95-28, June 20, 1995.

- A system of internal review and audit to ensure the integrity of the overall risk management process."[2]

The requirements of the risk management system/process should have the following considerations as well: consistency with the risk strategy of the bank's Board, comprehensive information to make decisions, reasonable and consistent measurements translated readily into actions to protect the Bank's capital, and, finally, it must make the trade-offs between timeliness and precision to provide management a real tool for real choices and results. The Bank will need to develop a safe and sound investment policy in the transition phase to manage the movement of the large cash position into risk free investments for the privatized entity's asset base: the first and a continuing aspect of the ALM strategy.

Several categories of risk should be noted for consideration in the interest risk management process. Gap analyses, sensitivity analyses, and simulations should be instituted for all interest-rate sensitive assets and liabilities and will target the resulting impacts of these risks areas. The financial model developed as part of this study begins this process at a rudimentary level, by including sensitivity analysis and the Monte Carlo simulation for the selected scenarios. As the portfolio of assets and liabilities gets more diverse and sophisticated, the Bank should look to purchase or develop sophisticated modeling tools.

RTB will be more seriously affected by changes in interest rates as a private institution. It is critical that management identifies, measures, monitors and controls this exposure. Interest rate sensitivity risk broadly reflects the consequence of a change in the level and structure of interest rates on the bank's net interest income (interest income less interest expense) on earnings, and net portfolio value (market value of assets less liabilities) on capital. Sensitivity risk occurs for a variety of reasons: repricing risk, yield curve risk, basis risk and options risk.

- Repricing risk occurs when and if the amount of assets able to reprice due to adjustable rate features or maturity differ from the amount of liabilities repricing in the same period.
- Yield curve risk reflects the consequence of a nonparallel change in interest rates of different term-to-maturity.
- Basis risk refers to the consequence of a nonparallel change in interest rates of the same maturity but different index.
- Options risk reflects the potential change in cash flow or timing of cash flow that occurs when interest rates change by a sufficient margin to effect prepayment, calls or puts.

RTB must develop reports that measure these risk exposures. At a minimum, RTB will need to develop a gap report that reflects the repricing schedule of its assets and

[2] "Interest Rate Risk Description: Final Policy Statement" OCC Bulletin 96-36, June 26, 1996

liabilities. If the institution's assets or liabilities contain many options regarding rates or term, RTB will need to develop or retain a simulation model to ascertain the effect of parallel and nonparallel changes of interest rates on both the net interest income and the net portfolio value. Interest rate risk need not be eliminated; it must be managed to levels that allow the institution to retain viability under a range of economic conditions.

Institutional Considerations

The three types of institutions originally under consideration by the RTB Board were depository institutions or commercial banks with a primary interest in deposits; finance companies specializing in business and consumer lending; and cooperative associations which act to further common objectives of its members. Regardless of the type of organizational structure finally selected, the Board must become expert not only in evaluating the credit risk of the loans made by the Bank, but also in managing the entirety of the Bank’s assets and liabilities. Staffing these expert considerations has been reviewed in the Organizational Blueprint of this study.

Following the review of the preliminary reports of the Asset/Liability Management and the Regulatory Review, the Board elected to eliminate the option of a commercial bank from further consideration, choosing to focus further analysis on the options of a cooperative financial institution or a finance company. The reasons for eliminating the commercial bank option were: 1) extensive regulation that accompanying depository institutions i.e., equity and capitalization requirements, articles of association, location of office, and place of residence of Directors and Board Members; 2) extensive regulation regarding the concentration of credit to single borrowers, and diversity of risk; 3) a general lack of desire to set up a bank with depository accounts and branches that would require the bank to diversify its offerings; and 4) the Board’s desire to continue to focus on serving rural communities as a source of financing for rural telecommunications.

Even though the Board has eliminated the commercial bank option, the performance measures used by regulators in judging the performance of commercial banks are excellent guidelines for ascertaining the success of any financial institution. The privatized Bank will begin life with exceptional capitalization, and given the possibility the Board may decide they can best serve their borrowers by remaining a non-profit institution, accessing the market for additional capital will dictate the adoption and execution of a strong Asset/Liability Management (ALM) strategy. The Board should consider as a guideline in establishing its ALM management philosophy the performance measures included in the rating system used for commercial institutions **(CAMELS: Capital, Asset Quality, Management, Earnings, Liquidity, Sensitivity)**.

