Research Update:

National Rural Utilities Cooperative Finance Corp. Downgraded To 'A-' On Exposure To Texas Utilities; Outlook Negative

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Overview

- National Rural Utilities Cooperative Finance Corp. (CFC) is exposed to Texas utilities that could experience elevated credit stress due to the settlement of ERCOT transactions and the higher cost of natural gas that occurred during extreme weather conditions in February.
- One such utility and a CFC borrower, Brazos Electric Power Cooperative Inc., filed for bankruptcy on March 1, 2021.
- We are lowering our long- and short-term issuer credit ratings on CFC to 'A-/A-2' from 'A/A-1'.
- The negative outlook reflects that we could downgrade CFC in the next six to 12 months if credit losses erode capital adequacy more than we expect, or if CFC's funding or liquidity weakens, in our view.

Rating Action

On March 5, 2021, S&P Global Ratings lowered its long-term issuer credit rating on National Rural Utilities Cooperative Finance Corp. (CFC) to 'A-' from 'A'. The outlook is negative. We also lowered our senior secured and senior unsecured debt ratings on CFC to 'A-' from 'A', our subordinated debt rating to 'BBB' from 'BBB+', and our short-term issuer credit and commercial paper ratings to 'A-2' from 'A-1'.

Rationale

The downgrade reflects that CFC is materially exposed to Texas utilities that are experiencing elevated credit stress, in large part due to the settlement of Electric Reliability Council of Texas (ERCOT) transactions that occurred during extreme weather conditions in February, as well as the higher cost of natural gas. Texas accounted for approximately 15% of CFC's $27 billion of loans outstanding as of Nov. 30, 2020.

One such utility and a CFC borrower, Brazos Electric Power Cooperative Inc. ('D'), filed for bankruptcy on March 1, 2020. CFC has $81.6 million in unsecured outstanding loans and letters of credit totaling $3.4 million to Brazos. In addition, CFC has a $29.6 million secured outstanding loan to Brazos' wholly owned subsidiary, Brazos Sandy Creek Electric Cooperative, which is not a debtor in the bankruptcy filing.

While some utilities, like Brazos and Rayburn Country Electric Cooperative (CC/Watch Neg), are facing staggering bills because of the extreme weather in February, we think those that were net long power on the ERCOT grid outperformed. Nevertheless, if ERCOT exercises "uplift" provisions that socialize defaulting market participants' unpaid bills among remaining market participants, it could weaken remaining members' creditworthiness.

Our ratings on CFC are based on, in our view, its unique business position in financing its rural electric utility members, adequate capitalization, historically strong asset quality, adequate funding and liquidity, and access to funding from the Federal Financing Bank, Farmer Mac, and member subordinated debt, which is subordinate to all other debt issues.

We think that CFC has sufficient capital cushion to absorb any losses related to Brazos and Sandy Creek. As of Nov. 30, 2020, CFC had an S&P Global Ratings risk-adjusted capital (RAC) ratio of 8.7%, reflecting $2.4 billion of total adjusted capital. A hypothetical $100 million credit loss would lower the RAC ratio by about 37 basis points. We generally consider a RAC ratio of 7%-10% to be indicative of adequate capital.

While CFC historically has had large single-name exposures, its underwriting and loss experience have been favorable. However, the weather event in Texas illustrates how a low-probability, high-impact event could affect multiple borrowers, and it was a key consideration of our reassessment of the company's risk position.

We continue to believe CFC has adequate funding and liquidity. As of Nov. 30, 2020, it reported $8.656 billion of total liquidity relative to $8.496 billion of total line of credit unadvanced commitments, of which $5.202 related to facilities subject to material adverse change clauses. In addition, CFC issued over $1.775 billion of debt in February, compared with $454 million of long-term debt maturities, which further bolstered liquidity. However, significant credit provisions could erode the cushion on its minimum average adjusted times interest earned ratio (adjusted TIER), which must be at least 1.025x for the six most recent fiscal quarters in order to borrow under its revolving credit agreements.

Outlook

The negative outlook indicates that we could downgrade CFC if, in the next six to 12 months, credit losses erode capital adequacy more than we expect, or CFC's funding or liquidity weakens, in our view. In our base case, we expect CFC will maintain its role as an important source of financing for the rural electric utility industry, a RAC ratio of 7.0% or better, and adequate funding and liquidity.

Downside scenario

We could lower our ratings if the company's RAC ratio declines below 7.0% on a consistent basis, or if, in our view, liquidity weakens or the company's unique business position erodes.

Upside scenario

We could revise the outlook to stable if CFC maintains a RAC ratio above 7.0% as uncertainty related to its borrowers in Texas is resolved, while maintaining, in our view, adequate access to funding and liquidity.

Ratings Score Snapshot

	To	From
Issuer Credit Rating	A-/Negative/A-2	A/Stable/A-1
SACP	a-	a
Anchor	bb+	bb+
Entity-Specific Anchor Adjustment	+1	+1
Business Position	Very Strong (+2)	Very Strong (+2)
Capital, Leverage, and Earnings	Adequate (0)	Adequate (0)
Risk Position	Adequate (0)	Strong (+1)
Funding and Liquidity	Adequate and Adequate (0)	Adequate and Adequate (0)
Comparable Ratings Adjustment	+1	+1
External Influence	0	0
Government Influence	0	0
Group Influence	0	0
Rating Above the Sovereign	0	0

Related Criteria

- General Criteria: Hybrid Capital: Methodology And Assumptions, July 1, 2019
- 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
- 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

- Brazos Electric Power Cooperative Inc., TX Rating Lowered To 'D' From 'A' Due To Bankruptcy Filing, March 1, 2021
- National Rural Utilities Cooperative Finance Corp., Nov. 20, 2020

Ratings List

Downgraded; CreditWatch

	To	From
National Rural Utilities Cooperative Finance Corp.		
Issuer Credit Rating	A-/Negative/A-2	A/Stable/A-1
National Rural Utilities Cooperative Finance Corp.		
Senior Secured	A-	A
Senior Unsecured	A-	A
Senior Unsecured	A-p	Ap
Subordinated	BBB	BBB+
Commercial Paper	A-2	A-1