

FINANCE COMPANY CREDIT REPORT

National Rural Utilities Cooperative Finance Corp.

Counterparty Credit Rating

A/Negative/A-1

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Major Rating Factors

Strengths:

- Continuous support from members of the rural electric cooperative system
- Strong market position in the rural utilities lending industry
- Historical track record of low loan losses
- Funding support through the U.S. Department of Agriculture

Weaknesses:

- Concentrated exposure to the utilities industry
- Heavy reliance on wholesale funding
- Increase in long-term leverage
- Limited access to new equity capital

Rationale

Standard & Poor's Ratings Services' ratings on the National Rural Utilities Cooperative Finance Corp. (CFC) reflect its continued support from members, its strong market position in the rural utilities lending industry, historically low loan losses, and access to low-cost funding through a U.S. Department of Agriculture (DOA) financing program. CFC's concentrated exposure to the utilities industry, heavy reliance on wholesale funding, increase in long-term leverage, and limited access to new equity capital somewhat offset the strengths.

The company plays an important role, even if not government sanctioned, in financing the rural electric utility and telephone industries because many of its members have limited direct access to the capital markets. Its members are dispersed throughout the U.S. and its territories. During the past several years, CFC has reduced single-obligor borrower exposure, established syndication, and refocused on lending to the electric distribution sector.

CFC has seen significant investment support from its members, who purchased \$3.7 billion of commercial paper, daily liquidity funds, medium-term notes, and subordinated certificates

outstanding at fiscal year-end May 31, 2009. In addition, members make up approximately 19% of CFC's funding profile.

Management has a history of working closely with borrowers in financial difficulty, which tends to reduce its ultimate losses, but has lengthened the repayment terms. Nonetheless, during the past year CFC has increased provisions significantly, reflecting the deterioration in the market value of the collateral supporting Innovative Communication Corp. (ICC), its only nonperforming loan.

Access to a long-term, committed, government-sponsored loan facility through the U.S. Department of the Treasury and guaranteed by the DOA lowers CFC's overall cost of borrowing. Additional funding is available through the Federal Agricultural Mortgage Corp. (Farmer Mac) and committed bank lines. These sources have been instrumental in providing much needed support to offset the intermittent volatility in the capital markets as was experienced during the last quarter of 2008.

CFC is concentrated in the utilities industry because of its cooperative status. The electric portfolio represents companies that are mostly investment grade and have stable operating histories. Historically, the rural utilities sector has performed fairly well in economic downturns, with minimal charge-offs, which mitigates this concern.

Given the most recent market dislocations, in our view, CFC's high reliance on wholesale funding presents an incremental risk factor.

CFC's long-term leverage, as measured by its debt-to-equity ratio, has increased significantly during the past 12 months. CFC reported that total debt increased by \$1.4 billion—mainly long-term debt, reflecting a 25% increase in this type of debt from one year earlier. We note that management has established internal goals for improving leverage by fiscal year-end 2014, with a target debt-to-equity ratio of 5.57x, which we consider a positive development, and supportive of the current rating level.

A weakness of CFC's financial flexibility is its limited ability, as a private, not-for-profit cooperative association, to increase capital except by generating retained earnings and increasing the level of members' subordinated certificates and hybrid capital instruments. However, CFC has taken steps, which we view as positive, to continue to strengthen its capital, including issuing additional member capital securities and revising the retirement guidelines of its patronage capital.

Outlook

The outlook is negative. We believe that CFC's continued high exposure to short-term wholesale funding, increased leverage, potential for additional future credit-quality deterioration with its limited existing loan-loss reserves, and potential exposure to interest rate movements could lead us to lower the ratings. We could review the outlook for a revision to stable if management succeeds in reducing leverage and the company's dependence on short-term funding.

Profile

CFC has a large market share of a narrow business mix limited to the utilities industry. Founded in 1969, CFC is a privately owned, not-for-profit cooperative association that provides loans to its members in the rural utility industry to supplement the loan program of the DOA's Rural Utilities Service. CFC's loan and guarantee portfolio totaled \$21.5 billion as of May 31, 2009, and \$244 million of this is guaranteed by the RUS. CFC's 1,522 consolidated members consist of electric distribution cooperatives (65% of its loan and guarantee portfolio), power supply cooperatives (24%), statewide and associate members (1%), and the Rural Telephone Finance Cooperative (RTFC) and National Cooperative Services Corp. (NCSC) (8% and 2%, respectively), which are consolidated for accounting purposes.

