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National Rural Utilities Cooperative Finance Corp.

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National Rural Utilities Cooperative Finance Corp.

Credit Highlights

Issuer Credit Rating
A-/Stable/A-2

Overview	
Key strengths	**Key risks**
Very strong business stability owing to decades of providing financing to member electric utility cooperatives	Relatively high leverage and modest earnings
Low credit risk of electric utility loans	Single-borrower and industry concentrations
Access to low-cost funding from the Federal Financing Bank, Farmer Mac, and members	

Our ratings on National Rural Utilities Cooperative Finance Corp. (CFC) reflect the company's very strong business stability. This stability stems from decades of providing financing to member electric utility cooperatives, the low credit risk of electric utility loans, and access to low-cost funding from the Federal Financing Bank, Farmer Mac, and members. Conversely, our ratings also reflect the company's relatively high gross leverage, modest earnings, and 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.

Outlook

The stable outlook reflects S&P Global Ratings' expectations that National Rural Utilities Cooperative Finance Corp. (CFC), over the next 12-24 months, will maintain a risk-adjusted capital (RAC) ratio of 7.0% or better with adequate funding and liquidity, while maintaining its role as an important source of financing for the rural electric utility industry.

Downside scenario

We could lower our ratings if the company's RAC ratio declines below 7.0% on a consistent basis, perhaps due to unexpectedly large credit losses, or if, in our view, the company's unique business position erodes or its liquidity weakens.

Upside scenario

We could raise our ratings if the company's RAC ratio rises well above 10.0% while it maintains minimal credit losses with continued access to funding from the Federal Financing Bank, Farmer Mac, and members. The company's concentrated business model and use of short-term debt limit the probability of a higher rating.

Company Description

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

Anchor: Reflects 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. As with banks, U.S. finance companies' anchor reflects the country's diverse and high-income economy.

Given CFC's unique competitive position with lower risk relative to other finance companies, we raise the finance company anchor one notch to 'bbb-'. 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 the 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 RUS. CFC and its primary competitor, CoBank ACB, meet 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, have engendered loyalty over many years. As of May 31, 2022, CFC had 1,425 members and 248 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. As of Aug. 31, 2022, the company had a modest geographic concentration in Texas, which represented about 8% of borrowers. Loans outstanding in Texas-based electric utility organizations totaled $5.2 billion and accounted for approximately 17% of total loans outstanding.

Capital And Earnings: Adequately Capitalized

We view CFC as adequately capitalized on a risk-adjusted basis, as reflected in a RAC ratio of 8.8% as of Aug. 31, 2022. We generally consider a RAC ratio of 7%-10% to be indicative of adequate capital. We adjust CFC's adjusted common equity (ACE) for the prior-year cumulative derivative forward-value adjustment and current year-to-date derivative forward-value gains or losses, which totaled gains of $195 million as of Aug. 31, 2022. This is up from losses of $612 million as of Aug. 31, 2021, due to rising interest rates.

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 fall and the forward-value adjustments convert to losses, we would add back such losses to ACE.

We treat CFC's subordinated deferrable debt and member capital securities as having intermediate equity content, meaning we would include them at par amount in total adjusted capital up to 33% of ACE. One of the conditions required to maintain intermediate equity content for hybrid instruments is to have residual time until effective maturity exceeding 20 years. For the subordinated deferrable debt due April 2043, we would change our treatment of it in April 2023 to fully debt (no equity content). All else equal and pro forma for this treatment change, we expect our RAC ratio to remain unchanged.

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 company's interest-earning assets had an average yield of 3.82% and the net interest yield was 1.46% for the fiscal year ended May 31, 2022. For the quarter ended Aug. 31, 2022, the interest-earning assets average yield was 3.90% and net interest yield was 1.24%. Over the next 12 months, the company expects the yield curve to remain inverted, leading to a modest decline in adjusted net interest income and adjusted net interest yield. At the same time, the company expects its adjusted debt-to-equity ratio will be elevated above its target of 6.00x due to increasing total debt outstanding to fund anticipated loan growth.

