FITCH AFFIRMS NATIONAL RURAL UTILITIES COOPERATIVE FINANCE CORPORATION AT 'A'/'F1'; OUTLOOK STABLE

Fitch Ratings-Chicago-01 October 2018: 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. A full list of rating actions follows at the end of this release.

KEY RATING DRIVERS

IDRs

CFC's Long-Term IDR is 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 and inability to access the equity capital markets, and modest earnings given CFC's business model.

Fitch estimates that CFC consistently garners over 20% of the U.S. electric cooperative lending market. Moreover, the company continues to strengthen its franchise, demonstrated by the number of borrowers that use CFC exclusively for all borrowing needs (100% borrowers), increasing to 235 as of fiscal year ended May 31, 2018 (YE18), up from 224 at May 31, 2017 (YE17).

CFC has a demonstrated track record in credit risk management, having recorded very low credit losses over time. The company's primary credit exposure is to rural electric cooperatives that provide essential electric services to end-users. Over CFC's 49-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 of $10.2 billion 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 YE18 and nominal accrued troubled debt restructured loans.

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. As of May 31, 2018, CFC had aggregate liquidity of $9.2 billion, comprised of $941 million in cash and investment securities, $6.9 billion in available borrowing capacity, and $1.4 billion in expected loan repayments over the next 12 months. Fitch believes CFC has sufficient liquidity to address its $6.6 billion of debt maturities over the next 12 months.

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 remains heavily reliant on 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. As of May 31, 2018, capital markets funding (collateral trust bonds, non-member commercial paper and medium-term notes; and subordinate deferrable debt) represented 50% of total funding, compared to roughly 80% in FY04. Fitch views CFC's economic access to diversified funding sources favorably.

Fitch calculates CFC's debt to equity leverage to be 7.3x at YE18, down modestly from 7.8x at YE17, driven by growth in GAAP equity (inclusive of derivative fair value changes). In Fitch's view, CFC's leverage remains a rating constraint, and above similarly rated non-bank financial institutions. Fitch's leverage calculation makes adjustments based on the 'Corporate Hybrids and Notching Criteria' (hybrids criteria). Specifically, the agency gives CFC's subordinate 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 guarantee subordinated certificates (LGSC) 100% equity credit given the instruments' deep subordination and the ability to absorb loan 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 6.2x at YE18, up modestly from 6.0x at YE17 given an increase in debt outstanding to fund anticipated loan growth. The adjusted leverage metric is high relative to other rated non-bank financial institutions. However, Fitch views CFC's leverage as reasonable given low portfolio credit risk and CFC's ability and willingness to access subordinated debt markets to support growth.

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 YE18, GAAP equity represented 41.5% of CFC capital of $3.6 billion, compared to 2009 when it was just under 20%. Fitch views the growth in GAAP equity positively.

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 YE15-YE18. Nevertheless, Fitch believes CFC's 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 its analysis of earnings, Fitch places a greater emphasis on the company's adjusted net income, and adjusted times interest earned (TIER) metrics. These measures have been adequate and consistent with Fitch's 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 1.17x at YE18, relatively stable compared to 1.16x at YE17. Given the company's strong credit quality and ability to adequately price loans, Fitch expects adjusted TIER to remain in excess of its 1.1x target over time.

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.

The Short-Term IDR is derived from the mapping between the Long-Term and Long-Term IDRs outlined in Fitch's 'Non-Bank Financial Institutions Rating Criteria'. CFC's Long-Term IDR of 'A' corresponds to a Short-Term IDR of 'F1'.

COMMERCIAL PAPER AND SENIOR DEBT

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

SUBORDINATE AND OTHER HYBRID SECURITIES
The subordinate 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
While Fitch does not anticipate upward rating momentum 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 ratios for 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 Fitch's leverage metric approaching 9.0x, and/or deterioration in the firm's liquidity profile.

COMMERCIAL PAPER AND SENIOR DEBT
CFC's commercial paper rating is sensitive to changes in the firm's Short-Term IDR and could be expected to move in tandem.

CFC's senior 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.

SUBORDINATE AND OTHER HYBRID SECURITIES
CFC's hybrid debt ratings are sensitive to changes in CFC's Long-Term IDR.

Based in Dulles, VA, CFC was formed in 1969 to provide financial and business management services to approximately 1,450 members, including 908 electric cooperative distribution and power supply owners/members across the U.S. As of May 31, 2018, CFC had a loan portfolio amounting to $25.2 billion.

Fitch has affirmed the following ratings:

National Rural Utilities Cooperative Finance Corporation
--Long-Term IDR at 'A';
--Short-Term IDR at 'F1';

--Commercial paper at 'F1';
--Senior secured debt at 'A+';
--Senior unsecured debt at 'A';
--Subordinate deferrable debt at 'BBB+'.

The Rating Outlook is Stable.

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Applicable Criteria
Corporate Hybrids Treatment and Notching Criteria (pub. 27 Mar 2018)
https://www.fitchratings.com/site/re/10024296
Non-Bank Financial Institutions Rating Criteria (pub. 22 Jun 2018)
https://www.fitchratings.com/site/re/10034715