RTFC is a not-for-profit cooperative association that provides and arranges financing for rural telecommunications members and their affiliates. NCSC is a private cooperative association and provides financing to entities that are owned, operated, controlled by, or provide substantial benefits to CFC members.

Strategy

Management's strategy is conservative and supports CFC's cooperative principles. It aims to provide low-cost lending to its members, build its capital base, and manage credit relationships to minimize risk. Management seeks a balance between charging the lowest reasonable loan and guarantee rates, while maintaining the financial performance necessary to access the capital markets on behalf of its members. Some members of the cooperative system can tap directly into the capital markets, but for many this is not an option. This makes CFC an important financing alternative. CFC issued \$278 million in member capital securities during fiscal 2009, and the board of directors has recently extended its guidelines for retiring member patronage capital. We see these as positive steps to rebuild the company's capital base to preserve equity for a longer period. Management has a history of working closely with borrowers in financial difficulty, which tends to reduce its ultimate losses but has lengthened the repayment terms, because the workout periods tend to be much longer. Since its inception, CFC has incurred only \$183 million in net charge-offs (NCOs).

Risk Management

We assess CFC's enterprise risk management as adequate. During the past five years, CFC has reduced single-obligor and telecom exposure (down to 8% at fiscal year-end 2009 from 15% in 2005), established a syndications effort, and refocused on lending to the electric distribution sector. However, concentration risks exist in CFC's loan portfolio, with exposure to its 10 largest borrowers representing a high 1.73x members' equity and members' subordinated certificates at May 31, 2009, which is a negative rating factor. Overall, historical cumulative NCOs have been very low. The assessment also considers CFC's organizational structure, which is a cooperative. CFC's customers are required to purchase membership-subordinated certificates and loan and guarantee subordinated certificates, which they can use to offset loan exposures.

Credit risk

Overall, credit risk is high because of the concentration risk in the electrical utility and rural telecommunications sectors and the large individual exposures. A majority of CFC's electric utility borrowers are unregulated monopolies, which supply an important service to the market. As of May 31, 2009, 89% of CFC's total loans and guarantees outstanding were to electric distribution and power-supply cooperatives. The rural telecommunications sector represents CFC's second-largest sector concentration, although this concentration has fallen to 8% from 15% at fiscal year-end May 31, 2005. This decline is attributable as much to a falloff in loan demand from the sector as to a strategic initiative. Most notably, 19% of total loans and guarantees is represented by the 10 largest borrowers outstanding.

At May 31, 2009, 86% of CFC's loans outstanding was secured. Collateral typically consists of a first lien on the property and revenues of the borrower. At May 31, 2009, 2.59% of outstanding loans was nonperforming, and an additional 2.66% of outstanding loans was performing on a restructured basis. Although these asset-quality ratios are high compared with financial industry standards, they contain two large loan concentrations. During the past year, CFC has increased provisions significantly, reflecting the deterioration in the market value of the collateral supporting ICC, its only

nonperforming loan. We will continue to monitor any transactions related to ICC for any impact they may have on earnings. However, we do not expect these concentrations to have a major negative effect on the ratings.

CFC has a history of working closely with borrowers in financial difficulty, which tends to reduce its ultimate losses but has lengthened the repayment terms. Since its inception, CFC has incurred only \$183 million in NCOs. Given the need for significant loan-loss provisioning against the ICC exposure, though, it seems that charge-offs may increase considerably.

Market risk

Interest rate risk is inherent to CFC's balance sheet. CFC's loan portfolio represents 93% of total assets, and 74% of the loans is long-term fixed-rate. The customer has tenor options on CFC fixed-rate loan offerings of one to 35 years. CFC manages its interest rate risk exposures using matched funding and derivatives. The company's liabilities aim to have average maturities that closely match the repricing terms of its assets, within a range of 3% of total assets excluding derivative assets. (For a more in-depth discussion of CFC's use of derivatives, refer to the "Liquidity risk" section below.)

Management reported that CFC terminated several interest rate swaps during fiscal 2009. This allowed the company to realize an economic benefit sooner. By doing this, however, we believe the company may have increased its exposure to interest rate movements.

Liquidity risk

The company's sources of funding include the capital markets, private debt issuances, CP sold directly to members, and a revolving bank line facility. We view CFC's ability to borrow through private debt issuances and revolving credit facilities as a positive ratings factor. CFC also has access to the Federal Reserve Board's Commercial Paper Funding Facility until its expiration, scheduled for February 2010.

