RURAL TELEPHONE BANK PRIVATIZATION STUDY
ORGANIZATIONAL REVIEW

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Executive Summary

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.

1.0 Introduction

The key results of the Rural Telephone Bank (RTB) Organizational Review presented in this report are two organizational design alternatives for the private RTB (Bank), a proposed organizational design for the Bank's Board of Directors (Board), a description of operational activities, an estimate of the Bank's operating cost, and a summary of financial modeling results for different operating scenarios.

The organizational designs are responsive to the Bank's mission and to stakeholders' interests. The designs stem from an analysis of the Bank's value creation process, assuring that value-creating activities are incorporated into the organizational design. Operating costs are estimated for all the activities in which the Bank will engage as a private entity - these estimates are based on private industry norms. Different operating scenarios are postulated to determine the range of returns that the Bank may experience in the years immediately following privatization. These scenarios assume both a high and low operating cost, different spreads above the Bank's cost of funds (COF), and various methods of paying down 100% of the Government's Class A stock.

2.0 The Bank's Mission and Stakeholder Interests

Mission

The Board's Privatization Committee agreed that the following mission statement should be used to direct the design of the private Bank organization:

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.

The mission outlines key objectives that need to be satisfied in the operation of the private Bank. For the organization to achieve these objectives it must develop or obtain core competencies as described here:

Quick turn around—Effective, efficient and customer-focused loan applications and approvals

Low costs—Strategic asset and liability management (ALM) directed towards low cost sources of funds for both equity and debt, operational efficiency, and matching our products with minimum margins

Specialized lending to the rural telecommunications community—A focused market strategy with expanding products to meet this target segment of the marketplace as it changes in the future

Commitment to quality professionals—Obtaining and developing an expertise in the core competencies of efficient and low cost bank operations and protecting the collateral of our portfolio

Protecting our growing capital investment—Safe and secured loans in a geographically diversified telecommunications portfolio using stringent lending discipline and responsible growth objectives from our understanding of this industry segment

While expanding the interests we serve—Understanding the industry and its changing lending needs and satisfying the rural telecommunications stakeholders including local rural communities, the Bank's shareholders, the RUS, rural telephone associations, etc.

Understanding Stakeholders' Interests

In support of developing an organizational blueprint for the private bank, SAIC contacted a number of the Bank's stakeholders to gather input from them and factor in their thinking about how best the private Bank can continue to serve the rural telecommunications market. (See Appendix A, *Outreach Program*, for a list of the organizations contacted.) From these discussions, the following insights into organization considerations for the private Bank were gained:

Sticking to the core business of rural telephone companies is vital for the Bank's future and the continued support of its stakeholders. This industry is unique; it has largely weathered the telecommunications storms so far because of less competition in the rural markets and smaller business line to residential line ratios.

Smaller companies serving the rural market and those with the highest per line costs are the ones most in need of the Bank's programs.

All current assets would transfer to the private Bank – some concern was expressed on who owns the assets. The Bank has a large cash balance on deposit with the U.S. Treasury, nearly $1.1 billion as of September 30, 2002. Because of restrictions driven by the Federal Credit Reform Act, the Bank has been restricted in the use of its cash and this has raised questions in the minds of some stakeholders as to the ownership of these assets. The ownership of all assets would need to transfer to the privatized Bank or privatization is not a true option to consider here. Some stakeholders believe the Bank should get a written commitment from the Office of Management and Budget (OMB) on the transfer of cash before taking further steps towards privatization. Stakeholders have indicated this is one of the major concerns driving the 5 percent limit that has been placed by Congress, in USDA's annual appropriation, on the amount of Class A stock that can be retired.

Most shareholders and other key stakeholders interviewed indicated they would support the Bank's privatization assuming there is a workable business plan and business objectives in place to protect the Bank's assets, continue to meet the rural communities needs, and meet shareholder investment expectations.

The Bank must obtain additional management expertise for private sector success. As a private bank, management will need to understand competitive markets, sophisticated financial arrangements like credit enhancement alternatives, and the private credit market. The Bank's management team would have to be able to execute the business plan within assumed operating parameters. The Bank would also need to understand how to adjust its operations to meet the requirements of the capital markets and rating agencies for it to continue to meet its low cost provider mission.

Determining an approach to changing the current legislation, and how any suggested changes would impact the Bank and available capital operations was mentioned as a key determinant for privatization support. The Bank will need to have some results-oriented discussions with the key legislative and Administration officials to be able to articulate the legislative approach and expectations.

It was suggested that the Bank should expand its product offerings, and consider eliminating some of its current administrative and engineering requirements. Although low cost financing is important, if the requirements of the Bank were lowered, the changes in requirements could be balanced against slightly higher private bank rates.

As it expands after privatization, the Bank should continue to focus on preserving a high quality portfolio and low loan loss exposure, while considering risk weighted pricing and cautious reserves for loan losses.

From discussions with stakeholders, it is apparent that the Bank will need to continue to discuss the privatization effort frequently. There is uncertainty on the part of stakeholders about how the privatization will affect them because of a lack of information. In confronting change, it is expected that participants will be anxious and perhaps skeptical about privatization because the legislation is vague and the Bank has not presented much information about its plans for continued operations. The following are some of the questions and concerns that were revealed during this initial outreach effort:

What is going to happen to the RTB? What exactly will be different?

What is going to happen to this source of capital? Can the privatized Bank get access to capital to continue to meet the rural telecom market needs?

What interest rates can we expect and what is the estimated rate difference compared to a government entity?

What will happen to my investment in the Bank? Will the Bank's assets and value be protected?

Will management take risks that will not preserve the interest of the Bank? Is there a way to pull my capital out of this investment in the future?

Will stakeholders have any say in the choices or actions related to the Bank's privatization?

Does the Board and management team have the plans, talent and resources it will take to execute the Bank's privatization successfully?

Is there a need for another private lending institution in the rural telecommunications marketplace? Why would this entity be successful in the private sector?

Can the Bank build a successful private operation, separate from the RUS?

Is the government abandoning the rural telecommunication marketplace after privatization? Will the RUS telecommunication program still exist and for how long?

If these questions are not addressed directly, stakeholder anxiety and cynicism will impact the Bank's privatization efforts and erode support from the financial community and rural telecommunications end users, potentially discouraging new borrowers and investors and undermining the stakeholders' commitment to the Bank. Effective communications will both improve understanding of the privatization effort and encourage active participation and support by the stakeholders.

Some stakeholders believe that privatization is an option rather than a requirement of the law, not realizing that there are two important drivers:

1. The Rural Electrification Act, as amended, requires the Bank to be privatized. Privatization has already begun and as of September 30, 2002 over 27% of the Government Class A stock has been retired. Once 51% of the Class A stock is retired, the control of the Bank shifts to the publicly elected members of the Board. Since 1996, there have been limitations placed in USDA's annual appropriations on the amount of Class A stock the Bank can retire. This limitation has been set each year at 5% of the outstanding amount of Class A stock. Assuming this limitation continues and the Board continues to retire stock up to the limit, the Bank would retire over 51% of the Class A stock in fiscal year 2010.

2. The Administration is proposing an aggressive plan for privatization. In the last two President's budgets, it has been stated that the Bank would be privatized during that fiscal year with funding for the Bank set at zero. In the appropriations process, Congress has restored funding for the Bank including loan authorization in the amount of $175 million each year.

It is clear that for the privatization effort to have a managed process, the Administration and the Bank need to craft additional messages and a strong case for aggressively pursuing the plans for privatization. The Bank needs to develop a final plan for how it would privatize, and seek participation from the stakeholders to formulate a responsive business plan. There should be some discussion and articulation of the consequences of success or failure in terms the stakeholders can identify with. The plan should consider what roles would be expected of stakeholders in executing a workable solution; most obvious is a formal stakeholder meeting or roundtable to hear and address the voices of the various constituents.

