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National Rural Utilities Cooperative Finance Corp.

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Major Rating Factors

Issuer Credit Rating
A-/Stable/A-2

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

Outlook

The stable outlook reflects our 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 maintaining minimal credit losses with continued access to funding from the Federal Financing Bank, Farmer Mac, and its members. The company's concentrated business model and use of short-term debt limit the probability of a higher rating.

Rationale

Our ratings reflect the company's very strong business stability from decades of providing financing to member electric utility cooperatives, low credit risk of electric utility loans, and access to low-cost funding from the Federal Financing

Bank, Farmer Mac, and its members. Conversely, our ratings reflect the company's relatively high gross leverage, modest earnings, as well as 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.

Business Description

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

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

Given CFC's unique competitive position, we raise the finance company anchor one notch to 'bbb-', reflecting its lower competitive risk relative to other finance companies. 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 federal government's RUS. CFC and its primary competitor, CoBank ACB, provide 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--has engendered loyalty over many years. As of May 31, 2021, CFC had 1,424 members and 246 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.

Capital, leverage, and earnings: Adequate for the risk profile

We view CFC as adequately capitalized on a risk-adjusted basis, as reflected in a RAC ratio of 8.4% as of Aug. 31, 2021. We generally consider a RAC ratio of 7%-10% to be indicative of adequate capital. We adjust CFC's adjusted common equity for the prior-year cumulative derivative forward-value adjustment and current year-to-date derivative forward-value gains or losses, which totaled losses of $612 million as of Aug. 31, 2021. 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 rise and the forward-value adjustments convert to gains, we would deduct such gains from total adjusted capital.

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 3.95%, and the net interest yield was 1.47% for the year ended May 31, 2021. For the quarter ended Aug. 31, 2021, the average yield was 3.83%, and net interest yield was 1.47%.

CFC also reports a times interest earned ratio (TIER), a measure of its ability to cover interest expense. Adjusted for noncash derivative items, 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, 2021, the company's adjusted TIER was 1.23x, and it was 1.27x for the quarter ended Aug. 31, 2021. 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 the 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 CFC's loans to electric utilities have low risk of default, which is reflected in the modest charge-offs the company historically has reported on its mostly senior secured loans. Prior to Brazos Electric Power Cooperative's bankruptcy filing in March 2021, CFC did not have any defaults or charge-offs in its electric utility and telecommunications loan portfolios since fiscal years 2013 and 2017, respectively. The company has reduced its exposure to telecom loans, which historically had weaker credit performance, totaling $431 million as of Aug. 31, 2021, compared with $2.99 billion reported as of May 31, 2005. CFC had $232 million of nonperforming loans to four borrowers as of Aug. 31, 2021, representing 0.80% of total loans outstanding. Each of these borrowers have continued to make scheduled loan payments, except for Brazos, which has $86 million of loans outstanding from CFC.

Despite CFC's low historical loss experience, borrower concentration is a risk, in our view. CFC's 20 largest borrowers accounted for 22% of its loans outstanding (21% net of loans covered under its standby purchase commitment agreement with Farmer Mac) as of Aug. 31, 2021. Also, the February 2021 polar vortex showed that a low-probability event could impact more than one of CFC's borrowers. Brazos and Rayburn Country Electric Cooperative, which had loans outstanding from CFC of $86 million and $375 million, respectively, were significantly impacted by the polar vortex. Positively, CFC's senior secured positions help to mitigate expected losses in the event of a borrower defaulting.

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. The Federal Financing Bank, a government entity, and Farmer Mac, a government-sponsored entity, provide CFC with 35% of its current debt outstanding, offering a source of relatively low-cost, long-term financing to help fund rural utility lending. Additionally, CFC's members account for 18% of its borrowings, and CFC has a long history of accessing the broader debt capital markets, which represent about 47% of its current debt outstanding. CFC's stable funding ratio was 78% as of Aug. 31, 2021, 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.

As of Aug. 31, 2021, the company had $2.140 billion in availability with Farmer Mac, $975 million under the Guaranteed Underwriter Program from the Federal Financing Bank, and $303 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 roughly $570 million.

