RURAL TELEPHONE BANK PRIVATIZATION STUDY
LEGISLATIVE ASSESSMENT

January 2003

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Executive Summary

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.

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.[1] 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

[1] 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.)

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 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, a 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. *Final Financial Audit.* The Bank and the Government would benefit from a final financial audit as of the effective date of the Bank's privatization.

Introduction

The legislation governing Rural Telephone Bank (RTB) operations (mainly the Rural Electrification Act [RE Act] as amended) was established to support a Government agency and is considered overly restrictive for private bank operations. Eleven key areas of legislative relief are discussed in the following sections. The recommended changes range from lifting restrictions on the types of products the private bank may offer and the customer base that the private bank may serve to the manner in which interest rates are calculated and providing the bank protection from risks associated with the Government loans that the private bank will assume.

If the legislation is not amended before the bank is privatized, the private bank will be unable to compete in the private sector on an equal footing and is unlikely to be able to maintain long-term financial viability. Therefore, it is recommended that legislative changes such as those described herein be considered by the RTB Board of Directors and be pursued in such a manner that legislative relief would be gained before the bank is privatized.

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Legislative Issue # 1: Ability to Change the Manner in Which Interest Rates are Determined for New Loans

Section: 408 of the RE Act

Recommendation:

Strike or modify the provisions in the RE Act that dictate interest rate formulation for the bank. The bank must be able to operate as a private business free of restraints that will hurt its ability to compete in the marketplace. It must be able to set different interest rates for loans to different borrowers taking into consideration such factors as the borrower's financial condition, the risk associated with the project under consideration, the bank's marginal cost of money, etc.

Discussion:

Interest rates charged on RTB loans are set using a formula proscribed in Section 408 of the RE Act. This formula does not take into account administrative costs, profit, the marginal cost of money, or the costs of equity beyond dividends paid on outstanding stock. Without modifying the Act, the bank would be unable to recover required business costs even though this is common practice for other private banks. Currently, bank administrative costs are paid through appropriations, profit is not a factor on Government loans and the cost of equity is equivalent to the dividends paid on the bank's stock.
The Act allows for an annual determination of interest rates charged for all RTB loans based on the average cost of money set by Treasury and does not allow any rate differentiation between borrowers regardless of the risks presented by the projects being funded or by the borrower's financial condition. Private banking business practices distinguish between borrowers with strong financial backing from those with weaker financial conditions and price loans based on the marginal cost of money at the time the loan is made.

Business Importance:

1. The bank's ability to recover normal business costs and account for risk through the interest rates it offers on its loans is key to a positive net income and long-term business viability. Loan pricing should also consider the term of the loan, the interest rate (fixed or floating), the embedded options in the loan agreement, and the existence and quality of collateral and guarantees.

2. To attract investment in the private bank, it will need to offer investors a competitive rate of return on its investment. In addition to dividends paid, investors in private banks also look for capital appreciation. For a typical commercial bank, investors look for combined returns on the order of 10 –15 percent. The bank will need to consider such returns if it is going to be a private corporation that is attractive to investors in the private market.

Government Considerations:

The restrictions in the RE Act were useful for the Government loan program and helped establish impressive results in terms of supporting the development of rural telecommunications across the country. However, this and other restrictions included in the RE Act will place the private bank in a very difficult position in a competitive market. Without legislative relief from these restrictions, the bank would not maintain fiscal viability over the long-term and the Government would be back in the position of deciding whether it needed to commit more funds to support the continued development of rural telecommunications.

Legislative Issue # 2: Need to Allow the Bank to Offer Other Products and Act as a Private Bank Focused on Serving the Rural Telecommunications Market

Section: 408 and other sections of the RE Act

Recommendation:

Strike or modify the provisions in the RE Act that restrict the type of financial products the bank may offer and that restrict the bank's customer base. As a private business that must compete with other lenders, the bank must have the flexibility to act as a private business. It must be free to make normal business decisions just as its competitors are. Otherwise, its opportunity for success in the private market will be greatly diminished.

Discussion:

Sections of the RE Act now limit the bank's ability to offer loans other than "cost of money" loans. These loans are in essence fixed-rate, medium-to-long term loans. In addition, the legislation limits the purposes which loans can be made to cover. 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. With a change in legislation, the privatized bank would have the opportunity to expand its services to the rural telecommunications community with additional products such as variable rate loans, unsecured or subordinated debt, loan guarantees, etc., and perhaps to serve larger communities that are still in rural areas of the country but may not currently qualify for RTB loans due to overly restrictive size limitations. These would enhance the bank's financial viability by diversifying its offerings and expanding its customer base.