During the transition period, the Bank should continually and quickly share breaking news or decisions that impact the plan. Keeping strategic issues (and why they're important) up-front, the Bank will need to continue to present its plan to stakeholders. For example, how the private Bank plans to improve customer service and loan-decision response time since this is a weakness that is frequently mentioned by the Bank's stakeholders and one which is causing the Bank's borrowers to get funding elsewhere at higher costs.

The Bank's communications plan should include benefits, believable actions, two-way communication (focus groups or outreach programs to listen to the stakeholders), and a sense of urgency. It should be understandable to all participants and focus on progress and next steps. Holding open privatization meetings is a good way to allow stakeholder review of the process. Establishing an Internet site with privatization activities, news and decisions would form an immediate foundation. Checking feedback and collecting information from the outside world to identify market pressures and issues will become important and add to the communication message of what the Bank is trying to achieve through privatization – a successful and continued source of capital to the rural telecommunications marketplace.

3.0 Proposed Organization Structures

As the Bank approaches privatization, it will need to adopt an organization structure appropriate for a private bank. Two organization structures have been designed for the Board's consideration. The design of the alternative organization structures reflect three perspectives: (1) the ability of the private bank to create value for its customers and shareholders, (2) the current operations of the Bank as a government agency and part of RUS, and (3) discussions with the Board's privatization committee, various stakeholders, banking experts, and the Bank's current management. The proposed organization structures further considered the Bank's market focus, conservative style, geographic coverage, loan portfolio size, and organizational affiliations.

Value Creation Process

The Bank's organization represents the value creating activities of the business and includes the essential chain of operating functions shown in Figure 1. For the private Bank to maximize its effectiveness, its organization should be structured in a manner that enhances its value creation process.

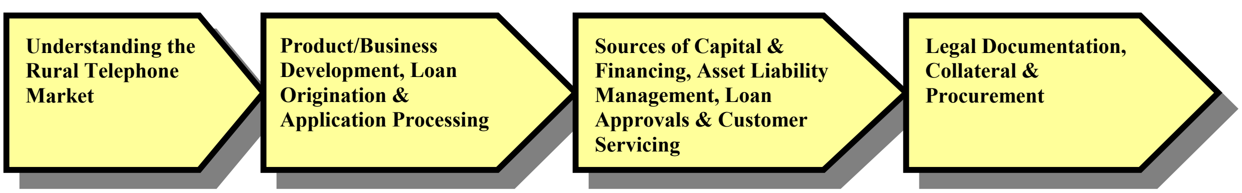


Figure 1. RTB Primary Value Adding Activities

The proposed organization structures and concomitant operating cost estimates presume that several major areas of the operations would be outsourced (they could be handled internally if benchmarked against the cost to outsource) and are included as indirect expenses. These are activities that are commonly outsourced in banking and private industry. The Bank can conduct a make-or-buy analysis to determine whether these functions can be done more efficiently by the Bank or outsourced.

Alternate One

Alternate One is depicted in Figure 2 and provides an organization structure that satisfies all value creating activities and serves the Bank's customers and shareholders. It includes the following major components: (1) the CEO and staff, (2) the Engineering/Telecommunications Department, (3) the Business Development Department, (4) the Finance Department, (5) the Legal Department, (6) Office Administration, and (7) Internal Audit. The organizational details are provided in Appendix B, *Organization Charts*. In total, this organization structure would result in the Bank employing a staff of 52.

The CEO's Office

The CEO's office would consist of 4 employees: the CEO, a secretary, a staff analyst, and a person in charge of shareholders relations. This team would ensure that the Bank was operating at peak efficiency at all times. In addition to this direct staff, five people would report directly to the CEO under this organizational structure: the four department heads and the Director of Administration. Together with the CEO, these five employees would make up the Bank's management team and be responsible for managing the Bank's operations on a day-to-day basis.

Engineering/Telecommunications Department

Understanding the Rural Telephone Market

The Engineering/Telecommunications Department will provide the understanding of the rural sector telecommunications market and its infrastructure needs. The organization would include experts in the rural telecommunications business arena, specifically those in tune with infrastructure needs and telecommunications traffic patterns, and trends of commercial and private users.

This department would develop a rural telecommunications environmental scan and use it on a continuing basis to update a dashboard of reporting information, trends and forecasts that would inform key decisions on products and services to meet the lending needs of this market. The rural telecommunications business is not an extension of the urban or suburban telecommunications business. It is a distinct marketplace with unique attributes, players, and economic forces; the rural marketplace operates outside of the mainstream telecommunications economics. This key specialization in rural telecommunications would become an internal core competency, and the Bank and risk management focus will require considerable investment in building rural lending-relationships and providing product leadership therein.

