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National Rural Utilities Cooperative Finance Corp.

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National Rural Utilities Cooperative Finance Corp.

Major Rating Factors

Issuer Credit Rating
A/Stable/A-1

Strengths:

- Very strong business stability owing to decades of providing financing to member electric utility cooperatives
- Low credit risk of electric utility loans
- Access to low cost funding from the Federal Financing Bank, Farmer Mac, and its members

Weaknesses:

- Relatively high leverage and modest earnings
- Single borrower and industry concentrations

Outlook

The stable outlook on National Rural Utilities Cooperative Finance Corp. (CFC) reflects S&P Global Ratings' expectation that over the next 18-24 months the company will maintain its role as an important source of financing for the rural electric utility industry, a risk-adjusted capital (RAC) ratio of 7.0% or better, minimal credit losses, and diversified funding that includes the Federal Financing Bank, the Federal Agricultural Mortgage Corp. (Farmer Mac), and CFC's members.

Downside scenario

We could lower our ratings if the company's RAC ratio declines below 7.0% consistently, credit losses significantly increase, or if the company's unique business position or funding becomes eroded, in our view.

Upside scenario

We could raise our ratings if the company's RAC ratio rises well above 10.0% while maintaining minimal credit risk in its loan portfolio and maintains funding from the Federal Financing Bank, Farmer Mac, and its members. The company's concentrated business model and use of short-term debt limits the probability of a higher rating.

Rationale

Our ratings reflect the company's very strong business stability as a result of decades of providing financing to member electric utility cooperatives, low credit risk of electric utility loans, and access to low cost funding from the Federal Financing Bank, Farmer Mac, and its members. Conversely, our ratings reflect the company's relatively high gross leverage, modest earnings, as well as single borrower and industry concentrations in its loan portfolio.

We rate all the company's senior secured and senior unsecured debt the same as the issuer credit rating. We rate the company's subordinated deferrable interest notes two notches below the issuer credit rating to reflect subordination and interest deferral risks.

Business Description

CFC is a tax-exempt, member-owned cooperative that provides credit to rural electric cooperatives and rural utilities. CFC has played an important role--even though it is not government sponsored--for decades in financing the rural electric utility industry because many of its members have limited direct access to the capital markets.

Anchor: Reflects CFC's unique competitive position among finance companies

Our starting point--or anchor--for our ratings on nonbank financial institution finance companies in the U.S. is currently 'bb+'. We initially set the anchor for finance companies three notches below the anchor for banks in the same country to reflect the typical lack of central bank access, lower regulatory oversight, and higher competitive risk for finance companies relative to banks. U.S. finance companies typically rely on bank facilities, secured and unsecured debt, and other wholesale funding, whereas U.S. banks mainly rely on deposit funding. While consumer finance companies generally are subject to consumer protection laws, U.S. finance companies are not subject to the significant prudential regulatory oversight of banks' capital and liquidity, which we view as generally supportive of creditworthiness. While U.S. finance companies may compete with banks, they often focus on higher-risk lending than banks and are subject to greater cyclical volatility. Like banks, U.S. finance companies' anchor reflects the country's diverse and high-income economy.

Given CFC's unique competitive position, we raise the finance company anchor one notch to 'bbb-', reflecting its lower competitive risk relative to other finance companies. CFC supplements financing offered by the Rural Utilities Service (RUS) to not-for-profit rural electric utilities and has few direct competitors. Additionally, CFC has access to low-cost government funding from Federal Financing Bank and low-cost funding from Farmer Mac, a government-sponsored enterprise.

Business position: Strong market position in lending to rural electric utility cooperatives

CFC makes loans to its members so they can acquire, construct, and operate electric distribution, generation, transmission, and related facilities. Its members are dispersed throughout the U.S. and its territories, and often borrow from the federal government's RUS. CFC and its primary competitor, CoBank ACB, provide most of these electric cooperatives' supplementary financing needs. Some members borrow from CFC even when they have additional capacity with the RUS, and an increasing number have been borrowing solely from CFC. We believe CFC's focus on and knowledge of the industry--as well as some of the ancillary services it provides to members--has engendered loyalty over many years. As of May 31, 2020, CFC had 1,439 members and 232 associates. As a member-owned cooperative, CFC's objective is not to maximize profit, but to provide cost-based financial products and services to its members.