Business Importance:

1. The bank's ability to offer a wider number of products to its traditional customer base will enhance the bank's attractiveness to customers and diversify its holdings enhancing net income and long-term business viability.

2. Similarly, the bank's ability to broaden its customer base will enhance its marketability in the private sector and decrease its risk.

3. These factors will enhance the bank's attractiveness to investors helping to ensure its long-term viability.

Government Consideration:

1. It is in the Government's best interest to ensure that the private bank is able to act as a private business since this will allow the bank its best opportunity to succeed and continue to serve the rural telecommunications market.

2. Since the bank's shareholders are required by the Government to invest in the bank as part of obtaining a loan, any restriction imposed by the Government that would impact the bank's ability to be successful after privatization could have a deleterious effect on the value of their stock and open the Government to criticism from the bank's shareholders.

Legislative Issue # 3: Earning Servicing Fees on Financing Account Loans

Section: 408 of the RE Act and 661 of the Federal Credit Reform Act (CRA)

Recommendation:

Add language to legislation that would allow the Government to allocate to the private bank a negotiated percentage of the interest paid on financing account loans. This would offset, at a minimum, the bank's administrative costs associated with these loans.

Discussion:

Currently, loans made by the bank after FY 1991 (loans in the financing account) are an interest income/expense wash to the bank in accordance with the formula set forth in Section 408 of the RE Act. This formula does not include general and administrative costs in developing the interest rate charged on these loans. The administrative costs associated with servicing these loans are currently funded through appropriations. The RTB currently receives an appropriation of approximately $3 million dollars each year to cover the administrative costs associated with RTB operations and apportions are provided to the RUS annually. Part of that reimbursement covers financing account servicing costs. It is assumed that after privatization, appropriations will no longer be available to the bank to cover these expenses.

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 to by the Government but are unadvanced on the privatization date. Upon privatization, a servicing fee should be paid to the private bank for continuing to service these prior Government loans.

Business Importance:

1. It is important that these financing account loans remain with the RTB after privatization. Even though they carry no added value in and of themselves they represent contractual relationships and goodwill with RTB current customers.

2. The servicing of these loans will add cost to the privatized operations going forward. Determining an agreed upon servicing fee on the outstanding loan amount for administering these loans should be viewed as a reasonable cost to the Government.

3. It would be in the best interest of the bank to determine a reasonable servicing arrangement before privatization. This will protect both the private bank and the RUS by locking in a firm commitment as to reimbursing the costs associated with servicing these loans.

Government Considerations:

Since the RTB loans are tied directly to similar loans issued by RUS, there may be an opportunity for outsourcing the administration of both the RTB and RUS loans to the private bank. This would be in keeping with the Administration's desire to outsource functions that can be more effectively accomplished by the private sector.

Legislative Issue # 4: Needed Ability to Access New Treasury Debt

Section: New

Recommendation:

1. Add language to legislation that would allow the bank continued access to Treasury debt for commitments made by the Government prior to the bank's privatization.

2. If the bank is not allowed continued access to Treasury debt for commitments made by the Government prior to the bank's privatization, legislation should allow the bank to (a) have the option to transfer these loans back to the Government, or (b) recover from the Government the total projected cost associated with the risks of servicing these loans.

Discussion:

The Bank will need continued access to Treasury debt to finance outstanding commitments made by the Bank while it was still a Government agency. On the privatization date, the Bank will continue to hold approximately $1 billion of unadvanced loan commitments in the Bank's financing account. This contingent obligation results when an RTB loan applicant is approved for an amount of future financing on rural telephone projects, but does not take the total amount of the loan as an advance of funds but retains the right to request future advances up to the total amount of the loan.

These obligations should be considered obligations of the Government even after privatization and therefore should be financed with Government debt. The Bank will not be able to finance these loans with debt obtained on the private market, and offer borrowers loan interest rates at the low levels to which they are accustomed. The cost of money available to the Bank as a private entity will almost certainly be higher than the rates the Bank had previously secured, forcing it to pass on the additional cost with future loan advances. Thus, to continue to offer the same low rates that borrowers received from the RTB, Treasury debt will be needed.