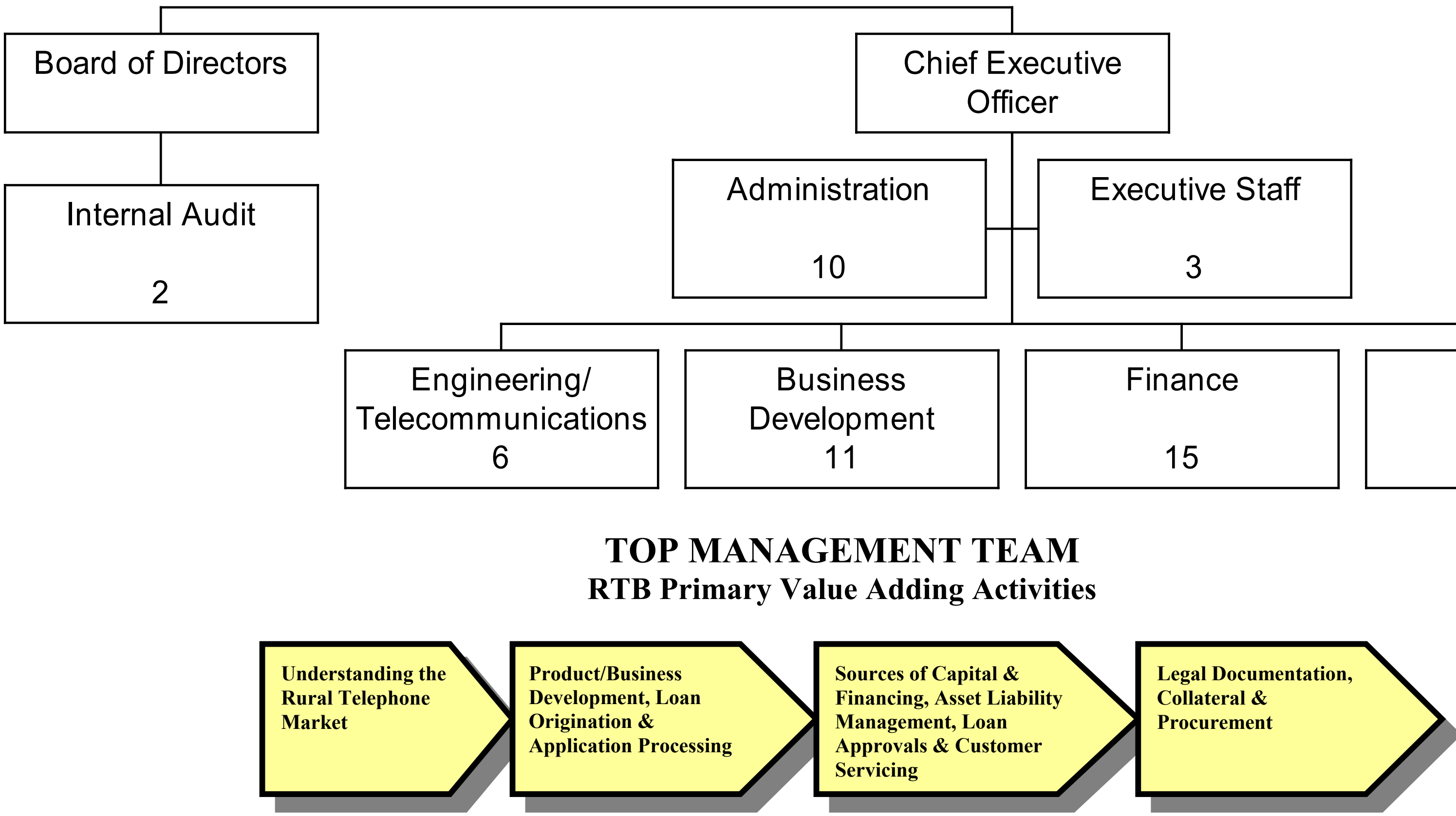


Figure 2. Alternate One Organizational Structure

The Engineering/Telecommunications Department has six telecommunications experts that understand the rural companies that will use the Bank services, their demographics, motivations, needs, wants and buying decision styles, the equipment and technology competitors, and the number, strengths, weaknesses, and sustainable advantages of each. This department would identify engineering and telecommunications technological developments, infrastructure opportunities, and approve any required engineering studies that the Bank may request as part of it loan application process.

Business Development Department

Product/Business Development, Loan Origination & Application Processing

The Business Development Department will focus on developing the lending products that the rural telephone companies will need to finance their future infrastructure needs and developing new products for the Bank to offer to expand its services to the rural telecommunications community. This will require employees with telecommunications market expertise. Designing the right products, terms and services to fit with the rural telephone loan marketplace should be a continuing market research effort through extensive field representation and liaison. Pushing empowerment down close to the customers and having a corporate culture that fosters a flexible and well-tuned rural telecommunications business development team should drive market and product choices for Bank product and service offerings.

The proposed Business Development Department has eleven employees. In addition to The Department Head and clerk, two will provide marketing expertise and four employees will be field market representatives, serving to communicate directly with the marketplace, by acting as the eyes and ears of the private bank in the field. Business development field representatives will serve the vital role of making sales calls on the Bank's borrowers and prospective customers, explaining and providing the Bank's product guidelines, supporting and assisting the customers in understanding the Bank's offerings, and helping borrowers navigate through the loan request and application process.

Three employees in the Business Development Department will review loan applications and prepare them for presentation to a separate loan approval team (loan approvals will fall outside the business development domain for proper internal control through separation of duties). Standardizing the loan application requirements, assembling the complete packages, and substantiating the application contents will serve as a driver and foundation for the Business Development Department in making recommendations to the loan approval team.

Tracking and communicating the status of the application process will be supplemented with technology. It is anticipated that a system that interfaces with the loan servicing system would be procured that manages the loan through these important initial stages of the loan processing life cycle. Data captured and maintained in the loan application process would be set up for follow-through on all requirements for loan approval, and act as a source of input into loan servicing functions at a later point if the loan is approved. Thus, this system would be integrated with the loan processing system. (Most probably procured through an outsourcing arrangement.)

The Finance Department

Sources of Capital & Financing, Asset Liability Mgmt., Loan Approval & Customer Service

The Finance Department will be responsible for maintaining adequate and low cost sources of capital and flexible financing. The department will require employees that are experts in the capital market, credit rating agency requirements, and sources of capital available to provide to the rural telecommunications market given the wide variety of financing options that will be available to the Bank. The finance department may need a professional expert with interest rate swaps and caps expertise, to change or plan for changing the repricing of funds raised by the bank to meet the needs of their customers (e.g. change a fixed rate loan to floating).

For example, the Bank will continue to hold U.S. Treasury debt when it is privatized, and may have continued access to U.S. Treasury obligations to offset advances on loans originated by the Bank when it was under the government control but not yet funded. It may also continue to require private sector equity capital from borrowers (should the Bank continue to require a percentage of the loan face value as a capital investment from borrowers), will need to establish private sector debt financing (through any number of private debt markets), have the opportunity to participate in government programs such as the RUS Loan Guarantee Program, and make its own public offerings of additional equity or debt.

The proposed Finance Department would have a staff of fifteen. The sophistication of financial knowledge on the privatized bank team will be vital to its success as it transitions from a Government agency with no real financing or investment options to a private bank with a world of financing and investment options. The Finance Department of the Bank encompasses several major functions:

- Managing the internal treasury functions, for example the investment of cash, and maintaining cash liquidity requirements (both short term and long term). Establishing a solid investment policy acceptable to the Board for the risks it will choose to take.
- Establishing a strong ALM system and process. An ALM process sets and reviews profit and risks attributes of the asset liability structure on an ongoing basis. ALM will have to be closely coordinated with the Bank's lending policies, products, and procedures to assure interest rate spreads and asset matches are sufficient to (1) attract new borrowers, (2) cover capital and operating costs, and (3) meet targeted returns on equity.
- Finding new sources of debt and equity capital, and establishing the foundation for the capital structure of the Bank as a privatized entity. Restructuring the Bank's capital to meet the Bank's targeted growth and equity returns will help focus the

financial arrangement efforts for the early years of privatized operations. Even if it is required to retire all of the Class A stock upon privatization, the Bank has sufficient capital remaining in Class B and C stock to begin operations as a private bank. Raising additional equity capital should not need to be an immediate priority.

- Exploring access to debt with the US Treasury during the Bank's transition to determine the role and mix it would play in the privatized capital structure. For example, if all or part of the 49 percent of the remaining Class A stock can be converted to U.S. Treasury notes, this could provide access to additional low cost debt. Other possible low rate financing alternatives could include participation in government loan guarantee programs.
- Managing the specific requirements laid out for investment grade ratings by the various credit rating agencies will be a central focus that will determine the Bank's cost of capital and structure limitations. If the Bank is going to continue to be a low cost provider to the rural telecommunications industry, it will need to maintain a very high credit rating. It is recommended that the Bank adopt the evaluation criteria established for safety and soundness in the commercial banking industry.
- Establishing a Loan Department for managing the loan approval process to ensure the coordination and discipline of approving loans with the terms and conditions that meet/match the requirements established under the ALM strategy. Including the expertise in interest rate swaps and caps, as required to meet the needs of the Bank's customers who might demand variable interest loans.
- Managing asset operations, i.e., the management of loan processing throughout the loan life cycle,. These functions include:
  - setting up the loans in individual accounts with the terms and amortization schedules as dictated by the note agreements;
  - monitoring of loan covenants;
  - processing of loan payment transactions (possibly through a lockbox) and applying the monies to interest and the applicable note principal balances;
  - distributing loan payment statements on a monthly, quarterly and annual basis including Internal Revenues Service reporting;
  - monitoring of loan payment aging and actions required in delinquency or loan covenant breach;
  - interfacing this system with loan applications processing for data and transaction input as well as interfacing this system to the accounting functions for reporting and reconciliation; and
  - after loan customer service, interfacing with the borrowers after a loan has been made.
- Maintaining internal management accounting requirements to support sound business and risk decisions, as well as, external reporting to various users of the Bank's financial statements. External users will include credit rating agencies, the Government (RUS, IRS, Congress, State, and local), shareholders, stakeholders, and Government oversight agencies such as the Securities and Exchange Commission

(SEC) acting as the main interface with internal and external auditors, tax reporting and tax audit, and compliance reporting and audit. The establishment of sound internal accounting and operational controls must be completed and reviewed for effectiveness on an ongoing basis.

Technology selection and implementation in many of these key areas could enhance the services provided by the Finance Department. Evaluating the lease versus purchase decisions throughout the operations will need the support of the financial experts. This Department will also be the user of many of the significant bank operational systems including, the accounting operation and reporting system, the ALM system, and the loan-servicing system. Therefore, this Department will need to work closely with Office Administration to ensure that the information management resources of the Bank adequately serve these requirements.