CAMELS is an acronym representing financial ratios, or other indicators measuring the performance of “**C**” capital adequacy, “**A**” the quality of the assets owned by the institution, “**M**” the capacity of the institution to identify, measure, monitor and control the risks acceptable to the institution, “**E**” earnings and the risks associated with future earnings, “**L**” liquidity or the adequacy of the funds management process in terms of the current and prospective markets in which the institution has elected to operate, and “**S**” sensitivity or the degree to which interest rates and price risks can affect assets, earnings, liquidity, and capital. These categories of performance represent a comprehensive approach to managing the institution's success.

As a point of reference, the Business Advisory Team reviewed a recent rating agency report of one of RTB's counterparts once the bank is privatized to gain insight into what these agencies consider important when looking at the operation of a similar financial institution. The opening statement of the February 2002 Moody's rating of the National Rural Utilities Cooperative Finance Corporation references some of the performance measures used in the CAMELS rating system and provides an excellent example of how the market assesses and reacts to the strengths and weaknesses of financial institutions based on such measures. The attached table also contains some of the key performance measures and compares the measures for representative entities of the cooperative associations and finance companies. These citations represent only a few of the measures used by the CAMELS ratings system. An overview of the reasons behind CFC's A1[3] debt rating is provided below:

"The A1 senior secured debt rating of the CFC is based on its excellent competitive position, management's strong track record, the quality of its portfolio, which has an outstanding loan loss history and a strong collateral position. The rating also incorporates the single obligors exposure, the large amount of restructured loans in the portfolio, the significant reliance on debt to finance its business, and the size of the CFC's telecommunications portfolio…The rating outlook is negative reflecting concerns about other weak credits in the portfolio, as well as CFC's ability to increase its loan loss reserve account, reduce leverage and manage growth."

If one were to apply this same logic to RTB as it privatized, one could envision the rating agency making a statement along the following lines:

> The senior secured debt rating of the privatized RTB is based on its strong competitive position as a result of its existing customer base transferred from the government accounts, the quality of its portfolio, an outstanding loan loss history, its low cost financing transferred from the Treasury, a very low debt to equity ratio, and an extremely strong collateral position. From this current financial position the RTB could conservatively increase its leverage, increase its loan loss reserves, and increase its portfolio if assets and liabilities are managed and matched appropriately. A significant departure from its operations under the government accounts is the absorption of a full back office banking operation, which is no longer provided by the government subsequent to privatization. The rating outlook also incorporates concern related to the transition from a

3 Moody's defines debt with a rating of A as "Bonds and preferred stock which possess many favorable investment attributes and are to be considered as upper-medium-grade obligations. Factors giving security to principal and interest are considered adequate but elements may be present which suggests a susceptibility to impairment some time in the future." The modifier "1", as in A1, indicates that Moody's considers this obligation to rank at the top end of the rating category as opposed to a 2 or 3 which would indicate that the debt was considered to be in the middle or lower end of the rating category.

government organization to a private organization which will have to compete more directly for its customers, an unproven management track record, the possible loss of ability to gain financing directly from the U.S. Treasury at risk-free rates, and a lack of diversification outside of the rural telecommunications industry.

As inferred in the above rating and envisioned statements, ALM is a mandated strategic approach to RTB privatized operations and encompasses more than simply sound management of the institution's assets and liabilities. It also requires an understanding of the financial markets, the fiscal and monetary environment, the competitive environment, the privatized operating capabilities, and the flexibility to react quickly to rapid changes. The complete rating statement includes discussion on some key performance measures. Copies of the rating statement will be made available for the Board.

The following discussion will track the ratings report, in part, and, where appropriate, the items being discussed will be compared with RTB's envisioned privatized structure.

Risks/Weaknesses Noted in Moody's CFC Rating Report That Could Also Apply to RTB

- **Single obligor exposure remains an ongoing concern, particularly given the lack of liquidity on the asset side of the ledger. (The following focuses on the electric side of CFC's business, but provides useful ALM insights)** *Single obligor remains a chronic condition with the portfolio. As of late 2001, the top three loan exposures alone represented 96% of the total amount of member's subordinated certificates, members' equity, and the loan loss reserve. Additionally, the electric coop portfolio is long dated, and the assets are not very liquid. Moody's believes that both items have become higher risk factors in recent times, particularly given the amount of leverage on CFC's balance sheet and CFC's reliance on the capital markets to fund its business.*

