

August 24, 2009

Research Update:

National Rural Utilities Cooperative Finance Corp. Outlook Revised To Negative; 'A/A-1' Rating Affirmed

Primary Credit Analyst:

Sunsierre Newsome, New York (1) 212-438-2421; sunsierre_newsome@standardandpoors.com

Secondary Credit Analyst:

Adom Rosengarten, New York (1) 212-438-7382; adom_rosengarten@standardandpoors.com

Table Of Contents

Overview

Rating Action

Rationale

Outlook

Related Research

Ratings List

Research Update:

National Rural Utilities Cooperative Finance Corp. Outlook Revised To Negative; 'A/A-1' Rating Affirmed

Overview

- Although CFC remains one of the premier lenders to rural utilities, it still relies heavily on short-term wholesale funding, long-term leverage has increased significantly, and it is exposed to interest rate risk.
- We are revising the outlook to negative from stable, while affirming our 'A/A-1' counterparty credit ratings on the company.
- We could revise the outlook to stable if the company meaningfully reduces its leverage and dependence on short-term funding.

Rating Action

On Aug. 24, 2009, Standard & Poor's Ratings Services revised its outlook on National Rural Utilities Cooperative Finance Corp. (CFC) to negative from stable. At the same time, we affirmed our 'A/A-1' counterparty credit ratings on the company.

Rationale

The rating affirmation recognizes our view of CFC's continued strong market position as one of the premier lenders to the rural utility sector, the important role it plays in providing financing to the otherwise underserved rural electric and telephone industries, and its continued support from members. We believe these strengths are somewhat offset, however, by its long-term increase in leverage and potential exposure to interest rate risk. Given market dislocations, in our view, reliance on wholesale funding presents an additional risk for CFC, and its high dependence on these markets is an incremental risk factor. We acknowledge that it may be difficult and challenging for CFC to further reduce its dependency on wholesale short-term funding over the next few years, while reducing its leverage.

While 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. Indeed, member investments account for 36% of its outstanding \$4.8 billion short-term debt.

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. In our opinion, there is little cushion in capital ratios under CFC's revolving bank lines covenants. 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 view CFC's ability to borrow through private debt issuances and revolving credit facilities as a positive ratings factor.

Management reported that CFC terminated several interest rate swaps during fiscal 2009. This accelerated the future economic benefit the company would have realized in future periods. By doing this, we believe the company has increased its exposure to interest rate movements.

Management has recently taken what we see as positive steps to rebuild the company's capital base to preserve equity for a longer period. CFC issued more than \$300 million in member capital shares, and the board of directors has extended its guidelines for retiring member patronage capital. Also, management has established internal goals for improving leverage by fiscal year-end 2014, with a target debt-to-equity ratio of 5.57x. Finally, while we believe CFC's credit risk is not great at this time, we think there's little flexibility for any rising credit losses should they arise in the context of the firm's existing loan loss reserves and in relation to equity.

Outlook

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

Related Research

- "Rating Finance Companies," March 18, 2004

Ratings List

National Rural Utilities Cooperative Finance Corp

Ratings Affirmed; Outlook Action

	To	From
Counterparty Credit Rating	A/Negative/A-1	A/Stable/A-1
Ratings Affirmed		
Senior Secured	A+	
Senior Unsecured	A	
Subordinated	BBB+	

Preferred Stock	BBB
Commercial Paper	A-1

Complete ratings information is available to RatingsDirect subscribers at www.ratingsdirect.com. All ratings affected by this rating action can be found on Standard & Poor's public Web site at www.standardandpoors.com; select your preferred country or region, then Ratings in the left navigation bar, followed by Find a Rating.

Copyright © 2009, Standard & Poors, a division of The McGraw-Hill Companies, Inc. (S&P). S&P and/or its third party licensors have exclusive proprietary rights in the data or information provided herein. This data/information may only be used internally for business purposes and shall not be used for any unlawful or unauthorized purposes. Dissemination, distribution or reproduction of this data/information in any form is strictly prohibited except with the prior written permission of S&P. Because of the possibility of human or mechanical error by S&P, its affiliates or its third party licensors, S&P, its affiliates and its third party licensors do not guarantee the accuracy, adequacy, completeness or availability of any information and is not responsible for any errors or omissions or for the results obtained from the use of such information. S&P GIVES NO EXPRESS OR IMPLIED WARRANTIES, INCLUDING, BUT NOT LIMITED TO, ANY WARRANTIES OF MERCHANTABILITY OR FITNESS FOR A PARTICULAR PURPOSE OR USE. In no event shall S&P, its affiliates and its third party licensors be liable for any direct, indirect, special or consequential damages in connection with subscribers or others use of the data/information contained herein. Access to the data or information contained herein is subject to termination in the event any agreement with a third-party of information or software is terminated.

Analytic services provided by Standard & Poor's Ratings Services (Ratings Services) are the result of separate activities designed to preserve the independence and objectivity of ratings opinions. The credit ratings and observations contained herein are solely statements of opinion and not statements of fact or recommendations to purchase, hold, or sell any securities or make any other investment decisions. Accordingly, any user of the information contained herein should not rely on any credit rating or other opinion contained herein in making any investment decision. Ratings are based on information received by Ratings Services. Other divisions of Standard & Poor's may have information that is not available to Ratings Services. Standard & Poor's has established policies and procedures to maintain the confidentiality of non-public information received during the ratings process.

Ratings Services receives compensation for its ratings. Such compensation is normally paid either by the issuers of such securities or third parties participating in marketing the securities. While Standard & Poor's reserves the right to disseminate the rating, it receives no payment for doing so, except for subscriptions to its publications. Additional information about our ratings fees is available at www.standardandpoors.com/usratingsfees.

Any Passwords/user IDs issued by S&P to users are single user-dedicated and may ONLY be used by the individual to whom they have been assigned. No sharing of passwords/user IDs and no simultaneous access via the same password/user ID is permitted. To reprint, translate, or use the data or information other than as provided herein, contact Client Services, 55 Water Street, New York, NY 10041; (1)212.438.7280 or by e-mail to: research_request@standardandpoors.com.