The Legal Department

Legal Documentation Collateral & Procurement

The Legal Department will provide significant support to all areas of the Bank. To support these activities, it is projected that this Department will have a staff of four, including attorneys, paralegals, and a legal secretary. Chief among the legal requirements that the Bank will need to cover is the need to ensure that all secured, lending documents are properly and accurately filed to protect the collateral/security interests of the Bank. Attorneys with experience in these areas are important not just in establishing the loan at inception, but for controlling the security interest over the life of the loan. For example, the Bank will want to install a periodic tracking system to control and update security interest filings in all of the states where the Bank has outstanding loans to maintain the proper collateral interest of the loan portfolio on an ongoing basis. There should also be a periodic review of federal, state and local business requirements, and potential loan regulations to form compliance requirements.

Since the Bank will have a significant number of shareholders there will be compliance and reporting requirements that should be reviewed and released by the Legal Department. Final review of SEC filings, if needed, would be one example where legal expertise would be needed. Legal experts should review all shareholder correspondence that could include information that may be restricted as “forward looking” statements by the SEC and public financial statements for legal disclosure compliance. The Legal Department should determine all corporate or cooperative and other regulatory requirements are being established properly and maintained within the ever-changing regulatory environment.

Procurement of the right insurance protections is a vital concern for protecting the Bank’s assets, the Board, and bank management and will require extensive legal support. A review of all non-bank risk issues should be made, and plans and procedures to mitigate these risks should be considered along with protection from insurance as required.

Products for insurance consideration and risk mitigation include this preliminary listing of insurance products: Commercial Insurance Products, Business Owners Package, Commercial Property, Commercial General Liability, Business Automobile, Workers Compensation, Commercial Excess Liability, Employment Practices Liability, Directors & Officers Liability, Errors & Omissions, and Professional Liability.

The Bank will enter into significant financial arrangements; debt instruments, leases, and computer service agreements are some examples. These contracts, and additional terms and conditions could be an area for continued legal contractual compliance review and scrutiny. Early in the privatization process there is expected to be considerable agreements made with the Government on a variety of issues and compliance with these agreements will need continued legal support. The privatized bank will initially be operating under agreements established before privatization, mainly the loans with borrowers and Treasury debt instruments that will be transferred to the Bank upon privatization. The Legal Department will need to review all existing arrangements and documents to ensure the transfers, or legal assignments, include the complete rights and protection of the private bank.

Office Administration

Office Administration activities include Infrastructure, Human Resources, Technology and Procurement. An organization's value to its customers is often optimized by a seamless interconnection of activities and services that provide the customer with a clear view of the whole of the company's offerings. Office Administration would focus on operational effectiveness. A competitive advantage can be gained through the coordination of activities, and the optimization of the Bank's operations. For example, a smooth interconnectivity of systems allows for data and information to transition from one to another without a manual or more costly interface. Loan processing requires coordination across activities in the Business Development Department, Engineering/Telecommunications Department, Finance Department and Legal Department. Office Administration would assure that these activities can be accomplished expeditiously through a seamless interface between the Departments. Another example would be a user-friendly Internet website that fully explains the Bank's products and services. Such a site can create leads for business development, identify areas where borrowers have greater interest, articulate lending policies and procedures, offer a method for electronic loan applications, and serve as a substitute to marketing literature design and printing. In total, it is estimated this staff will have ten employees to support these activities.

Infrastructure consists of a number of activities including general office management and planning including facilities management, phone services, maintaining Local Area Networks and Internet connectivity, travel support and oversight, Bank websites, and the distribution of public information. It is projected that a staff of two will be needed to support this workload.

Human Resources (HR) will be vital as the Bank's operations must be built from the ground up, with key positions hired early on to establish the Bank's initial operating team. Ongoing HR activities will involve recruiting, hiring, and training staff, developing compensation programs, and then managing these programs for all of the Bank's employees. HR for this Bank will play a key role in creating a competitive advantage by developing programs that ensure the Bank is able to attract employees with the requisite skills and motivation needed to ensure the Bank's success and then keeping these employees for a long period of time. A key measure of success for any company in a competitive environment such as the one this Bank will be entering in is its ability to hold on to its outstanding performers as measured by the organization's turnover rate. HR is projected to need a staff of four.

Technology is embodied in every activity of the Bank. Staying up to date in terms of taking advantage of available technology will be a key driver for keeping the Bank's operating costs low. Outsourced technology applications that might be needed by the various Departments include accounting systems, communications systems (E-mail and internet service), and/or loan processing systems and services. Figure 3 shows a brief outline of the systems considerations and assumptions made in this organizational design. A full lease, purchase, or outsource alternative study should be part of the Bank's transition planning and has been included in the proposed transition plan. The Bank's Technology requirement is projected to need a staff of two.

The Procurement function will be responsible for purchasing the inputs needed throughout the Bank. Procurement would lease or purchase office space, furniture, computers or equipment, telecom and internet services, outside consultant and legal support that may be needed from time-to-time, setting up travel agreements, and providing the tools necessary throughout the Bank (from legal libraries to calculators).

The cost of procurement is usually an insignificant portion of total costs, but it could have a large impact on the Bank's overall cost and differentiation, therefore the policies and procedures governing this function will be important for meeting the objectives of the Bank. Procurement is recommended to have a staff of two.

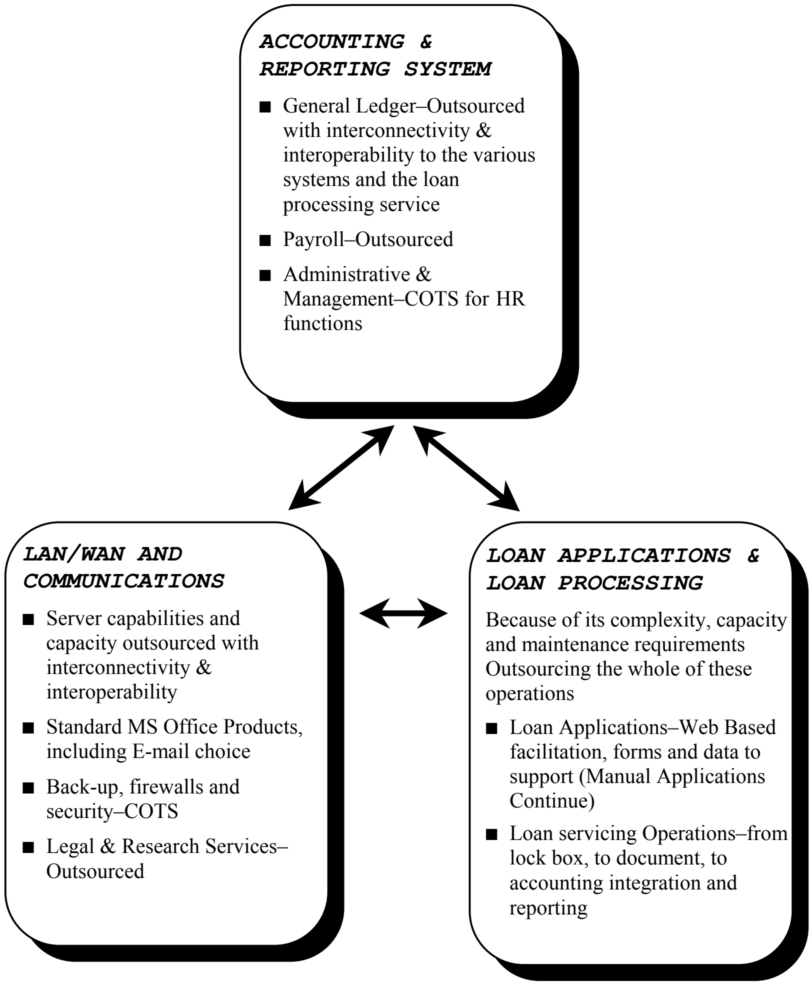


Figure 3. Interfacing Computer Systems

Alternate Two

Alternate Two is depicted in Figure 4 and provides Bank organization structure that would represent what could be considered the lower bounds of the configuration needed to fulfill the value-creating activities and maintain financial reliability. (See Appendix B, *Organization Charts*, for details of this organization.) The significant difference is that Alternate Two does not include the Engineering/Telecommunications Department, but does include the other departments. The level of staff is reduced in each of the other departments from the level in Alternate One. Staff Support in various divisions under

Alternative Two would include replacement with subcontractor support, sometimes by pushing more work and the costs to firms who provide the Bank outsourced systems or seat management. In total, this organization structure would result in the Bank employing a staff of 35.