As the REA currently reads there is no discussion on the privatized Bank accessing Treasury debt to cover outstanding commitments made prior to the privatization date or what will happen to these obligations upon privatization.

Business Importance:

1. The Bank's long-term viability will be tied in large part to its ability to hold on to current borrowers since these borrowers represent the majority of the companies and cooperatives serving the rural telecommunications market. To do so, the Bank must be in a position to continue to service outstanding commitments made by the Government prior to the privatization date.

2. Interest rate risk represents one of the largest risks facing any bank. Without continued access to Treasury debt, the transferred outstanding loans could become a losing proposition for the Bank and force it into financial difficulty since these loans will make up the majority of the Bank's portfolio in its first several years of private operation. Forcing the Bank to retire low rate Treasury debt with higher rate debt will depress net income and may cause default.

3. The continuing presence of Treasury debt on the Bank's balance sheet will help the Bank secure a higher rating from the rating agencies and, as a result, a lower cost of debt on the private market. New loans made by the Bank will be financed using private funds. For the privatized Bank to be competitive, it will need to offer attractive rates and to do so it must maintain a strong credit rating.

Government Considerations:

1. Continuing to offer the Bank access to Treasury debt for loans made while the Bank was a Government agency should not adversely impact the Government, as payments on that debt were matched with loan payments from borrowers. The risk of a default on the part of the Bank would be related to the risk of default of the borrowers and the loan loss reserve that the Bank is maintaining. The risk of a Bank default should be very low, because of the Bank's cash balance, strong liquidity, and substantial equity position. It should be noted that liquidity and capital can change very quickly for failing banks, and credit rating agencies will be targeting these measures in their reviews and assessments.

Legislative Issue # 5: Timing And Method Of Retirement Of Class A Stock After The Privatization Point Has Been Reached

Section(s): 406(c) and 410 of the RE Act

Recommendation:

1. If the Government determines that it wants all of the Class A stock redeemed immediately upon privatization, the bank should be allowed the option to request a long-term loan from Treasury to pay for the stock. That would allow the bank the opportunity to maintain its cash holdings, offer encouragement to the private market that the Government is confident about the future of the bank and willing to loan money to the bank, and secure the Government a higher rate of return than the 2 percent dividend currently being paid on Class A stock. In addition, it would consolidate the Government's interest as a creditor of the bank improving the Government's standing in the unlikely event of a bankruptcy.

2. If the Government decides that it cannot offer the bank the option of taking out a Government loan to pay back the outstanding Class A stock, it would be in the best interest of the bank if a set payback schedule (e.g., 5 or 10 years) were included in revised legislation to soften the immediate effect of the payback on the bank and to allow the market time to fully understand the action and factor the payback into its expectations for the bank.

Discussion:

RTB will be privatized after 51 percent of the Class A stock is retired in accordance with Section 410 of the RE Act. However, at the 51 percent point, there still would be approximately $290 million of Class A stock outstanding that will need to be redeemed and retired at some future point. Some will argue that from the Government's standpoint the faster this stock is redeemed the better. However, this could have a negative impact on the long-term viability of the privatized telephone bank if its cash on hand were immediately reduced by $290 million or more depending on the privatization date. In addition, the Government's immediate withdrawal may lead other large shareholders to seek to have their shares also cashed out.

As the RE Act currently reads there is no requirement to retire the remainder of the Class A stock over a set period of time. Section 406(c) requires that "Class A stock shall be redeemed and retired by the telephone bank as soon as practicable after September 30, 1995, but not to the extent that, the Telephone Bank Board determines that such retirement will impair the operations of the telephone bank….". It also goes on to state that the amount retired each year should at least equal the amount of Class B stock that is sold by the bank each year. Last fiscal year that would have amounted to just under $3 million. However, the bank has been retiring the Class A stock on a much faster basis. In FY 2002, $20.6 million was retired but the amount was limited by language in the

Appropriations Act to no more than 5 percent of the outstanding Class A stock. A similar restriction is expected to be included in the FY 2003 Appropriations Act.

Business Importance:

1. Total retirement of Class A stock when the 51 percent point is reached would cause the bank to use a large portion of its cash on hand or require the bank to take out private debt for the purpose of retiring this stock when either the cash or additional debt could be used more effectively by the bank to make loans or investments that would result in a positive return to the bank.