RTB may face similar criticisms, based on the degree of concentration of the top few borrowers/shareholders (e.g., Alltel, Verizon, Century Telephone, TDS, Citizens). However, with the adoption of strong credit limitation policies, much of the risk concentration may be avoidable. With the degree of consolidation that has been occurring in the rural telecommunications industry in the past several years, many of the largest borrowers include large companies such as Verizon and Alltel. Even though these companies are considered by most analysts to be among the most stable component of the telecommunications industry, the degree of concentration of these borrowers will need continual review including risk concentration credit management policies focusing attention and investments to mitigate or diversify some of the risk. (RTB's five largest borrowers: Alltel, Verizon, Century, Citizens [including Frontier], and TDS control over 48 percent of the RTB's Class B stock.) As also discussed in the CFC ratings report, the geographic diversity of RTB's borrowers across the United States and the base of rural customers who are less likely to switch providers will also be mitigating factors.

At a minimum, RTB must develop and adhere to stringent loans-to-one borrower limits to ensure that losses from one loan or borrower do not lead to insolvency. The bank regulatory authorities recently have increased such limits in many US states to 25 percent of unimpaired capital and surplus. If RTB needs to originate loans larger than a prudent loan-to-one borrower exposure, it will need to participate or sell portions of these loans to other financial institutions.

Given the industry exposure of RTB and the susceptibility of the telecommunications industry to technology changes and innovation, the bank will need to ensure that its investment portfolio is relatively large and diversified away from the telecom industry. In addition, the institution will need relatively more capital than many financial institutions to absorb the consequence of concerns related to the telecommunications industry.

- **CFC's leverage remains high particularly given the lack of liquidity on the asset side of the balance sheet**. *For analytical purposes, Moody's treats the combination of allocated but unretired margins and member subordinated certificates as equity. The level of subordinated certificates and member equity has grown from $468 million in 1999 to over $2 billion. However, this level of capital still represents only 10% of total capitalization in November 2001, compared to 16% in 1997 and 24% in 1994. CFC's ability to increase member equity contributions will greatly help support CFC's credit quality.*

The RTB should not face this risk/weakness factor in the immediate future because the overwhelming majority of capital is member equity and this can be leveraged as the Bank enters the capital markets. Whereas RTB's debt to equity ratio is currently on the order of 0.16:1 or 16 percent,[4] CFC's debt to equity ratio adding members' subordinated certificates to equity as Moody's discusses above, results in a debt to equity ratio of 6.7:1.[5] Even if RTB were forced to retire all of the Class A stock on the privatization date, the Bank's debt to equity ratio would only increase to approximately 0.22:1 or 22 percent if the buyback were paid for with cash, or 0.59:1 or 59 percent if financed with long term debt. On the asset side of the balance sheet, RTB currently carries a relatively large proportion of its assets (i.e., 40 percent) as funds deposited with Treasury or the equivalent of cash. CFC's balance sheet is not nearly as liquid; less than 1 percent of its assets are classified as cash or cash equivalents.

As it currently stands, RTB's balance between equity and debt capitalization should be able to remain positive for many years of managed growth. Additionally, the Bank has a very strong cash position which will be available for operational and capitalization needs, in lieu of debt, during the transition to a private entity.

[4] Calculated from data included in RTB's Report of Treasurer, Rural Telephone Bank Board Meeting, November 9, 2001.

[5] Calculated from CFC's Form 10-Q filed with the United States Security and Exchange Commission for the quarterly period ended February 28, 2002.

However, this cash position is currently subject to constraints of the Rural Utilities Service, the U.S. Treasury, and the Office of Management and Budget, and some of the cash may be needed to buyback Class A stock to reduce the Government's interest in the RTB once the 51 percent privatization threshold has been reached.

- **CFC's exposure to non-performing loans or restructured loans has increased materially in the past year** (due to one electric borrower [Co-Serv] and its affiliates). *CFC is the dominant senior secured lender to this borrower and its affiliates with a total indebtedness of $958 million. However, on balance CFC has an excellent loan loss history with only $107 million in net losses taken in its 32 year history.* ***(Fitch's January 2002 rating also downgraded CFC paper due to the financial exposure created by this same borrower. Copies of this report will be made available to the Board.)***

The Rural Telephone Bank has an excellent loan loss history and the same, if not better, relationship with its borrowers. However, the effect of the rating discussion reflected above should be an integral part of the discussion and design of a loan loss reserve policy for the Board particularly in light of the Bank's relatively large exposure to a small number of borrowers such as Alltel, Century Telephone, TDS, and Citizens Communications.