Many of the Engineering/Telecommunications Department functions described in the Alternate One organization could be outsourced as needed. The government, i.e., RUS, will retain engineering review functions for joint loan applications and the Bank would plan to use outsourced resources or the borrowers themselves for other engineering support that may be needed. The detailed understanding of the rural telecommunications market and its infrastructure requirements attributed to this department in Alternate One will still be key to the Bank's operation but supplied from the Business Development Department and as a natural course of sharing information across the departments in day-to-day business transactions.

The Business Development Department has 10 employees (versus 11 in Alternate One). The reduction reduces the loan processing staff and the market research staff by one in both but adds a telecommunications technical expert to cover the key functions provided by the Engineering/Telecommunications Department in Alternate One and continue to provide value-creation at a level required for financial viability.

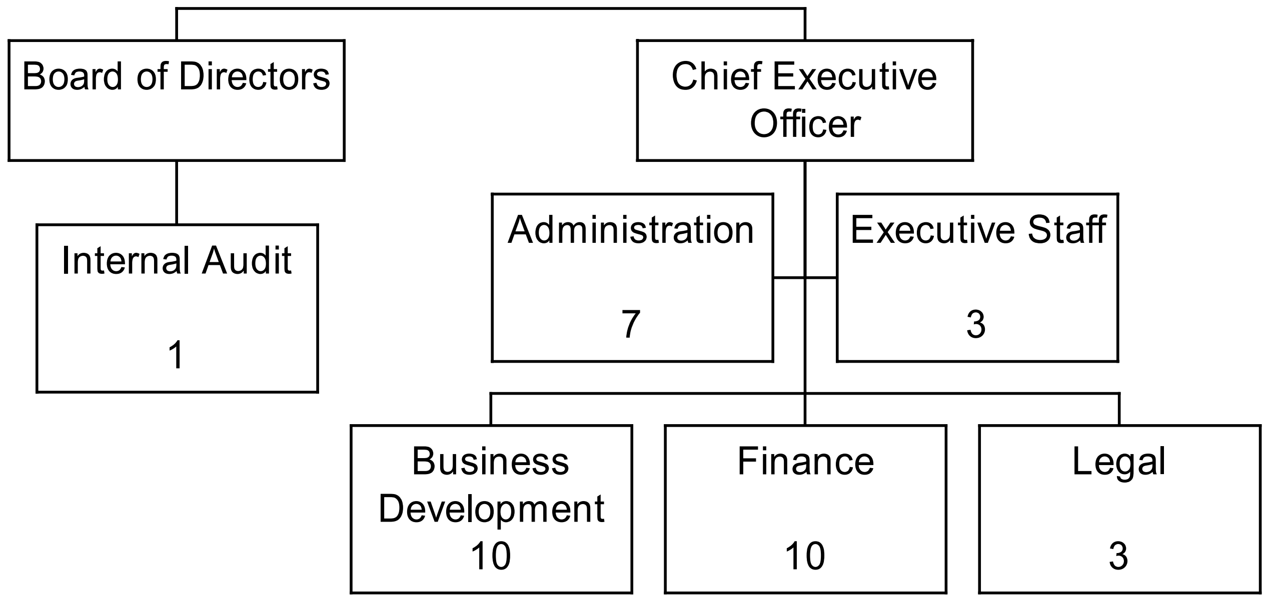
The Financial Department has 10 employees (versus 15 in Alternate One). This organization has smaller staffs than the Alternate One organization in the accounting, lending, loan servicing, and customer service functional areas.

The Legal Department has 3 employees (versus 4 in Alternate One) from the elimination of the paralegal position. The Office Administration Department has 7 employees (versus 10 in Alternate One). This reduces the in-house IT and Business systems support, and the HR staff, partly as a reflection of the size of the Alternate Two organization.

The Board Organizational Blueprint

Once 51 percent of the Government's Class A stock has been retired, the Board will be reduced from thirteen to eight members, dropping the five USDA appointees. The remaining eight members include the six elected members (three representatives of cooperatives and three representatives of commercial shareholders) and the two Presidential appointees from the public. Responsibilities of the Board at privatization should become more focused towards the governance of a private financial institution and should include these considerations from private industry and the banking sectors:

- The Board should consider expansion from the eight-person representation to include several outside representatives elected from the rural telecommunications associations. These key stakeholders represent the industry that will remain the focus of the Bank's critical mission and could provide valuable support and insight to the Bank.
- The Board should also consider adding independent representatives and should consider the results of the new Sarbanes-Oakley Act 2002 in designing the Board membership to include some present or past Certified Public Accountants. Since the Bank may have to follow SEC regulations, planning for compliance with this Act and other laws effecting corporate governance as a public company seems prudent.



TOP MANAGEMENT TEAM

RTB Primary Value Adding Activities

Figure 4. Alternate Structure Two

- Expansion might also include or combine additional banking/financing representation, since a significant key to the privatized bank's success will be its knowledge and ability to work in the private sector capital markets and with the credit rating agencies.
- Other key considerations or perspectives that the Board may want to consider for expansion could include individuals with non-telecommunications marketplace insights, stakeholder management expertise, strategic planning expertise, and/or rural economic development expertise.

Any private board must fulfill three general responsibilities (1) ensuring the company complies with laws and regulations, (2) assisting the chief executive officer, as necessary, and, (3) acting as a trustee for the company's owners and stakeholders in pursuit of profitability and asset protection.

In carrying out these responsibilities, the Board should consider involving individual Board members in various committee roles, benefiting the Bank by offering management multiple perspectives, experiences, and expertise. Several committees are discussed that form the basis of a proposed Board organization structure as shown in Figure 5.

Five focused committees are proposed:

- The Executive Committee would be authorized to act on behalf of the full Board and manage the Board functions between regular meetings. It could review and coordinate the information from all the various Board committees and closely oversee the Bank's operations.
- An Asset and Liability Committee (ALCO) would oversee the Bank's balance sheet, including measuring the Bank's performance using a set of performance measures. If the Bank does not link the process of obtaining, pricing and using funds from the financial markets in a coordinated and controlled manner, the Bank risks losing value for its shareholders and future operations. ALM requires this coordination and this important Board committee must prioritize the operating profit goals relative to the Bank's ability to manage its spread over its cost of funds and its low-cost service objectives. This will drive the Bank's process of acquiring and distributing funds. This committee must understand the ALM strategy, use and understand information available about the risks facing the Bank to make sound decisions, and substantiate that decisions made at the Board level are put into operation as designed, measuring the results as an ongoing test.