CFC also reports an adjusted times interest earned ratio (adjusted TIER), a measure of its ability to cover interest expense. Adjusted to include derivative cash settlements in interest expense and exclude derivative fair value from net income, 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, 2022, the company's adjusted TIER was 1.30x, and it was 1.26x for the quarter ended Aug. 31, 2022. 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 Electric Utility Loan Portfolio, Notwithstanding Some Large Single-Borrower Exposures

CFC has a low-risk loan portfolio, strong asset quality metrics, and prudent risk management policies, in our view. We believe its loans to electric utilities have a low risk of default, which is reflected in the modest charge-offs the company historically has reported on its mostly senior secured loans. The company has reduced its exposure to telecom loans, which historically had weaker credit performance, to $470 million as of Aug. 31, 2022, from $2.99 billion as of fiscal year-end 2005.

Prior to the bankruptcy filings by Brazos Electric Power Cooperative (Brazos) in March 2021 and Brazos Sandy Creek in March 2022, CFC had not had any defaults or charge-offs in its electric utility and telecommunications loan portfolios since fiscal years 2013 and 2017, respectively. The company had $218 million of nonperforming loans to three borrowers as of Aug. 31, 2022, representing 0.71% of total loans outstanding. This is a slight decrease from 0.80% of total loans outstanding as of Aug. 31, 2021. Of these three borrowers, one has continued to make scheduled loan payments, while Brazos and Brazos Sandy Creek, which had a total of $114 million of loans outstanding from CFC, have not made any payments since their respective bankruptcy filings.

Despite CFC's low historical loss experience, borrower concentration remains a risk, in our view. CFC's 20 largest borrowers accounted for 21% of its loans outstanding (20% net of loans covered under its standby purchase commitment agreement with Farmer Mac) as of Aug. 31, 2022. Also, the February 2021 polar vortex showed that a low-probability event could affect more than one of CFC's borrowers. Brazos and Rayburn Country Electric Cooperative were significantly impacted by the polar vortex, although Rayburn paid a portion of its loans back to CFC in 2022 after it successfully completed a securitization transaction to cover costs incurred.

Positively, CFC's senior secured positions help mitigate any expected losses in the event of a borrower defaulting. In addition, we do not expect CFC's credit quality to be materially affected by the frequent hurricanes in some states that the company operates in.

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. As of Aug. 31, 2022, CFC had $28.1 billion of debt outstanding (excluding subordinated deferrable debt and member capital securities). The Federal Financing Bank and Farmer Mac provide CFC with 31% of its total debt outstanding as of Aug. 31, 2022, offering a source of relatively low-cost, long-term financing to help fund rural utility lending. The company also has a long history of accessing the broader debt capital markets, which represent about 50% of its total debt outstanding.

CFC's members account for 19% of its borrowings, including members' subordinated securities. CFC's member subordinated certificate is subordinated to all other debt issues, including nonmember subordinated securities, providing additional cushion to senior creditors. Members' subordinated certificates consist of membership subordinated certificates ($629 million), loan and guarantee subordinated certificates ($364 million), and member capital securities ($244 million).

CFC's stable funding ratio was 82% as of Aug. 31, 2022, reflecting some usage of commercial paper and other short-term borrowings. We would view increased usage and reliance on short-term borrowings as a weakness; however, CFC currently has a very diverse capital structure with numerous counterparties, including its members.

We expect CFC to maintain adequate liquidity to meet its unadvanced loan commitments. As of Aug. 31, 2022, CFC's total unadvanced commitments were approximately $8.8 billion in line of credit loans and $5.4 billion in long-term loans. Typically, the utilization rate for line of credit loans is under 100%, but borrowers generally draw on the majority of long-term loan commitments. As of Aug. 31, 2022, the company had $2.979 billion in availability with Farmer Mac, $975 million under the Guaranteed Underwriter Program from the Federal Financing Bank, and $232 million in unrestricted cash and equivalents. It also had access to $2.597 billion in unsecured revolving credit facilities with a group of banks, as well as a liquid fixed-income investment portfolio of $562 million.

Environmental, Social, And Governance

ESG Credit Indicators

E-1	**E-2**	E-3	E-4	E-5	S-1	**S-2**	S-3	S-4	S-5	G-1	**G-2**	G-3	G-4	G-5

ESG credit indicators provide additional disclosure and transparency at the entity level and reflect S&P Global Ratings' opinion of the influence that environmental, social, and governance factors have on our credit rating analysis. They are not a sustainability rating or an S&P Global Ratings ESG Evaluation. The extent of the influence of these factors is reflected on an alphanumerical 1-5 scale where 1 = positive, 2 = neutral, 3 = moderately negative, 4 = negative, and 5 = very negative. For more information, see our commentary "ESG Credit Indicators: Definition And Applications," published Oct. 13, 2021.

