



Fitch Affirms National Rural at 'A'/'F1'; Outlook Stable

Fitch Ratings - Chicago - 24 September 2019:

Fitch Ratings has affirmed the Long-Term and Short-Term Issuer Default Ratings (IDR) of National Rural Utilities Cooperative Finance Corporation (CFC) at 'A' and 'F1', respectively. The Rating Outlook is Stable.

Key Rating Drivers

IDRs, SENIOR DEBT AND CP

CFC's ratings are supported by its 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 relatively higher leverage compared to peers, its unique capital structure comprised of retained earnings, member subordinated certificates, member capital securities and subordinated deferrable debt, as well as its inability to access the equity capital markets, and modest earnings given CFC's business model.

Fitch estimates that CFC garners over 20% of the U.S. electric cooperative lending market and 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 238 at fiscal year-end May 31, 2019 (YE19), up from 235 at YE18, 224 at YE17, and 221 at YE16.

CFC has a demonstrated track record in credit risk management, having recorded very low credit losses over time. 99% of the company's primary exposure is to rural electric cooperatives that provide essential electric services to end-users. Over CFC's 50-year operating history, the company has experienced only 16 defaults and six losses in the electric utility portfolio, with net-write offs totaling \$86 million, or 0.84% of average loans on \$10.5 billion of loans since inception, evidencing a strong and stable lending space, as well as solid credit risk management. Fitch expects management to maintain its strategic focus on core members, as the firm has significantly reduced exposure to telecommunication entities, which has been the cause of most of CFC's credit losses over its history. CFC had no loans on non-accrual status at YE19 and only a nominal amount of accruing troubled debt restructured loans.

Earnings and profitability metrics are very low compared to similarly rated non-bank financial institutions, with pre-tax income as a percentage of average assets averaging 0.8% in FY16-FY19. Nevertheless, 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 FY19, CFC recorded a net loss of \$151 million due to a shift in derivative fair value changes attributable to a decline in medium and longer-term interest rates during the second half of FY19. Fitch would expect 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) metrics. These measures have been adequate and consistent with our expectations. CFC's adjusted TIER excludes the impact of unrealized derivative forward fair value gains and losses, and includes periodic cash derivative settlements in adjusted interest expense. Adjusted TIER amounted to 1.19x at YE19,

compared to 1.17x 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 calculates CFC's debt to tangible equity leverage to be 7.7x at YE19; up from 7.3x a year ago as Fitch's calculation includes derivative fair value changes. In Fitch's view, CFC's leverage remains a rating constraint, and above similarly rated non-bank financial institutions. However, we view 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.

Fitch's leverage calculation makes adjustments based on the 'Corporate Hybrids and Notching Criteria' (hybrids criteria). Specifically, the agency gives 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.

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 5.7x at YE19, down from 6.2x given the issuance of \$250 million of 5.5% subordinated deferrable debt due 2064 in May 2019, which receives 100% equity treatment under CFC's adjusted leverage calculation.

CFC's ability to grow equity is limited to its ability to source hybrid equity from its members and retain earnings. CFC's capital is comprised of GAAP equity (retained earnings), member subordinated certificates, member capital securities, and subordinated deferrable debt. Management has taken 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 YE19, GAAP equity represented 35.5% of CFC capital of \$3.6 billion, compared to YE09 when it was just under 20%. Fitch views the growth of retained earnings positively.

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. Still, CFC obtains 49% of its funding from wholesale funding sources.

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, 2019, capital markets funding (collateral trust bonds, non-member CP, and medium-term notes; and subordinated deferrable debt) represented 49% of total funding, compared to roughly 80% in YE04. Fitch views CFC's economic access to diversified funding sources favorably.

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

According to Fitch's 'Short-Term Ratings Criteria', dated May 2, 2019, 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 collateral trust bonds (CTB) 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

While Fitch does not anticipate upward rating momentum for CFC in the near-to-medium term, positive momentum could develop over time from 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.

While not currently anticipated, ratings could be adversely impacted by 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 the Fitch-calculated leverage metric approaching 9.0x, and/or deterioration in the firm's liquidity 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.

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 1,447 members, including 909 electric cooperative distribution and power supply owners/members across the U.S. As of May 31, 2019, CFC had a loan portfolio amounting to \$25.9 billion.

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.

ESG Considerations

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of 3 - ESG issues are credit neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity.

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 ● Affirmed	A ●
	ST IDR F1 Affirmed	F1
senior unsecured	LT A Affirmed	A
subordinated	LT BBB+ Affirmed	BBB+
senior secured	LT A+ Affirmed	A+
senior unsecured	ST F1 Affirmed	F1

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Applicable Criteria

Non-Bank Financial Institutions Rating Criteria (pub. 12 Oct 2018)
Corporate Hybrids Treatment and Notching Criteria (pub. 09 Nov 2018)
Short-Term Ratings Criteria (pub. 02 May 2019)

Additional Disclosures

Dodd-Frank Rating Information Disclosure Form
Solicitation Status
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