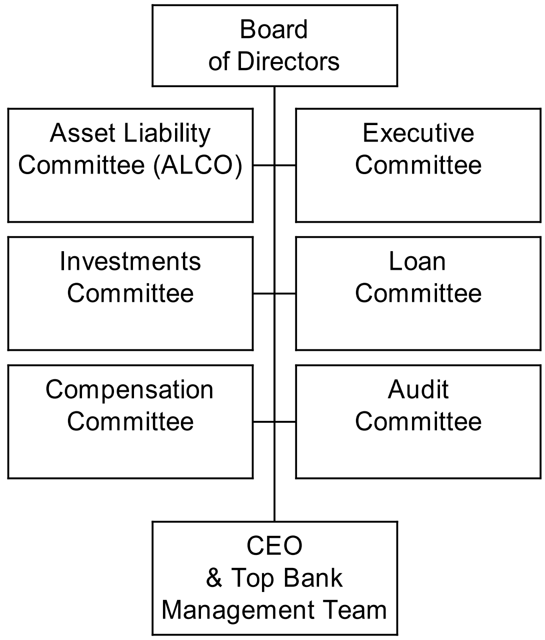


Figure 5. Proposed Board of Directors' Organization Structure

- The Audit Committee would be the compliance and oversight committee with the primary concern to ensure all laws and regulations are being followed. It should be comprised of independent directors and may be subject to some new requirements for public companies dictated by the Sarbanes-Oakley Act of 2002 and other recent legislation on corporate governance. The Bank should implement public audits prepared by a certified public accounting firm as soon as possible. This will ensure that there can be a history of audited financial statements substantiating the Bank's operations. Rating agencies and shareholders will be sure to require such audited financials.

  This committee would also become the key liaison for the auditors to the Board. They will review the audited (or examination) reports and consider the auditors' recommendations, and report the results to the Board. Because of their key role in the audit area, their efforts should have some direct impact on the internal accounting controls of the Bank operations and will be key in establishing sound internal control policies, practices, and procedures. Examples would include segregation of duties, account reconciliation to external sources and the accounting budget and review processes. The Board should have internal auditing personnel assigned to directly report to this committee on the Board. (We have included these personnel in the alternate organization structures discussed above.) Here, they would be allowed to exercise their responsibilities without being under pressure from internal bank management.

- The Investment Committee would focus on the non-loan investments of the Bank, setting investment risk levels, goals, and objectives. This committee would provide guidelines and policy to direct management in its investment options.

The committee should institute polices, practices and procedures to ensure its investments strategy is protecting bank's assets and adequately considering liquidity needs (cash available to make loans), risk, pledging requirements, size, mix, and diversification. Given the large cash balance the Bank will possess upon privatization, an investment committee will be needed early on to guide the Bank's investments since it is unlikely that the Treasury will continue to pay interest on the cash balance at the current rate and may require the funds to be transferred to private accounts immediately upon privatization.

- The Loan Committee would set loan policies and procedures to meet the needs of the Bank, and match the credit risk philosophy of the Board. It would set minimum acceptable debt to equity ratios, loan to value ratios, collateral requirements, and other loan terms, conditions and covenants that act as first-line protection of the Bank's loan portfolio. It will actively participate in the credit decisions of the Bank, and be responsible for the delegation of authority to bank management on certain credit risk decisions. This committee must be knowledgeable of the rural telecommunications marketplace and have a clear understanding of the businesses behind the credit risks presented to the Bank for loan consideration.
- The executive salary and bonus committee (i.e., compensation committee) would approve and set guidelines for the compensation package for the top tier executives of the Bank. It also establishes management level goals and objectives, and ties the compensation packages to these objectives. As the Bank becomes subject to increased regulations, including possible SEC requirements, this committee will need to understand the impact of these regulations. The committee could also set policies and procedures of compensation standards at some of the lower levels of the Bank such as company contributions to retirement programs. This committee needs to keep abreast of compensation factors within the marketplace.
- Ad hoc committees include those that arise to review operations or subjects of interest for making specific recommendations – for example budget committees might meet at year end, environmental scanning committees might meet periodically to contribute to strategic planning sessions, and a strategic planning committee might convene to scrutinize and substantiate management plans, objectives, and bank direction. These committees would not be needed immediately upon privatization, but would be developed as needed after the Bank has some private operating experience.

4.0 Projected Operating Costs

This section of the report will project the Bank's annual operating costs based on the alternate organizational structures presented in Section 3. Several issues need to be considered by the Board when viewing these projected operating costs:

- The private Bank would not need a large organization to operate, and it could conceivably hire this team within a six-month search period. It was assumed that staff could be phased in over the first year of private operations. The proposed transition plan schedules the Bank to hire its top management team during the latter stages of the transition. After privatization, the remainder of the Bank's staff would be hired. In the interim period, the Bank should be able to operate using contractor labor or under a temporary agreement with RUS. This would also allow time for the private bank to gain control of its operations and focus on finding the right talent, for the right budget, over a reasonable period of time.
- The two alternatives discussed in Section III are not intended to "set in stone" the organization, staff sizes, or reporting authorities; but rather to confirm that all of the functions required to meet the mission are adequately considered. The intent is to give the new management team a target operation that it must build from the ground up. Depending on the mix of talent that is available and that the Bank can engage, the specificity of these organizations become less important, and the target budgets become the foundation for implementation of a operating team that fits within the financial scenarios and assumptions discussed below.
- The two alternatives provide the basis for projecting the operating budgets. The labor budgets were derived from researching the salary markets and costs for the various positions. The assumptions are taken from the Financial Services industry, in the East-Cost marketplace, for institutions with annual revenues from $50 million to $200 million, and are forecast (using 3 % escalation) out to 2007. See Appendix B for more details.

Using this information, the overall labor budget for these two alternatives is estimated to fall between $3.5 million and $5.0 million. Table 1 compares the projected labor budgets for the two alternatives.

Table 1. Projected Labor Budgets by Function

Function	Alternate One	Alternate Two
Chief Executive Officer Staff	$846,000	$777,000
Business Development Department	$926,000	$776,000
Finance Department	$1,299,000	$1,098,000
Legal Department	$464,000	$417,000
Engineering/Telecommunications Dept.	$620,000	None
Office Administration	$789,000	$491,000
TOTAL	**$4,944,000**	**$3,559,000**

The salary estimates are an average for the East Coast. During the transition, the Bank will decide on a preferred location(s) for the Bank's offices. The salary estimates for this industry segment for all regions of the country are 99% of the cost of the East Coast estimate. There is not a large difference in labor costs from one region of the country to another as shown in Table 2.

Table 2. Estimated Labor Costs by Region Compared to the East Coast

Region	As a Percentage of the East Coast Estimates
West Coast	104%
East Coast	100%
Midwest	99%
Central Plains	97%
South	95%
All Regions	99%

Total Operating Expenses

The estimate operating expenses for the two alternatives range from $8 million to $9.7 million and are below the range of 0.75% to 1.5% of non-cash assets used in our scenario reviews (Section 5). Table 3 shows the estimated operating costs for Alternate One organization structure. The four largest items, representing over 80 percent of the estimated operating expenses, were based on the following:

- A research firm referred to SAIC by human resource specialists in the financial industry provided Bank salary data. The research service provided salary information for the key positions used in the organization charts and the average annual compensation is included here. Some of these salaries were further compared to SEC reports for entities with similar business and scope, to test and further support the data (see Appendix B, *Organization Charts*, for salary details by position).
- Salary overhead and benefits (estimated at 35 percent of salaries) represents estimates from human resource specialists.
- Office expenses were determined after discussions with a commercial property management company. These estimates were based on the Bank leasing a vacant property and included their expert estimate of the costs associated with rental space, office expenses, telecommunications, and computers.
- Annual loan servicing costs were determined after discussions with a national vendor who provided their pricing formulas. There are several firms that provide full-service loan servicing functions. The formulas reviewed also include web-enabled loan application processing, reporting, and tracking.