2. An immediate redemption of Class A stock could be perceived by the market as a loss of backing from the Government and lessen the bank's attractiveness to new customers and investors.

3. Other large shareholders may decide that their interests would be better served if they were allowed to cash out their investment in the bank and begin to lobby for the ability to do the same, further hurting the bank's balance sheet and its viability in the eyes of potential investors.

4. The presence of Class A stock on the bank's balance sheet would help the bank secure a higher rating from the rating agencies and as a result a lower cost of debt on the private market, helping to ensure the bank's continued success and ability to serve the rural telecommunications market.

5. A set retirement schedule for Class A stock would allow the bank a period of time to establish itself in the eyes of the rating agencies and offer the market greater certainty, helping to assure the bank's long term viability.

Government Considerations:

1. Without a set schedule for retiring Class A stock, the period of time before the Government received all of the money it has invested in the bank could be relatively long given the minimum requirements set forth in Section 406(c). These requirements would become even more uncertain after privatization if the bank no longer offered Class B stock and the legislation as currently written specifically refers to Class B stock.

2. Once the bank is privatized, the Government could be subject to greater risks because the bank would face competition and may want to take on additional risks in order to leverage its assets more quickly.

3. As a requirement of getting a loan from RTB, the Government required borrowers to buy Class B stock that in some cases has now been converted to Class C stock. Class B and C shareholders now control a majority of the equity of the RTB (as of September 30, 2002, nearly 75 percent) and the Government could be subject to

criticism from these shareholders if the bank's viability and thus the value of their investment were to be severely hurt as a result of Government actions such as demanding that all Class A stock be redeemed immediately upon privatization.

4. The Government is receiving a two percent dividend on Class A stock. This rate of return exceeds the average dividend yield of the Standard & Poor's 500 and the rate paid today by the U.S. Department of the Treasury on short term Treasury bills so the continued ownership of Class A stock for a set period of time would not negatively impact the Government as this point in time.

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Legislative Issue # 6: Need to Provide For A Transition Period To Allow The Bank To Transition From A Government Agency To A Private Entity

Section: New

Recommendation:

Include language in legislation that would allow for a set transition period over which the bank would transition its operations from a Government agency to a private bank. This legislation would need to be allow Government employees to be part of a transition team and allow the transition team access to Government facilities and equipment related to the bank's accounts and systems. Language should also specify how the cost of the transition would be shared between the Government and the bank, that the bank's assets could be used to support the costs associated with the transition effort, and to encourage an orderly transition and transfer of assets to the private bank.

Discussion:

The RE Act does not discuss how the private bank is to begin operations once it reaches the point that 51 percent of the Government's Class A stock is retired. A transition period will be needed to support the orderly transfer of the bank's assets and liabilities from the Government to the private bank. Such a transition period will allow steps to be taken to set up the private bank so that it is able to continue to serve the rural telecommunications community and operate efficiently without delay at privatization. During the transition period, the bank would continue to operate as a Government agency. At the end of the transition period, a minimum of 51 percent of the Government's Class A stock would be retired and the bank would begin operating as a private bank.

A transition team should be formed to carry out the transition effort. This transition team should be made up of Government personnel familiar with the bank's operations and private sector personnel with expertise in setting up private organizations. The transition team will need continued access to USDA facilities and personnel to collect information on the assets (including systems, policies, and procedures) and liabilities to be transferred to the private bank, and to receive instructions on how the bank's systems work.

Finally, the transition will require access to funding beyond that normally appropriated to the bank for administrative costs.

Business Importance:

1. The establishment of a private bank with over $2 billion in assets will be extremely complex and cannot be accomplished without a cooperative arrangement for continued Government support.

2. The establishment of the private bank will help to ensure the bank's long term success if done correctly or hurt its viability if done incorrectly. The financial markets will watch this transition and depending on its success, decide whether the bank is worthy of the best credit rating or some lower rating directly impacting the bank's ability to offer low cost loans or other products to its customers.

3. Without a defined transition supported by the Government, the ability of the bank to continue to provide high quality support the rural telecommunications market over the first few years of its private operations will be adversely affected.

Government Considerations:

1. The bank's early operations will be heavily dependent on continued support from the Government. Without a defined transition effort supported by the Government, the Government will likely have to continue providing support to the bank over an even greater period of time at additional cost.