Environmental, social, and governance factors are an overall neutral consideration in our credit rating analysis of CFC. We believe there is low credit risk in CFC's electric utility loan portfolio, but it has some large single-borrower exposures, and the February 2021 polar vortex showed that a low-probability event could affect more than one of its borrowers.

Ratings Score Snapshot

Issuer credit rating: A-/Stable/A-2

Stand-alone credit profile: a-

- Preliminary anchor: bb+
- Entity-specific adjustment: +1
- Business position: Very strong (+2)
- Capital and earnings: Adequate (0)
- Risk position: Adequate (0)
- Funding and liquidity: Adequate and adequate (0)

- Comparable rating analysis: Positive (+1)

Support: 0

- GRE support: 0
- Group support: 0
- Sovereign support: 0

Additional factors: 0

Key Statistics

Table 1

CFC Business Position

(Mil. $)	August 2022	May 2022	2021	2020	2019
Total assets	32,082	31,251	29,638	28,158	27,124
Gross receivables	30,687	30,063	28,427	26,702	25,917
Net income after extraordinaries	162	796	812	(585)	(149)
Net interest margin (%)	1.26	1.46	1.48	1.23	1.14

Table 2

CFC Capital And Earnings

	August 2022	May 2022	2021	2020	2019
S&P Global Ratings' RAC ratio before diversification (%)	8.8	9.0	8.5	8.6	8.4
Adjusted common equity/total adjusted capital (%)	75.19	75.19	75.19	75.19	75.19
Core earnings/average managed assets (%)	0.73	0.79	0.67	0.53	0.65

RAC--Risk-adjusted capital.

Table 3

CFC Risk Position

	August 2022	May 2022	2021	2020	2019
Growth in gross receivables (%) (YoY)	6.25	5.76	6.46	3.03	2.93
Nonperforming assets/receivables + other real estate owned (%)	0.74	0.79	0.87	0.67	0.05
Net charge-offs/average gross receivables (%)	0.00	0.00	0.00	0.00	0.00
New loan loss provisions/average gross receivables (%)	0.05	(0.06)	0.10	0.14	(0.00)
Loan loss reserves/gross receivables (%)	0.23	0.22	0.30	0.20	0.07
Loan loss reserves/gross nonperforming assets (%)	31.38	28.51	34.56	29.75	147.94

Table 4

CFC Funding And Liquidity

	August 2022	May 2022	2021	2020	2019
Stable funding ratio (%)	82.37	82.73	81.68	81.46	83.73
Liquidity coverage metric (x)	0.59	0.61	0.72	0.90	0.96

Table 5

CFC Total Adjusted Capital

(Mil. $)	August 2022	May 2022	2021	2020	2019
Common shareholders' equity	2,217	2,115	1,375	626	1,277
Plus: minority interest (equity)	30	27	25	23	27
Less: revaluation reserves	2	2	(0)	(2)	(0)
Less: other adjustments	195	91	(467)	(1,089)	(355)
Intermediate adjusted common equity	2,050	2,049	1,867	1,740	1,659
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	2,050	2,049	1,867	1,740	1,659
Plus: admissible preferred and hybrids	676	676	616	574	547
Total adjusted capital	2,726	2,725	2,483	2,314	2,206

Related Criteria

- General Criteria: Hybrid Capital: Methodology And Assumptions, March 2, 2022
- Criteria | Financial Institutions | General: Financial Institutions Rating Methodology, Dec. 9, 2021
- Criteria | Financial Institutions | Banks: Banking Industry Country Risk Assessment Methodology And Assumptions, Dec. 9, 2021
- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- 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
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Ratings Detail (As Of December 7, 2022)*	
National Rural Utilities Cooperative Finance Corp.	
Issuer Credit Rating	A-/Stable/A-2
Senior Secured	A-
Short-Term Debt	A-2
Subordinated	BBB
Issuer Credit Ratings History	
06-Aug-2021	A-/Stable/A-2
05-Mar-2021	A-/Negative/A-2
12-Apr-2016	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.