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

Fitch Ratings - Chicago - 13 Sep 2021: Fitch Ratings has affirmed the Long-Term and Short-Term Issuer Default Ratings (IDRs) 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 COMMERCIAL PAPER

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.

CFC has a demonstrated track record in credit risk management, having recorded very low credit losses over time. Over CFC's 52-year operating history, the company has experienced only 17 defaults which includes the most recent default of Brazos Power Cooperative, Inc. in March 2021 resulting from its bankruptcy filing, of which resulted in six losses in the electric utility portfolio. Net-write offs totaled only $86 million (0.84% of average loans) since inception, evidencing strong and stable lending, as well as solid credit risk management.

Fitch believes earnings have a lower influence on the overall ratings as CFC's mission 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 ratio (TIER), which amounted to 1.23x at fiscal year ended May 31, 2021, improved from 1.17x a 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.

Fitch calculated CFC's debt to tangible equity leverage to be 8.5x at YE 2021; down materially from

10.3x a year ago due to growth in GAAP equity from retained earnings and positive derivative fair value changes. 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.

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, 2021, CFC had aggregate liquidity of $8.9 billion, comprised of $871 million of cash and investments and $6.2 billion of borrowing capacity on various credit facilities. Additionally, CFC had $1.8 billion of anticipated loan repayments over the next 12 months. Fitch believes CFC has sufficient liquidity, which provides 1.2x coverage, to address the $7.2 billion of debt maturities over the next 12 months, as of May 31, 2021.

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 "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 collateral trust bonds 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.

The commercial paper (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.

RATING SENSITIVITIES

IDRs, SENIOR DEBT AND CP

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 higherthen-peer leverage, and the challenging economic backdrop from the coronavirus pandemic. However, over time, positive momentum could be driven by 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.

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

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 could yield negative rating action.

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.

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

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. This means 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.

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Rating Actions

ENTITY/DEBT	RATING			RECOVERY	PRIOR
National Rural Utilities Cooperative Finance	LT IDR	A	Affirmed		A

ENTITY/DEBT	RATING			RECOVERY	PRIOR
Corporation					
	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

RATINGS KEY	OUTLOOK	WATCH
POSITIVE		
NEGATIVE		
EVOLVING		
STABLE		

Applicable Criteria

Corporate Hybrids Treatment and Notching Criteria (pub.12 Nov 2020)

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

Additional Disclosures

Solicitation Status

Endorsement Status

National Rural Utilities Cooperative Finance Corporation	EU Endorsed, UK Endorsed

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