- **CFC's telecommunications portfolio represents 26.8 percent of CFC's total portfolio.** *Loans to telecommunication companies account for over 25% of CFC's direct and guaranteed portfolio. Of the telecommunication loans, 75%, $3.9 billion, are to local exchange carriers at the lower end of the risk spectrum. However, Moody's has concerns about the fact that the top ten borrowers represent 68% of the portfolio. The remaining exposure, $1.3 billion, is to the more risky segment of the telecommunications business, PCS, cellular and cable. Additionally Moody's has concerns about the speed at which the portfolio grew to its current level (300 % growth since 1997) and the single obligor exposure. Moreover, through the non-LEC portion of its portfolio CFC is exposed to both competitive and technological risk not prevalent elsewhere.* ***(Two years earlier, Lehman Bothers saw the telecommunications exposure as a ratings positive because the added diversity lowered the total risk profile of the total CFC portfolio.)***

Although the RTB Board has decided that the privatized entity would continue to provide financing for rural telecommunications broadly defined, the concentration of lending to a single segment of industry could also affect the RTB rating and, thus, the cost of capital. The Board will need to establish policies for managing growth of the Bank, either by controlling the volume of lending or by determining the risk associated with expanding into new markets. Presently, the Bank is a relatively small player in overall telecommunications financing, and growth may only be accomplished by assuming additional risk in an industry that, on whole, is subject to rapid technological change. In RTB's favor, it is operating in a segment of the industry that would appear to be more stable than most since the rural market has not been overbuilt to the extent of urban markets, is less competitive, and serves a large and geographically diverse set of customers. This competitive market should drive the growth choices, loan loss requirements, credit policies, and the cost of funds accordingly.

- **CFC is highly reliant on both short-term and long-term capital markets for funding its business and for refinancing large portions of its maturing debt.** ***CFC is highly reliant on the capital markets as its funding source as the internal cash flow is very modest to its funding requirements.*** *CFC members provide about 16% of CFC's total capital base. During the past year CFC actively refinanced portions of its total debt with a broader objective of making it less dependent on variable rate debt and on the commercial market paper. In the past year, CFC has altered its strategy focusing now on managing the loan portfolio by slowing growth of the portfolio, raising new equity capital from members, and increasing its loan loss reserve.*

RTB should be able to avoid some of this criticism due to the significant amount of member equity which can be used to leverage needed capital and the current cash position, a part of which can be used either for operational expenses or leveraging capital. In addition, should the Bank retain its ability to carry its existing Treasury debt into its balance sheet when the Bank privatizes, this will represent a stable source of long-term debt with fixed interest rates. If RTB adopts a corporate structure whereby it would be required to pay income taxes, the tax shield provided by debt will provide a powerful incentive to borrow more funds. There is a tradeoff between risk and return related to capital structure. Choices in debt to equity ratios and the Bank's growth strategy will need close management to ensure lower cost funding options remain available to the Bank and its customers.

Opportunities and Strengths

- **Loan pricing flexibility enables CFC to reset margins sufficient to maintain its targeted coverage ratios, to add to its loan loss reserve, and to increase the subordinated certificates and member equity component of the capital structure.** *CFC derives significant benefit from its customers' use of short-term and variable rate debt (51% of outstanding debt to members) The monthly option to reset rates on long-term variable rate loans provides a powerful mechanism with which CFC can manage its TIER (times interest earned ratio of at least 1.10 times), loan loss reserve and leverage. The variable rate short-term loan monthly reset feature also provides a degree of flexibility with respect to raising rates and enhancing liquidity. CFC policy is to avoid interest rate risk by match funding assets and liabilities through interest rate derivatives. CFC strives to match funds within a range of 3% of total assets.* ***(Lehman Brothers, February 2000, also highlighted this management policy.)***

The RTB Board will need to carefully consider crafting new lending policies comparable to those used by competitors in order to continue as a private lender in this market. The market will likely demand new products be offered by the Bank including an increase in the offering of variable rate loans of different maturities. Further, implementation of any new policy will require an immediate transition to improved accounting and reporting systems to manage the key ratios and ensure that the Bank is able to adequately match the different rates and risks that it is offering. Additionally, there will be a need to factor in an adjustment period for current borrowers.