Table 3. Operating Expenses for Alternate Organization One—Review & Support of Estimate & Forecast

Accounting System & Support…………………………………………………	$ 190,000
➢ G/L, Payroll, AP, Report Writing, ALM	
➢ Full Systems Support & Annual Maintenance	
➢ Rating Agency Fees	
Annual Loan Servicing………………………………………………………	632,000
➢ Full Commercial Loan Servicing	
➢ Integrated to Loan Processing, Prospecting & Credit Standard/Scoring	
➢ Collateral & Tax Services	
Audit Services & Filings……………………………………………………	130,000
➢ Annual Audit and Quarterly Reviews	
Corporate Insurance, including Directors' Liability……………………………	65,000
➢ Corporate Liability Coverage & Directors' Liability	
Legal Support & Services……………………………………………………	280,000
➢ Legal Library & Services	
➢ Outside Legal Support	
Office Expenses…………………………………………………………….	994,000
➢ Rent on Office Space	
➢ Telephone & Lines	
➢ Computer Expenses	
Outside Professional Services…………………………………………………	350,000
➢ Operations & Loan Specialization	
➢ Environmental Specialization	
➢ Business & Financial Specialization	
Salaries…………………………………………………………………………	4,944,000
Salaries - Overhead & Benefits………………………………………………	1,730,000
➢ 35% of Salaries to Cover Health & Benefits	
Travel and Marketing…………………………………………………………	344,000
Total Annual Operating Expenses………………………………….	**$ 9,659,000**

5.0 Financial Model Runs

We looked at five sets of scenarios to explore certain conditions that may act as limitations or provide guidance in designing the operations of the private bank. These scenarios are considered conservative in that the projected operating costs included in these runs are higher than those projected in Section 4.0 above. The operating costs are based on a percentage of non-cash assets typical for banks of this size. Also, the scenarios are mainly focused on the Bank continuing to offer fixed rate, secured loans similar to its current products. Any combination of products, services and enhancements could offer additional prospects for revenue growth.

The following assumptions were used as a starting point for the cost analysis – others may be considered to refine the estimate during the transition period.

- The interest rates used in these scenarios were derived from assumptions on the rates as published in the Wall Street Journal and the Federal Reserve Bulletins for October 28, 2002. These rates drove the estimated marginal cost of funds in the private market (set at Moody's Seasoned Aaa 6.48%), and interest on cash (set at a portfolio of U.S. Treasury investments averaging 3.03%). This assumes that the Bank could get a cost of funds rate on debt at least as low as the Moody's Aaa rating which is considered the highest investment grade rating. It warrants caution that a Aaa rating is very difficult to obtain and maintain. Even with some governmental support, high capital and high liquidity, the bank may not meet the credit agency's threshold, and could have to pay more to borrow funds than projected.
- Two possible spreads above the Bank's cost of money are considered, thus a borrower's cost of money on loans offered by the Bank is calculated at 6.98% (a 0.50% spread above the Bank's cost of money in the private market) and 7.98% (a 1.5% spread).
- The advances for new private loans begins at $84 million in the first year of privatization and grow by approximately 15 percent per year, and advances on liquidating and financing account loans transferred from the Government to the Bank are fixed at $6 million and $20 million per year.
- U.S. Treasury debt remains on the books and is amortized over its estimated outstanding life.
- Minor prepayments were included on liquidating and financing loans outstanding (1% per year).
- Income tax was assumed to be zero. If the Bank elects a private finance company arrangement it could be subject to taxes estimated to average 35% of net income before tax. This would reduce the projected returns to 65% of those shown in this review.

Each of the five scenarios were prepared as a comparative set using the higher borrower interest spread on private loans offered by the Bank of 1.5% over the Bank's marginal cost of funds (COF) and the lower borrower interest spread of 0.5% over marginal COF.

- The first scenario is based on the Bank operating at the high end of expected operating costs (i.e., **high cost of operations** -- 1.5% of the non-cash assets), which by the fourth year of private operations would total $21 million. This scenario also has the Bank using its cash to pay down 100% of the Class A stock before the Bank's first year of private operations. Dividends are set at 2 percent for all shareholders.
  - Labeled 1-A & 2-A

- The second scenario is based on the Bank operating at the low end of expected operating costs (i.e., **low cost of operations** -- 0.75% of the non-cash assets), which by the fourth year of private operations would total $11 million. This scenario also has the Bank using its cash to pay down 100% of the Class A Stock before the Bank's first year of private operations. Dividends are set at 2 percent for all shareholders.
  - Labeled 3-A and 4-A

- The third scenario uses **new, low interest debt to pay down 100% of Class A Stock** and includes the **low cost of operations**. Dividends are set at 2 percent for all shareholders.
  - Labeled 3-B and 4-B

- The fourth scenario in an effort to gradually leverage the Bank's equity and increase returns, **pays out a relatively large cash dividend payment** (12 percent) to all shareholders for five years, includes the **low cost of operations**, and uses cash to pay back 100% of Class A stock before the first year of private operations.
  - Labeled 3-C and 4-C

- The fifth scenario in an effort to leverage the Bank's strong cash and equity position **provides additional credit enhancements** through a loan payment guarantee offering customers at a fee of 0.5 percent to seek a better interest rate from other lenders by showing that the private bank will guarantee their payments. The Bank would be in position to offer such guarantees if it was able to maintain a Aaa credit rating. Under this scenario, if the Bank were able to leverage its cash position 5 times by year 4 of private operations, it could earn an additional 2.5 percent in service fees on its cash balance.
  - Labeled 3-D and 4-D

Table 4 presents a summary of the model runs by scenario number. Appendix C provides more detailed information from each model run including a balance sheet and income statement.

Table 4. Scenario Review Summary

Statistics from Private Year 4										
	Scenario	**Interest Spread Above New Private COF**	**Long-term Borrowers' Cost on New Loans**	**Net Income ($)**	**Return on Equity (%)**	**Stockholders Equity**	**Operating Expenses $**	**Operating Expenses as a % of Non-cash Assets**	**Total Assets**	**Cash**
High Operating Costs Cash is Used to Pay Down 100% of Class A Stock						2% Dividend on Common				
1 – A	1.5% Spread	1.5%	7.98%	$76 M	4.88%	$1.55 B	$21 M	1.5%	$1.67 B	$251 M
2 – A	0.5% Spread	0.5%	6.98%	$70 M	4.58%	$1.54 B	$21 M	1.5%	$1.66 B	$242 M
Cash is Used to Pay Down 100% of Class A Stock Low Operating Costs						2% Dividend on Common				
3 – A	1.5% Spread	1.5%	7.98%	$87 M	5.48%	$1.59 B	$11 M	0.75%	$1.71 B	$288 M
4 – A	0.5% Spread	0.5%	6.98%	$82 M	5.19%	$1.57 B	$11 M	0.75%	1.70 B	$280 M
New Low Interest Debt is used to Pay Down 100% of Class A Stock Low Operating Costs						2% Dividend on Common				
3 – B	1.5% Spread	1.5%	7.98%	$73 M	4.60%	$1.58 B	$11 M	0.75%	$2.15 B	$731 M
4 – B	0.5% Spread	0.5%	6.98%	$67 M	4.31%	$1.57 B	$11 M	0.75%	$2.14 B	$723 M
Acceleration of Bank Leverage through Dividends and Stock Buyback Plan – A Commercial banking Perspective - Low Operating Costs						**12% Dividend on Common**				
3 – C	1.5% Spread Low Ops.	1.5%	7.98%	$57 M	5.88%	$ 974 M	$11 M	0.75%	$1.55 B	$129 M
4 – C	0.5% Spread Low Ops.	0.5%	6.98%	$ 52 M	5.41%	$ 963 M	$11 M	0.75%	$1.54 B	$121 M
Acceleration of Bank Leverage through Loan Guarantees/Enhancements leveraging Cash 5 times, charging 0.5% for enhancement = Cash interest & service return of 5.43%						**2% Dividend on Common**				
3 – D	1.5% Spread Low Ops.	1.5%	7.98%	$100 M	6.06%	$1.65 B	$11 M	0.75%	$1.77 B	$350 M
4 – D	0.5% Spread Low Ops.	0.5%	6.98%	$95 M	5.77%	$1.64 B	$11 M	0.75%	$1.76 B	$341 M

Our team reviewed with the privatization committee and the Bank's management team several scenarios and the following highlights from Table 4 support various levels of profitability for the privatized operations. Of course there are several limitations in running forward looking scenarios and this review comes with qualifications as to the probability of the Bank matching these returns.[1] The primary objective is to provide a range of supporting analyses to allow the Board to understand various options the Bank may want to consider as it moves towards privatization.