2. Government obligations on existing loans may be contested if borrowers feel that they are not receiving adequate service early in the private bank's operations due to a disruptive transfer of accounts between the Government and the private bank. If this were to happen, it would result in additional work for the Government.

Legislative Issue # 7: Asset Transfers Including Intellectual Property

Section: New

Recommendation:

Include language in legislation that would detail the transfers from the Government to the private bank as of the privatization date. This would provide a checklist of the assets that should transfer to the privatized bank and resolve any differences that may arise concerning these assets.

Discussion:

It is essential that all of the bank's assets transfer to the privatized entity. Other assets that are not reflected on the bank's financial statements include:

- physical loan files & documentation
- copies of historical records and transactions in electronic format
- specialized software programs, electronic files, and spreadsheets used in carrying out the business of the bank
- all customer lists and related files
- access to specialized research databases, services, libraries and/or subscriptions that can be transferred to the private bank
- forms and documents used by the bank
- bank policies, procedures, and processes
- audit work papers would be made available to future auditors for the capability of rendering their future audit opinions or comparative financial statements, footnotes, disclosures and historical trends

In addition to the items discussed above, fixes may be required to perfect the security interest in collateral pledged on loans made by the bank prior to privatization. During the transition, the transition team would need to review all documentation and recorded filings (including uniform commercial code compliance). Consideration may be given to obtaining insurance to hedge in this area. The private bank would need to make certain a perfected security interest is transferred and in the new bank's name.

Business Importance:

1. All of the bank's assets including ones that not included on the bank's balance sheet are necessary for the continuity of the business and are important for the start of operations of the privatized bank.

2. Assistance and time from key RUS employees during the transition period to determine what assets are available and how they can best be transferred to the private bank is vital.

3. Conversion assistance, electronic or physical, is vital for lowering the cost of transition.

4. Final reconciliation of the bank's assets will need top priority during the transition.

5. The importance of clear titles and perfected security interest poses the largest risk exposure to the private bank in terms of the assets being transferred.

Government Considerations:

It is in the Government's best interest to ensure that the assets being transferred to the private bank are free and clear of any legal issues. A closing audit would be advisable, from the Government side and for the privatized bank to preclude major differences in the future.

Legislative Issue # 8: Liability Transfers and Protections

Section: New

Recommendation:

Language should be included in legislation clarifying that the private bank shall be accountable for any liabilities arising out of its operations after the privatization date and that the Government will continue to be accountable for any liabilities associated with bank operations or commitments made prior to privatization until an action has been taken by the private bank which materially alters the agreement that the Government had originally entered into. It should also be made clear that neither party can be held accountable for any changes in agreements simply due to the act of transfer.

Discussion:

In addition to the liabilities shown on the bank's balance sheet that will transfer to the private bank, there are other potential liabilities and considerations that may not be shown on the financial statements but need to be considered prior to privatization. These include:

- possible environmental liabilities associated with collateral security interests being transferred to the privatized bank, discovered either before or after the bank privatizes
- unadvanced loan commitments (discussed previously)
- contractual obligations made by the Government prior to the bank's privatization that may not have been exercised prior to the bank's privatization
- Liabilities and obligations entered into by the bank while it was a Government agency should continue to be backed by the Government even after the bank is privatized. (Unadvanced loan commitments have been discussed previously.)

Business Importance:

1. The existence of open-ended or undefined liabilities will impact the private bank's long-term viability by creating uncertainty that may be perceived by the financial markets as a weakness thereby driving up the private bank's cost of money.

2. Assistance and time from key RUS employees during the transition period to determine the extent of the potential liabilities that the private bank may be exposed to are vital.

3. Final reconciliation will need top priority during the transition.

4. A closing audit would be advisable. This would provide a baseline for the Government and the private bank.

Government Considerations:

It is in the Government's best interest to ensure that the liabilities being transferred to the private bank including potential liabilities are fully understood by all parties. A baseline review of the potential liabilities should be conducted during the transition that would be agreed to by both parties to offer some protection to everyone. There may be a relatively small number of issues that need to be considered but until the study is done it is difficult to predict.

Legislative Issue # 9: Relationship With Other Government Programs After Privatization

Section: New

Recommendation:

Language should be included in legislation to offer the private bank protection from direct Government competition during the bank's first years of private operation. RUS could continue to require joint loan participation and offer the RTB first right of refusal on joint participation in future financing even for a limited time period to not directly compete with the newly privatized entity. There would need to be some recognition that the cost of loans from the RTB may be higher than the RUS portion.
Legislation in future appropriations acts could discontinue making appropriations for rural telecommunications cost of money loans in the RUS budget if it is determined that the entire program can be adequately served by the private sector after the bank is privatized.

