FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms National Rural's IDRs at 'A' and 'F1'; Outlook Stable

Fri 18 Sep, 2020 - 4:18 PM ET

Fitch Ratings - Chicago - 18 Sep 2020: Fitch Ratings has affirmed National Rural Utilities Cooperative Finance Corporation's (CFC) Long- and Short-Term Issuer Default Ratings (IDRs) at 'A' and 'F1', respectively. The Rating Outlook is Stable.

KEY RATING DRIVERS

IDRs, SENIOR DEBT AND CP

The rating affirmations are supported by CFC's unique competitive position within the electric cooperative lending space, strong asset quality, sufficient liquidity, funding diversity and adequate coverage of interest expenses. The ratings are constrained by CFC's higher leverage compared to similarly rated peers, its unique capital structure, a business model that results in modest earnings performance compared to rated peers and an inability to access the equity capital markets.

Fitch believes that the coronavirus pandemic will have a modest impact on CFC's financial metrics over the medium term. Borrower-credit risks will remain elevated as declining levels of employment and household income, absent additional economic relief and stimulus, could negatively impact CFC's asset quality performance and coverage metrics.

However, Fitch believes these risks are manageable, as CFC's borrowers operate in a defensive industry that has been historically resilient to economic downturns. Thus far, CFC has not experienced any delinquencies in scheduled loan payments and has not received any requests from borrowers for payment deferrals or covenant relief, which should support asset quality and coverage metrics in the current environment.

Fitch's Global Economic Outlook (GEO), published Sept. 7, 2020, forecasted global GDP in 2020 to contract 4.4%—improved from a 4.6% contraction forecasted in June—noting that the initial phase of economic recovery from coronavirus-related lockdowns has been faster than expected. Even though the coronavirus has yet to be contained, Fitch's base case assumption assumes that major advanced economies will avoid renewed national lockdowns, but economic activity in the U.S. will not fully return to pre-virus levels until 4Q21.

Fitch estimates that CFC garners over 20% of the U.S. electric cooperative lending market. The company continues to strengthen its franchise, as demonstrated by the number of borrowers that use CFC exclusively for long-term borrowing needs (100% borrowers), which increased to 245 at fiscal year-end May 31, 2020 (YE 2020), up from 238 at YE 2019 and 235 at YE 2018.

CFC has a demonstrated track record in credit risk management, having recorded very low credit losses over time. Over CFC's 51-year operating history, the company has experienced only 16 defaults and six losses in the electric utility portfolio, with net-write offs representing 0.84% of average loans since inception, evidencing strong and stable lending, as well as solid credit risk management. As of May 31, 2020, CFC had a nominal amount of accruing troubled debt restructurings and only one loan on non-accrual status, to a power supply borrower, representing 0.7% of total loans. Fitch expects management to maintain its strategic focus on rural electric cooperatives that provide essential electric services to end-users, which should support relatively stable asset quality performance over time.

Earnings and profitability metrics are low compared to similarly rated non-bank financial institutions, with pre-tax income as a percentage of average assets averaging 0.8% in fiscal years 2017-2020. Fitch believes earnings have a lower influence on the overall ratings as CFC's mission (and its members' expectation) is not to generate large profits, but instead to cover its cost of funding, cost of operations and its loan losses.

In fiscal 2020, CFC recorded a net loss of $589 million due to a shift in derivative fair value changes attributable to a decline in medium and longer-term interest rates. CFC's current ratings incorporate an expectation of potential period-to-period volatility in reported earnings given mark to market changes on CFC's derivatives. In its analysis of earnings, Fitch places a greater emphasis on the company's adjusted net income and adjusted times interest earned ratio (TIER). These measures have been adequate and consistent with Fitch's expectations over time. CFC's adjusted TIER excludes from net income the impact of unrealized derivative forward fair value gains and losses and includes periodic cash derivative settlements in adjusted interest expense and net interest income. Adjusted TIER amounted to 1.17x at YE 2020, compared to 1.19x one-year prior. Given the company's strong credit quality and ability to adequately price loans, Fitch expects the adjusted TIER to remain in excess of CFC's 1.1x target over time.