Capital, leverage, and earnings: Adequate for the risk profile

We view CFC as adequately capitalized on a risk-adjusted basis, as reflected in a RAC ratio of 8.5% as of Aug. 31, 2020. We generally consider a RAC ratio of 7%-10% to be indicative of adequate capital. We adjust CFC's adjusted common equity for the prior-year cumulative derivative forward-value adjustment and current year-to-date derivative forward-value gains or losses, which totaled losses of $1.002 billion as of Aug 31, 2020. These adjustments are related to interest-rate swaps that CFC uses to hedge interest-rate risk related to differences in the repricing characteristics of its loan portfolio and its borrowings. Those hedges create some timing asymmetry in the company's financial reporting under generally accepted accounting principles. Although CFC has not sought the hedge accounting treatment necessary to have its interest-rate swaps classified as cash flow hedges for financial reporting, we believe these hedges are economically effective, therefore,we adjust reported equity in the same manner we do for cash flow hedges. If market interest rates rise and the forward-value adjustments convert to gains, we would deduct such gains from total adjusted capital.

The company's business model has historically generated relatively modest--yet stable--earnings. It aims to provide members with attractively priced loans and allows them to benefit from CFC's relatively low-cost funding. The loan portfolio had an average yield of 4.26%, and the net interest spread was 1.01% for the year ended May 31, 2020. For the quarter ended Aug. 31, 2020, the average yield was 4.07% and net interest spread was 1.24%.

CFC also reports a "times interest earned ratio" (TIER), a measure of its ability to cover interest expense. Adjusted for noncash derivative items, it is essentially a ratio of net income plus interest expense over interest expense. The company targets a minimum annual adjusted TIER of 1.10x. Under a covenant on the company's revolving credit lines, an average ratio over a six-quarter period cannot drop below 1.025x. For the year ended May 31, 2020, the company's adjusted TIER was 1.17x and it was 1.28x for the quarter ended Aug. 31, 2020. Adjusted TIER is calculated based on adjusted net income plus adjusted interest expense for the period, divided by adjusted interest expense for the period.

Risk position: Low credit risk in the electric utility loan portfolio

CFC has a low-risk loan portfolio, strong asset quality metrics, and prudent risk-management policies, in our view. We believe CFC's loans to electric utilities have low risk of default, which is reflected in the modest charge-offs the company historically has reported on mostly senior secured loans. The company has reduced its exposure to telecom loans, which historically had weaker credit performance, totaling $396 million as of Aug. 31, 2020, compared to $2.99 billion reported as of May 31, 2005. CFC has only one nonperforming loan, which the company placed on nonaccrual status and had an outstanding balance of $161 million as of Aug. 31, 2020. Troubled debt restructurings (TDRs) were 0.04% of the loan portfolio.

However, borrower concentration remains a risk, though CFC's senior secured position mitigates expected losses in a default. Although it has reduced exposure to individual borrowers in recent years, its 20 largest borrowers still accounted for 22% of its loans outstanding (21% net of loans covered under Farmer Mac standby purchase commitment) as of Aug. 31, 2020.

Funding and liquidity: Stable funding sources and adequate liquidity

We believe CFC has adequate funding and liquidity, given its access to a variety of stable funding sources. The Federal Financing Bank, a government entity, and Farmer Mac, a government-sponsored entity, provide CFC with 36% of its debt, offering a source of relatively low-cost, long-term financing to help fund rural utility lending. While the CFC's funding is adequately diversified, the company is very active issuing debt in the capital markets. Debt from capital markets makes up 43% of the company's current debt outstanding, giving the company some sensitivity to potential changes in investor confidence or credit ratings. We would view increased usage and reliance on short-term borrowings as a weakness; however, the CFC currently has a very diverse capital structure with numerous counterparties.

As of Aug. 31, 2020, the company had $2.458 billion in availability with Farmer Mac, $900 million under the Guaranteed Underwriter Program from the Federal Financing Bank, and $348 million in unrestricted cash and equivalents. It also had access to $2.7 billion in unsecured revolving credit facilities with a group of banks, as well as a liquid fixed-income investment portfolio of roughly $528 million.

Comparable ratings adjustment: Benefits from favorable access to funding, and member subordinated debt provides a cushion to senior creditors

The Federal Financing Bank and Farmer Mac provide CFC with approximately 36% of its total debt, offering a source of relatively low-cost, long-term financing to help fund rural utility lending. Members not only borrow from CFC, but they also provide about 21% of its total debt, including members' subordinated certificates. CFC's member subordinated debt is subordinated to all other debt issues, including nonmember subordinated securities. Member subordinated debt consists of membership subordinated certificates ($630 million), loan and guarantee subordinated certificates ($440 million), and member capital securities ($229 million).

External influence: None

We don't factor any external influence into the ratings.