Discussion:

After privatization the RTB will be competing with other financial institutions to provide services to its customer. One of the private bank's competitors in this market is the RUS telecommunications program of loans. Under normal business practices, when a subsidiary is spun off from a private 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.

One approach is to offer the private bank the right of first refusal to act as a concurrent lender on RUS telecommunication loans for a period of time. RTB currently participates with the RUS in joint financing arrangements with it lenders, whereby RTB lends its prorated share of a loan and the RUS lends the remaining share of the loan. (Currently RTB annual lending authority stands at $175 million, and RUS is $300 million; thus the sharing ratio approximates 36.84% (175/475) for RTB and 63.16% (300/475) for RUS.)

Business Importance:

1. During the bank's first few years of private operation, it is expected that it will continue to serve the same community of borrowers offering similar products to those it has traditionally been associated with. While RTB and RUS's lending authority has been filled in recent years, the advances on these loans have been lagging. As a result, the bank has been advancing much less than the $475 million in lending authority it has available each year. Without cooperation with the Government, RUS

programs could cover all of the loan advances needed eliminating any portion for the RTB to fill.

2. Without some protection from competition with other Government programs, the bank's ability to operate on a profitable basis will be tested and its ability to continue to serve the rural telecommunications market will be adversely impacted.

Government Considerations:

The private bank's shareholders were required by the Government to invest in the bank as part of obtaining a loan. Any action taken by the Government to compete directly with the bank after privatization could have a deleterious effect on the value of this stock and open the Government to criticism from shareholders.

Legislative Issue # 10: General Duties and Prohibitions

Section: Section 206 of the RE Act

Recommendation:

1. Amend the legislation to clarify that restrictions, such as those stated in Section 206, do not apply to the private bank and/or the loans it issues. Rules and regulations adopted by the private bank should not be the subject of rulemaking as it pertains to Government operations. Otherwise, the private bank will be operating on a different set of rules than other private enterprises and such differences could adversely affect the bank's ability to be successful and offer competitive products to its customers.

2. Provide the private bank protection from the unchecked continuance of these prior Government commitments. Amend the legislation to provide the private bank the flexibility to (a) rescind the loan commitment if the bank determines that all of the purposes for which the loans was made to the borrower under the Act have been accomplished, or (b) allow the private bank to transfer the loan in question back to RUS for fulfillment.

Discussion:

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.

Under Section 206(b), the RTB cannot rescind an insured loan or RTB loan without the consent of the borrower. RTB has unadvanced loan commitments of over $1 billion and will continue to be responsible for these loans after privatization. Borrowers hold a firm commitment from the Government to be able to call upon those funds, as needed in their businesses, for items included under the purpose of the loans. It has been RTB policy to approve these additional requests with an allowance for changing the purpose of the initial loans. The purposes are usually changed via a budgeting change, and paper work (Change of Purpose) to explain the new purposes. In the past, RTB has approved changes to the original purposes of the loan and has on all occasions allowed "Change of Purpose" requests from borrowers to continue to make advances drawn on original commitments. The note is not changed unless the note has expired or the previous balance is fully amortized. The bank has recently requested that borrowers rescind older commitments and very few have done so. It would appear that many borrowers continue to hold onto these commitments in hopes that they may come into the market pricing again or as insurance against future needs.

Additionally some Government loan approvals exist where there is no note in place as yet, but commitments have been made. That is, a letter of commitment as been sent by the Government but the notes and documentation are not complete, and/or funds have not been drawn down on the commitment.

Business Importance:

1. As a private bank, RTB will need to significantly change its policies and procedures to be competitive in the private sector. For example, the bank may wish to offer different loan rates to different borrowers depending on the perceived risk associated with the loan in question, something that is not allowed under the bank's current rules and regulations. Similarly, commercial enterprises charge for open-ended loan commitments, which is not currently an option for the RTB. This is a potential income stream for the private bank and the potential cost to borrowers would be an incentive to close out some of these balances.

2. The ability of the private bank to maintain current customers is a solid foundation for the bank's continued success – for these loans and other loan product opportunities. Therefore, it is in the bank's interest to continue to provide first-rate service to these borrowers and not institute rules and regulations that would unjustly impact them.