Fitch adjusts its leverage calculation based on the agency's "Corporate Hybrids Treatment and Notching Criteria." Specifically, Fitch affords CFC's subordinated deferrable debt and member capital securities 50% equity credit due to the instruments' deep subordination and the cumulative nature of the coupon in the event of a deferral. Fitch also affords CFC's loan and member guarantee subordinated certificates (LGSC) 100% equity credit given the instruments' deep subordination and the ability to absorb losses. However, the treatment of the LGSC as equity is considered a variation to the hybrids criteria because the LGSC have a contractual or implied maturity, more akin to a hybrid instrument.

Fitch calculated CFC's debt to tangible equity leverage to be 10.2x at YE 2020; up materially from 7.7x a year ago as Fitch's calculation includes derivative fair value changes. Fitch believes leverage will be temporarily elevated given recent mark to market changes on CFC's derivatives, although this is incorporated in CFC's current ratings. While Fitch views CFC's leverage as reasonable given low portfolio credit risk and CFC's ability and willingness to access subordinated deferrable debt markets to support growth, CFC's current leverage metrics are higher than similarly rated non-bank financial institutions, and remain a rating constraint.

CFC assesses its leverage based on an adjusted debt to equity calculation, which strips out derivative fair value changes, and treats all member-held capital, member-held debt, and subordinated deferrable debt as 100% equity. Based on this treatment, CFC's adjusted leverage metric stood at 5.9x at YE 2020, up modestly from 5.7x a year ago, due primarily to loan growth.

CFC's ability to grow equity is limited to its ability to source hybrid equity from its members and retain earnings. Management took steps to build equity by changing its patronage capital payout policy in 2009, which increased the level of retained earnings and the length of time excess earnings are retained on the balance sheet before being returned to CFC's members. At YE 2020, GAAP equity represented 21.8% of CFC capital. Fitch would view the growth of GAAP equity through retained earnings favorably.

Fitch believes CFC has been able to maintain appropriate funding through various interest rate and credit cycles and has successfully diversified its funding base over time. Private funding programs with the Federal Financing Bank, under a guarantee from the Rural Utilities Service, and the Federal Agricultural Mortgage Corporation have become more prominent sources of funding in recent years, given their reliability, flexibility, and cost. At May 31, 2020, capital markets funding (collateral trust bonds [CTBs], non-member CP, and medium-term notes; and subordinated deferrable debt) represented 43% of total funding, compared to roughly 80% at YE 2004. Fitch views CFC's economic access to diversified funding sources favorably.

Fitch's analysis of CFC is heavily influenced by the firm's ability to maintain adequate liquidity to meet short- and long-term funding needs. At May 31, 2020, CFC had aggregate liquidity of $8.7 billion, comprised of $980 million of cash and investments and $6.06 billion of borrowing capacity on various credit facilities. Additionally, CFC had $1.7 billion of anticipated loan repayments over the next 12 months. Fitch believes CFC has sufficient liquidity, which provides 1.4x coverage, to address the $6.0 billion of debt maturities over the next 12 months, as of May 31, 2020.

The Stable Outlook reflects Fitch's expectation for strong asset quality, despite potential modest impact from the coronavirus pandemic, sufficient liquidity, continued access to diversified funding sources, and the maintenance of appropriate leverage and coverage of interest expenses.

According to Fitch's "Non-Bank Financial Institutions Rating Criteria," dated Feb. 28, 2020, a Long-Term IDR of 'A' maps to a Short-Term IDR of 'F1' or 'F1+'. In order to qualify for the higher rating, CFC would need to have a minimum Funding, Liquidity and Coverage (FLC) score of 'aa-'. CFC's score is currently 'bbb'. Accordingly, Fitch has affirmed CFC's Short-Term IDR at 'F1'.

The senior secured debt ratings benefit from a one-notch uplift from the Long-Term IDR given the strong collateral coverage backing such notes and the good recovery prospects for debtholders under a stress scenario. CFC's CTBs are backed by high-performing mortgage notes with strong, stable underlying hard assets and substitution requirements in the event of collateral underperformance.