Comparable ratings adjustment: Favorable access to funding, and member subordinated debt provides a cushion to senior creditors

The Federal Financing Bank and Farmer Mac provide CFC with approximately 35% of its total debt, offering a source of relatively low-cost, long-term financing to help fund rural utility lending. Members not only borrow from CFC, but they also provide about 18% of its total debt, including members' subordinated certificates. CFC's member subordinated debt is subordinated to all other debt issues, including nonmember subordinated securities, providing additional cushion to senior creditors. Member subordinated debt consists of membership subordinated certificates ($629 million), loan and guarantee subordinated certificates ($386 million), and member capital securities ($239 million).

External Influence: None

We don't factor any external influence into the ratings.

Ratings Score Snapshot

Issuer Credit Rating: A-/Stable/A-2

Stand-alone credit profile: a-

- Anchor: bb+
- Entity-specific anchor adjustment: +1
- Business position: Very Strong (+2)

- Capital, leverage, and earnings: Adequate (0)
- Risk position: Adequate (0)
- Funding and liquidity: Adequate and Adq. (0)
- Comparable ratings adjustment: +1

External influence: 0

- Government influence: 0
- Group influence: 0
- Rating above the sovereign: 0

Key Statistics

Table 1

Business Position

	August 2021	May 2021	2020	2019	2018
Total assets	30,092	29,638	28,158	27,124	26,690
Gross receivables	28,883	28,427	26,702	25,917	25,179
Net income after extraordinaries	(90)	812	(585)	(149)	455
Net interest margin (%)	1.48	1.48	1.23	1.14	1.13

Table 2

Capital, Leverage, And Earnings

	August 2021	May 2021	2020	2019	2018
S&P Global Ratings' RAC ratio before diversification (%)	8.39	8.50	8.63	8.35	7.93
Adjusted common equity/total adjusted capital (%)	75.19	75.19	75.19	75.19	75.19
Core earnings/average managed assets (%)	0.73	0.67	0.53	0.65	0.58

RAC--Risk-adjusted capital.

Table 3

Risk Position

	August 2021	May 2021	2020	2019	2018
Growth in gross receivables (%) (YoY)	7.26	6.46	3.03	2.93	3.33
Nonperforming assets/receivables + other real estate owned (%)	1.13	1.16	0.67	0.05	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 (%)	0.06	0.10	0.14	(0.00)	(0.07)
Loan loss reserves/gross receivables (%)	0.31	0.30	0.20	0.07	0.07
Loan loss reserves/gross nonperforming assets (%)	27.40	25.99	29.75	147.94	149.23

Table 4

Funding And Liquidity

	August 2021	May 2021	2020	2019	2018
Stable funding ratio (%)	78.47	81.68	81.46	83.73	84.34
Liquidity coverage metric (x)	0.59	0.72	0.90	0.96	0.98

Table 5

Total Adjusted Capital

	August 2021	May 2021	2020	2019	2018
Common shareholders' equity	1,228	1,375	626	1,277	1,474
Plus: minority interest (equity)	27	25	23	27	32
Less: revaluation reserves	0	(0)	(2)	(0)	9
Less: other adjustments	(612)	(467)	(1,089)	(355)	(35)
Intermediate adjusted common equity	1,865	1,867	1,740	1,659	1,532
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	1,865	1,867	1,740	1,659	1,532
Plus: admissible preferred and hybrids	616	616	574	547	506
Total adjusted capital	2,481	2,483	2,314	2,206	2,038

Related Criteria

- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- General Criteria: Group Rating Methodology, July 1, 2019
- General Criteria: Hybrid Capital: Methodology And Assumptions, 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
- Criteria | Financial Institutions | General: Issue Credit Rating Methodology For Nonbank Financial Institutions And Nonbank Financial Services Companies, Dec. 9, 2014
- Criteria | Financial Institutions | General: Nonbank Financial Institutions Rating Methodology, Dec. 9, 2014
- Criteria | Financial Institutions | Banks: Quantitative Metrics For Rating Banks Globally: Methodology And Assumptions, July 17, 2013
- Criteria | Financial Institutions | Banks: Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011
- Criteria | Financial Institutions | Banks: Commercial Paper I: Banks, March 23, 2004
- Criteria | Financial Institutions | Finance Companies: Commercial Paper II: Finance Companies, March 22, 2004

Related Research

- National Rural Utilities CFC Outlook Revised to Stable On Receding Texas Utility Risks; 'A-' Ratings Affirmed, Aug. 6, 2021
- National Rural Utilities Cooperative Finance Corp. Downgraded To 'A-' On Exposure To Texas Utilities; Outlook Negative, March 5, 2021

Ratings Detail (As Of November 9, 2021)*	
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.