3. The private bank will need legislative relief from these general duties and prohibitions to allow it to act as a private business offering competitive services. The private bank's ability to attract additional financing at low cost will be impacted by these restrictions.

4. Outstanding Government commitments are a part of the existing loan documents and cannot readily be removed from the asset and liability transfers to the private bank.

Government Considerations:

1. These restrictions pertain to Government operations and ensure that the public is aware of Government intentions.

2. The original loans were approved by the Government and packaged with loans and commitments from the RUS. The Government will still be a participant with these borrowers and will need to finance the RUS share of any future commitments.

Legislative Issue # 11: Final Financial Audit

Section: New

Recommendation:

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

Discussion:

RTB's 2001 Financial Statements were audited by Gardiner, Kamya & Associates, P.C. of Washington, D.C. The following limitation on financial statement disclosure accompanied their report. The annual reports presented by the Bank do not carry the customary auditors opinions that are found in private sector financial audits. The following disclosures are from the Bank's 2001 Annual Report.

> ***Limitation on Financial Statements***
> The financial statements have been prepared to report the financial position and results of operations of the Bank, pursuant to the requirements of the Chief Financial Officers Act of 1990 and 31 U.S.C. 3515(b). While the statements have been prepared from the books and records of the Bank in accordance with the formats prescribed by the Office of Management and Budget, the statements are in addition to the financial reports used to monitor and control budgetary resources which are prepared from the same books and records. The statements should be read with the realization that they are for a component of the U.S. Government, a sovereign entity. One implication of this is that liabilities cannot be liquidated without legislation that provides resources to do so.
>
> ***Basis of Presentation***
> The accompanying financial statements have been prepared to report the financial position, net costs, and changes in net position of RTB as required by the Government Management Reform Act of 1994 and in conformity with generally accepted accounting principles (GAAP). GAAP for federal financial reporting entities recognize the Federal Accounting Standards Advisory Board (FASAB) as the standards-setting body designated to establish these principles for these entities. The financial statements have also been prepared from the books and records of RTB in accordance with the form and content for entity financial statements specified by the Office of Management and Budget (OMB) Bulletin 97-01, Form and Content of Agency Financial Statements, as amended, except that credit subsidy reestimates are presented as a separate line item within total equity of the U.S. Government. The financial statements also follow USDA accounting policy guidelines.

Basis of Accounting

RTB's transactions are recorded on the accrual basis of accounting and with respect to certain information regarding budgetary resources and financing, a budgetary accounting basis. Under the accrual method, revenues are recognized when earned, and expenses are recognized when a liability is incurred. Budgetary accounting facilitates compliance with legal constraints and controls over the use of Federal funds. Any significant interfund and intrafund balances and transactions have been eliminated in the consolidation of the pre and post credit reform lending programs.

Credit Program Receivables, Net

Loans are accounted for as receivables after funds are disbursed. Loans receivable are carried at the principal amount outstanding, net of an allowance for estimated uncollectible amounts for pre-fiscal year 1992 loans. For direct loans obligated on or after October 1, 1991, RTB recognizes these assets at the present value of their estimated net cash inflows. The difference between the outstanding principal of the loans and the present value of their net cash inflows is recognized as a subsidy cost allowance. All loans receivable are due from non-federal borrowers and accrue interest daily based on the contractual interest rate.

RTB's allowance is estimated based on delinquency rates, current economic conditions, borrowers' credit histories, borrowers' outstanding balances, and an analysis of each borrower's financial condition.

The Credit Program Receivable footnote has been prepared to improve financial reporting for subsidy costs and performance of Federal credit programs as required by the May 2000 Statement of Federal Financial Accounting Standard No. 18, Amendments to Accounting Standards for Loans and Loan Guarantees.

Business Importance:

1. A final audit upon privatization would ensure the appropriate transfer of assets, allowing for a clean and well-documented separation of revenue and expenses and account balances as of the transfer date. This would protect both the Government and the current shareholders. This could be done in two reports, one as a final report completed in accordance with current procedures as described above, and another that would be completed in accordance with GAAP and Generally Accepted Auditing Standards that would form a starting basis for future financial audited statements as a private entity.

Government Considerations:

1. The final cut-off would ensure that Government accounting gets allocated its proper share of revenues and expenses through the privatization date.