In our view, given the recent market dislocations, reliance on wholesale funding represents an incremental risk factor for CFC. We recognize as a positive the company's ability to meet its funding needs during the challenging fourth quarter of last year, when credit markets froze temporarily. Consequently, credit costs increased for a short time. Positively, management was able to draw on bank lines and use the government's CP backup program as a stopgap.

Although management has reduced the company's short-term funding exposure since May 31, 2008 (its fiscal 2008 year-end), short-term funding still accounts for a high 25% of total funding. We see this as a significant portion of the funding profile, especially given the volatility and confidence-sensitivity of wholesale markets. On the positive side, CFC's members continue to increase their investments in the firm. Notably, member's investments in CFC comprise 67% of total CP outstanding, and make up 25% of the \$4.8 billion in short-term debt outstanding.

CFC's long-term leverage, as measured by its debt-to-equity ratio, has increased significantly. CFC reported that total debt increased by \$1.4 billion—mainly long-term debt, reflecting a 25% increase in this type of debt from one year earlier. It is important to note that, while reported leverage has increased, we adjust for subordinated deferrable debt and members' subordinated certificates as part of equity. Adjusted this way, the debt-to-leverage ratio has also increased in the past few years to 6.84x as of May 31, 2009 (its fiscal year end) from 5.62x in 2005. We acknowledge that it may be difficult and challenging for CFC to reduce further its dependence on wholesale short-term funding during the next few years while reducing its leverage.

National Rural Utilities Cooperative Finance Corp.

CFC uses derivatives to manage its interest rate risk. The company enters these transactions with counterparties that have high creditworthiness. CFC does not use derivatives for trading purposes. (For a discussion of the company's accounting for derivatives, refer to the "Accounting" section below.)

Other risk

Regulatory and legislative exposure to CFC is moderate. CFC is a member-owned, not-for-profit, tax-exempt cooperative. It is not a government-regulated entity. Its cooperative utility system members are mostly not regulated, and the majority of members have the capacity to set their own electric rates. However, CFC's customer base, funding options, and overall operating environment can be affected by regulatory rules and federal and local legislation. Often these regulations vary by state. Furthermore, such exposure could be either beneficial or detrimental. We do not expect customer choice to have a material effect on CFC or its borrowers because the co-ops in some states have the right to "opt out" of choice to maintain their monopoly status, and some states are actively moving away from choice. Furthermore, some states regulate cooperative rates and borrowing.

Accounting

CFC uses derivative financial instruments to manage its interest rate risk. These derivatives are typically held until maturity. CFC's derivatives generally do not qualify for hedge accounting. In accordance with Statements of Financial Accounting Standards (SFAS) No. 133, CFC records derivative instruments on the consolidated balance sheet as either assets or liabilities measured at fair value. Changes in the fair value of derivative instruments that do not receive hedge accounting treatment are recorded in the derivative forward value line item of the consolidated statement of operations, resulting in increased earnings volatility and affecting the company's times-interest-earned ratio (TIER). CFC's primary performance measure is adjusted TIER, which excludes noncash earnings volatility. The change in fair value of the derivatives recorded in the income statement theoretically reflects a timing issue because the economic offset would be to the fair value of the hedged item, based on the effectiveness of the hedge, which is not recorded in the financial statements. At maturity of the hedged item, the asymmetric accounting would be offset.

CFC's management believes that TIER, leverage, and debt-to-equity ratios based purely on GAAP can result in misleading conclusions. As a result, CFC adjusts certain ratios in its SEC filings to exclude the noncash effect of derivatives on the income statement and balance sheet, reflecting management's perspective on the company's operations and adjustments used to measure covenant compliance under its revolving credit agreements. We generally agree that these adjustments provide useful information in the analysis of CFC.

Profitability

CFC is a not-for-profit company, and as such, its profitability is weak in the context of replenishing capital. For the year ended May 31, 2009, CFC posted GAAP net loss of \$70 million, compared with net income of \$46 million one year ago. Adjusted net income, excluding the noncash impact of derivative forward values and including minority interest, decreased to \$86 million from \$138 million year-over-year. This decrease in net income is primarily from the \$114 million provision for loan losses for the year, compared with a \$30 million recovery the same period a year earlier. The increase in provision was due to the reduction in the fair value of collateral supporting its exposure to ICC.