Highlights

- The scenarios rely upon a reasonable growth plan with approximate advances forecasted to grow from $110 million, including $85 million of private loan advances, to $198 million by the fourth year of privatization. This equates to a projected growth rate of approximately 16 percent per year. With the Marketing Report estimating the total demand for infrastructure capital to be met by public debt financing at approximately $2.4 billion, this pro-forma represents between 5 percent and 9 percent of that demand. The privatized Bank will need to initiate a sound marketing plan to ensure that the Bank captures this demand as indicated.

- From the opinion of banking experts, commercial loan operations in typical commercial lending institutions range form 1.5% to 2.5% of the loan portfolio (for this Bank, that would be virtually all of its non-cash assets). This cost would include origination through servicing of commercial loans carried on the institution's books. These costs do not include a loan loss reserve, which is covered under another expenses category. It became apparent under most of the scenarios studied that the Bank's operating costs could not exceed 2 percent, without significant pressure on profits. The Bank will have to manage its operating costs, and for the most favorable scenarios, that would mean targeting the low operating cost assumption -- 0.75 percent of non-cash assets. We believe this is doable based on the organization structures proposed in Section 3. Compared to other entities serving the rural telephone market, the private bank's operating costs are expected to be high initially and then come down on a percentage basis as the Bank's loan portfolio grows. For comparison, if the private bank were able to operate at 0.75% of non-cash assets, this would represent an operating cost as a percentage of total assets of approximately 0.59%, CoBank's ratio is 0.64% of total assets (as of December 2001) and the telecommunications systems ratio from NRUCFC's consolidated reports is 0.19% of total assets as of May 2002. For 50 chartered banks with similar asset sizes, the average was 1.45% of total assets (from the FDIC reporting database as of September 2002).

[1] SAIC does not endorse or guarantee these results, but merely utilized the financial model to design several limited views of the operations of the privatized institution for the team to consider in making determinations and decision about privatization choices, opportunities and threats. Actual results are dependent on a variety of variables playing out as forecast including the Bank's ability to increase its loan advances and control its operating expenses.

- Loan loss reserves have been set to increase each year at 0.25% of loans outstanding, and are thus charged to operating income accordingly. It was estimated that the Bank would be prudent in setting and accumulating allowances for loan losses during privatization. The allowance for loan losses at year-end September 30, 2002 was $5.4 million. The loan loss forecast charge for the first year of privatization added an additional $5.3 million, and by the fourth year of privatization accumulates over $25 million of additional reserves. This would leave an estimate of approximately two percent (2%) of loans as an allowance for loan losses after the fourth year of privatization. Loan charge-offs would be applied to this allowance. Two percent approximates a reasonable commercial bank portfolio allowance.
- In the scenarios reviewed, if the Bank were to charge a 0.5% to a 1.5% spread to its marginal cost of funds on its loans, the Bank could cover its projected operating costs and make a profit. However, the projected returns (4.3 to 6.06 percent) would not be on par with those normally expected from private banks or financial institutions, and there could be some pressure from shareholders to increase returns. Loan volume will be inversely correlated to the spread charged (higher spreads usually mean lower loan volumes). Shareholders would have to expect that for at least the first several years of private operations that the Bank's returns would be likely to fall below finance industry norms. This would be the case until the Bank was able to leverage its assets to a level approximating that of a typical bank.
  - A 0.5% spread would obviously result in lower returns on equity and during the later years these returns were reduced further due to the fact that newer loans start to require debt funding and the portfolio shifts from loans funded with the Bank's cash to newer loans at a nominal lower spread. (In the first years of privatization, the Bank has enough cash on hand to cover its advances out of cash so these loans earn the full amount of the interest rate charged on the loan since there is no requirement for the Bank to pay off debt associated with these loans. After the Bank's cash balance has reached 15% of outstanding loans, new loans begin to be financed with new debt so the spread earned on these loans is only 0.5% above the Bank's COF). Under this constraint, fourth year returns on equity ranged from 4.3% to 5.77%.
  - A 1.5% spread resulted in higher returns on equity due to the additional one percent spread on new loan advances. Under this constraint, fourth year returns on equity ranged from 4.6% to 6.06%.
- If the Bank were able to accelerate its move into a more leveraged equity position, the Bank could begin to approach the returns necessary to compete for equity capital in the commercial banking equity markets. To do this, Scenarios 3C and 4C used a relatively large cash dividend to hasten the Bank's transition to a higher debt-to-equity ratio. This produced relatively modest increases in the fourth year returns at 5.4% for the lower spread scenario and 5.9% for the higher spread scenario. However, these scenarios result in the Bank partially liquidating its equity as more cash is paid out in dividends than is brought in through operations. Under these scenarios, the Bank could quickly face a possible downgrade from the credit agencies and would jeopardize its ability to continue to provide low cost funding to the rural market. Therefore, this scenario would not fulfill the Bank's mission.

- If the Bank could use it strong cash and equity positions to leverage its returns by using its outstanding credit to guarantee loan payments; it could provide additional returns, while helping to attract more capital from non-traditional sources to the rural telephone marketplace. This might prove to be an attractive product for the larger institutions that service the rural telecom marketplace but who do not come to the Bank today for loans. Under this scenario it was assumed that the Bank could gradually build up a portfolio of loan guarantees so that by the fourth year, guarantees in the amount of 5 times the Bank's cash balance are outstanding. Similar services are offered in other industries by companies such as MBIA and have proven to be successful. The Bank would charge those borrowers a 0.5% loan guarantee fee per annum. Under this scenario, the Bank would be projected to increase its returns to 5.77% to 6.06% by the fourth year of private operations.
- The Bank could elect to operate under a combination of these scenarios, varying operating cost within an acceptable range, varying borrowers interest spreads to match the risks, accelerating its leverage position, while continuing to meet the demands of the rural telephone marketplace, and the requirements set from its discussions with the credit rating agencies.
- The returns indicated in Table 4, Scenario Review Summary, meet the investment-returns of a cooperative structure with zero or low taxes. Returns are projected to range from 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.
- Several important drivers must be considered in obtaining the leverage required under a finance company structure. First, the Bank's primary lending target, the rural telecommunications marketplace, will drive or limit the ability and extent of growth for the loan portfolio. There are several lenders in this marketplace, and the Bank should expect competition to impact a leveraged growth requirement. The Bank would need to expand at much greater rates than those shown in these scenarios for it to become leveraged at the same level as a typical commercial bank. In addition the Bank must continue to manage the risks in building a quality performing loan portfolio and maintaining the highest credit rating.
- To meet the demands of a finance company structure, the Bank would need to manage its debt to equity structure. Most finance companies have a 90:10 debt to equity ratio. Executing a leveraging plan could only be considered within a sound and safe asset liability management strategy, rating agency considerations, and with the guidance of a team of financial and commercial lending experts. Shareholders would need to hold expectations to returns at lower levels for a long period of time until the Bank can capture the benefits of higher leverage.