Ratings Score Snapshot

CFC --Ratings Score Snapshot	
Issuer Credit Rating	A/Stable/A-1
SACP	a
Anchor	bb+
Entity-Specific Anchor Adjustment	1
Business Position	Very Strong (+2)
Capital, Leverage, and Earnings	Adequate (0)
Risk Position	Strong (+1)
Funding and Liquidity	Adequate and Adq. (0)
Comparable Ratings Adjustment	1
External Influence	0
Government Influence	0
Group Influence	0
Rating Above the Sovereign	0

National Rural Utilities Cooperative Finance Corp.					
	--Fiscal year-ended May 31--				
Balance Sheet Date Year	**Qtr Aug-2020**	**May-20**	**May-19**	**May-18**	**May-17**

National Rural Utilities Cooperative Finance Corp. (cont.)					
	--Fiscal year-ended May 31--				
Balance Sheet Date Year	**Qtr Aug-2020**	**May-20**	**May-19**	**May-18**	**May-17**
Business position					
Total assets	28,263	28,158	27,124	26,690	25,206
Gross receivables	26,929	26,702	25,917	25,179	24,367
Net income after extraordinaries	144	(585)	(149)	455	310
Net interest margin (%)	1.46	1.23	1.14	1.13	1.24
Capital, leverage and earnings					
S&P Global Ratings' RAC ratio before diversification (%)	8.48	8.63	8.35	7.93	7.84
Adjusted common equity/total adjusted capital (%)	75.19	75.19	75.19	75.19	75.19
Core earnings/average managed assets (%)	0.81	0.53	0.65	0.58	0.54
Risk position					
Growth in gross receivables (%) (YoY)	N.M.	3.03	2.93	3.33	5.20
Nonperforming assets/receivables + other real estate owned (%)	0.64	0.67	0.05	0.05	0.05
Net charge-offs/average gross receivables (%)	0.00	0.00	0.00	0.00	0.01
New loan loss provisions/average gross receivables (%)	0.00	0.14	(0.00)	(0.07)	0.03
Loan loss reserves/gross receivables (%)	0.21	0.20	0.07	0.07	0.15
Loan loss reserves/gross nonperforming assets (%)	33.38	29.75	147.94	149.23	283.73
Funding and liquidity					
Stable funding ratio (%)	78.75	81.46	83.73	84.34	83.56
Liquidity coverage metric (x)	0.74	0.90	0.96	0.98	1.08
Total adjusted capital - detail					
Common shareholders' equity	707	626	1,277	1,474	1,070
Plus: minority interest (equity)	25	23	27	32	29
Less: revaluation reserves	(2)	(2)	(0)	9	13
Less: other adjustments *	(1,002)	(1,089)	(355)	(35)	(341)
Intermediate adjusted common equity	1,735	1,740	1,659	1,532	1,427
Less: DTA arising from temporary differences not convertible into cash or government bonds exceeding 10% of Intermediate ACE	0	0	0	0	0
Adjusted common equity	1,735	1,740	1,659	1,532	1,427
Plus: admissible preferred and hybrids	573	574	547	506	471
Total Adjusted Capital	2,308	2,314	2,206	2,038	1,897
Plus: general reserves	24	18	17	18	36
Adjusted total equity	2,331	2,332	2,223	2,056	1,933

* Cumulative derivative forward value gains/(losses)

Related Criteria

- General Criteria: Hybrid Capital: Methodology And Assumptions, July 1, 2019
- General Criteria: Group Rating Methodology, July 1, 2019

- Criteria | Financial Institutions | General: Risk-Adjusted Capital Framework Methodology, July 20, 2017
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- Criteria | Financial Institutions | General: Issue Credit Rating Methodology For Nonbank Financial Institutions And Nonbank Financial Services Companies, Dec. 9, 2014
- Criteria | Financial Institutions | General: Nonbank Financial Institutions Rating Methodology, Dec. 9, 2014
- Criteria | Financial Institutions | Banks: Quantitative Metrics For Rating Banks Globally: Methodology And Assumptions, July 17, 2013
- Criteria | Financial Institutions | Banks: Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011
- Criteria | Financial Institutions | Banks: Commercial Paper I: Banks, March 23, 2004
- Criteria | Financial Institutions | Finance Companies: Commercial Paper II: Finance Companies, March 22, 2004

Ratings Detail (As Of November 20, 2020)*	
National Rural Utilities Cooperative Finance Corp.	
Issuer Credit Rating	A/Stable/A-1
Commercial Paper	
Local Currency	A-1
Senior Secured	A
Short-Term Debt	A-1
Subordinated	BBB+
Issuer Credit Ratings History	
12-Apr-2016	A/Stable/A-1
06-Jul-2015	A/Negative/A-1
20-Jan-2015	A/Stable/A-1
Sovereign Rating	
United States	AA+/Stable/A-1+

*Unless otherwise noted, all ratings in this report are global scale ratings. S&P Global Ratings' credit ratings on the global scale are comparable across countries. S&P Global Ratings' credit ratings on a national scale are relative to obligors or obligations within that specific country. Issue and debt ratings could include debt guaranteed by another entity, and rated debt that an entity guarantees.