The senior unsecured debt ratings are equalized with CFC's Long-Term IDR, reflecting their subordination to secured debt and average recovery prospects for debtholders in a stress scenario. Medium-term notes represent unsecured obligations that may be issued through dealers in the capital markets or directly to CFC's members.

The CP rating of 'F1' is equalized with the Short-Term IDR of 'F1'.

SUBORDINATED DEBT AND OTHER HYBRID SECURITIES

The subordinated deferrable debt ratings are two-notches below the Long-Term IDR due to the poor recovery prospects for debtholders in a stress scenario given their deep subordination to senior secured and senior unsecured debt. Nevertheless, Fitch believes these instruments would have higher recovery prospects than bank-issued debt, thus warranting narrower notching (two-notches) than a traditional hybrid instrument (up to three-notches).

RATING SENSITIVITIES

IDRs, SENIOR DEBT AND CP

Factors that could, individually or collectively, lead to negative rating action/downgrade:

These include a perceived drift in focus, evidenced by an increased level of lending to sectors outside of its rural electric member base, a spike in nonperforming loans due to financial stress within the sector indicating an inability to adapt to new legislation or an inability to pass along cost increases to end-users, an increase in Fitch-calculated leverage sustained above 10.0x, and/or deterioration in the firm's liquidity profile.

Factors that could, individually or collectively, lead to positive rating action/upgrade:

Fitch believes the likelihood of a ratings upgrade over the medium term is limited given CFC's higher-then-peer leverage, and the challenging economic backdrop from the coronavirus pandemic. However, factors that could, individually or collectively, lead to positive rating action/upgrade include a decline in leverage approaching 5.0x on a Fitch-calculated basis, which is more consistent with Fitch's investment grade benchmark ratio for balance sheet heavy finance and leasing companies, and enhanced funding flexibility as evidenced by the lengthening of CFC's debt maturity profile.

CFC's senior secured and unsecured debt ratings are sensitive to changes in the firm's Long-Term IDR, its funding mix, and availability of collateral for each class of debt.

The Short-Term IDR is primarily sensitive to the Long-Term IDR and would be expected to move in tandem. However, a material improvement in CFC's FLC profile, resulting in an upgrade of the sub-factor score to 'aa-' could result in an upgrade of the Short-Term IDR to 'F1+'.

CFC's CP rating is sensitive to changes in the firm's Short-Term IDR and would be expected to move in tandem.

SUBORDINATED DEBT AND OTHER HYBRID SECURITIES

CFC's hybrid debt ratings are sensitive to changes in CFC's Long-Term IDR and would be expected to move in tandem.

Based in Dulles, VA, CFC was formed in 1969 to provide financial and business management services to approximately 1,439 members and 232 associates across the U.S. As of May 31, 2020, CFC had a loan portfolio amounting to $26.7 billion.

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Financial Institutions and Covered Bond issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of four notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit [https://www.fitchratings.com/site/re/10111579]

CRITERIA VARIATION

The treatment of the LGSC as 100% equity is considered a variation to the hybrids criteria because the LGSC have a contractual or implied maturity, more akin to a hybrid instrument, which would typically receive 50% equity credit.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG CONSIDERATIONS

The highest level of ESG credit relevance, if present, is a score of '3'. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity(ies), either due to their nature or to the way in which they are being managed by the entity(ies). For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

RATING ACTIONS

ENTITY/DEBT	RATING			PRIOR
National Rural Utilities Cooperative Finance Corporation	LT IDR	A Rating Outlook Stable	Affirmed	A Rating Outlook Stable
	ST IDR	F1	Affirmed	F1
• senior unsecured	LT	A	Affirmed	A
• subordinated	LT	BBB+	Affirmed	BBB+
• senior secured	LT	A+	Affirmed	A+

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APPLICABLE CRITERIA

Corporate Hybrids Treatment and Notching Criteria (pub. 11 Nov 2019)

Non-Bank Financial Institutions Rating Criteria (pub. 28 Feb 2020) (including rating assumption sensitivity)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

National Rural Utilities Cooperative Finance Corporation EU Endorsed

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Non-Bank Financial Institutions   North America   United States