For the year ended May 31, 2009, CFC's TIER, a measure of the company's ability to cover its interest expense, was less than 1.00x, compared with 1.05x the previous year. The company's adjusted interest coverage ratio was 1.10x and 1.15x, for May 31, 2009, and 2008, respectively, and excluded

the noncash effect of derivatives treatment (required by SFAS 133) and foreign-currency adjustments (required by SFAS 52), providing a clearer picture of CFC's financial performance.

Capital

Capital levels remain adequate when some credit is given for the members' subordinated certificates and, to a lesser extent, hybrid capital instruments such as subordinated deferrable debt. Its capital position consists of retained equity, members' subordinated certificates, and hybrid capital instruments such as subordinated deferrable debt. At May 31, 2009, subordinated deferrable debt totaled \$311 million and members' subordinated certificates were \$1.7 billion.

A weakness of CFC's capital position is its limited ability to increase capital, which reflects its cooperative status. That being said, members have increased their long-term investment in CFC through the purchase of \$278 million in member capital securities. In addition, the board of directors recently revised the timing and amount of its patronage capital to be distributed. Under the new guidelines, CFC will retire 50% of the prior year's allocated margins and hold the remaining 50% for 25 years. We view these as positive steps to rebuild the company's capital base to preserve equity for a longer period.

The company's adjusted debt-to-equity ratio increased in the past few years to 6.84x as of May 31, 2009, from 5.62x in 2005. We would like to see this trend downward toward management's internally established goal of 5.57x by 2014, which corresponds to 5.68% according to our calculation.

Equity totaled \$509 million at May 31, 2009, a decrease of 23.7% from last year. This resulted from the patronage capital retirement of \$85 million and the noncash GAAP net loss of \$70 million for the fiscal year-end. The company adjusts its equity balance, totaling \$604 million, which is affected by changes in the fair value of its derivative instruments for hedge accounting treatment under SFAS 133.

Financial Statistics					
	—Fiscal year ended May 31—				
(Mil. \$)	2009	2008	2007	2006	2005
Total assets	20,983	19,379	18,575	19,180	20,060
Loans to members, net of allowance	19,569	18,514	17,570	17,749	18,382
Members' equity	604	613	566	545	524
Adjusted net income*	86	138	108	96	122
PROFITABILITY					
Adjusted net income/average assets (%)*	0.43	0.73	0.57	0.49	0.59
Adjusted TIER (times interest earned ratio)*	1.10	1.15	1.12	1.11	1.14
LEVERAGE (%)					
Debt/equity	40.21	28.08	25.13	23.42	25.20
Adjusted debt/equity†	6.63	7.06	6.37	5.97	6.07
LIQUIDITY (%)					
Loans to members, net/assets	93.26	95.54	94.59	92.54	91.64
Cash and cash equivalents/assets	2.41	0.92	1.64	1.36	2.09
ASSET QUALITY (%)					
Nonperforming loans/loans outstanding	2.59	2.66	2.77	3.15	3.25
Restructured loans/loans outstanding	2.66	3.03	3.33	3.43	3.17

*Excludes noncash losses related to derivative-forward contracts that do not qualify for hedge accounting. †Includes members' subordinated certificates and subordinated deferrable debt as part of equity.

Ratings Detail (As Of 04-Sep-2009)*

National Rural Utilities Cooperative Finance Corp	
Counterparty Credit Rating	A/Negative/A-1
Commercial Paper	
Local Currency	A-1
Preferred Stock (2 Issues)	BBB
Senior Secured (6 Issues)	A
Senior Secured (27 Issues)	A+
Senior Secured (2 Issues)	A/Developing
Senior Unsecured (190 Issues)	A
Senior Unsecured (1 Issue)	A-1
Senior Unsecured (10 Issues)	A/A-1
Senior Unsecured (1 Issue)	AAA
Short-Term Debt (1 Issue)	A-1
Subordinated (2 Issues)	BBB+

Counterparty Credit Ratings History

24-Aug-2009	A/Negative/A-1
03-Dec-2008	A/Stable/A-1
14-Dec-2007	A/Positive/A-1

Sovereign Rating

United States of America	AAA/Stable/A-1+
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*Unless otherwise noted, all ratings in this report are global scale ratings. Standard & Poor's credit ratings on the global scale are comparable across countries. Standard & Poor's credit ratings on a national scale are relative to obligors or obligations within that specific country.

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