- **Outstanding credit quality of CFC's loan portfolio, including its stellar loan loss history, and its strong collateral position on more than 90% of its loans.** ***CFC has an excellent loan loss history.*** *This history demonstrates … the ability of the borrower to take a long- term view concerning debt restructuring due to the unique relationship with its customer base and the fact that CFC is a non-profit organization. (This position is affirmed in other rating reports, including Fitch, which speaks to strong security positions, a history of limited losses, and growing reserves to meet potential losses.)*

The RTB is in a very favorable position regarding loan loss history and its collateral position, as well as its close relationship with its borrowers**.** However, the market will gauge the privatized Bank on how quickly and how affirmatively it reacts to unfavorable situations that may arise in the future, particularly on large loans. Also, as the Bank expands its offerings it will likely increase the overall risk of its loan portfolio. The Board needs to begin consideration of management policies to address these concerns before the Bank is privatized.

- **CFC has a dominant market share and an unmatched competitive position in the markets that it serves, particularly among electric cooperatives.** *CFC's membership encompasses over 97% of the rural electric cooperatives. Its largest direct competitor being CoBank, whose share of the market is considerably smaller. This dominance was enhanced in 1996 through CFC pre-approved credit commitments enabling borrowers to access the market quickly and efficiently through CFC.* CFC's operating expense ratio of average loans during 2001 was 0.17 %, compared to 0.18 % during 2000 and 0.23 % during 1999. All compare favorably with other finance companies.

Privatization of the RTB can provide the opportunity for growth in the rural telecommunications market due to the probability of access to more capital at a cost more comparable to CFC's through the use of variable rate loans and short term debt to reduce the overall cost of capital; the removal of current obstacles to speedy loan approval; and the possibility of a continued relationship with the Rural Utilities Service. Approximately 50 percent of CoBank's communications and energy portfolio in 2000 ($5.6 billion) is telecommunications loans, the RTB with just over $1.0 billion in outstanding loans ranks behind both CFC with $5.2 billion and CoBank with $2.7 billion, as well as CIT Finance with $1.5 billion in telecommunication loans, although much of the latter may be urban. RTB will not have this market dominance, but with a well thought out marketing strategy, it can maintain a strong presence in the telecommunications market place. For comparison, if RTB were able to keep its administrative costs at approximately $3M, its operating expense ratio would be about 0.27 % of the 2001 loan levels.

- **Diversification of the portfolio reduces event risk to investors.** *CFC's portfolio has diversified from the electric utility industry, as loans to telecommunications companies account for almost 25% of its total loan portfolio. This borrower segment is largely insulated from competitive pressures and provides stable cash flows and healthy margins.* ***Although single obligor risk exists, a portion of the risk is mitigated by the portfolio's substantial geographic diversification. No single state exposure was larger than 20% of total loans and guarantees at the end of August 2001. Rural local exchange carriers are fairly insulated from competition and one that should weather the weak telecommunications business environment reasonably well.*** ***(Lehman Brothers cite essentially the same diversification positives.)***

The fact that the total RTB portfolio is composed primarily of a geographically diverse set of rural local exchange carriers that have for years provided a stable market and strong earnings may mitigate a portion of the concern about the lack of diversity in the portfolio. However, the entire telecommunications industry has experienced difficulty in recent months and the possibility that this difficulty could spill over into the Local Exchange Carrier (LEC) market cannot be ruled out. RTB should now begin to examine its portfolio to determine the financial position of its largest borrowers, and what steps should be taken to mitigate any adverse situations, should they exist. Even though the LECs continue to remain a stable market, the rapidity of innovations or competitive pressures, not yet envisaged, could introduce more volatility to this environment.

Conclusion

The Bank needs to begin a thorough analysis of its existing portfolio from the perspective of the CAMELS performance measures to initiate consideration of the steps that will be needed to ensure the Bank begins life as a private entity in the strongest possible position.

In summary, how does the Board best leverage the existing CAPITAL base, i.e., the existing equity, portfolio assets, cash position, to meet future capital needs, maintain sufficient reserves to withstand difficult economic periods, and pursue growth strategies; what credit and risk management policies are necessary to best manage the portfolio ASSETS, how secure is the portfolio in eras of high interest rates or other difficult economic periods, are there problems with concentration; are MANAGEMENT's long-term policies and strategies consistent with the institution's financial resources, market position, depth and quality of management staff; has the institution met its EARNINGS objectives, is the institution increasing its value, improving capital position, are the credit and risk controls in place to assure achievement of earnings projections; are the core assets of the institution adequately matched with core liabilities, providing some assurance the institution's LIQUIDITY position is sufficient to provide self financing to see it through difficult times; how SENSITIVE is the balance sheet and portfolio assets and liabilities to interest rate changes, does management adequately monitor and control risk.

Appendix A to this report includes a typical ALM strategy outline.