

## Analysis

# Moody's Global Infrastructure Finance

December 2008

## National Rural Utilities Cooperative Finance Corporation (NRUC)

Herndon, Virginia, United States

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National Rural Utilities Cooperative Finance Corporation (NRUC) is a non-bank financial institution exclusively serving rural electric, service, and telecommunication utilities. NRUC was organized in 1969 by rural electric cooperatives (RECs) as a not-for-profit, tax exempt association that would provide an economical alternative to federally subsidized funds from the Rural Utilities Service (RUS) of the U.S. Department of Agriculture. NRUC is headquartered in Herndon, Virginia.

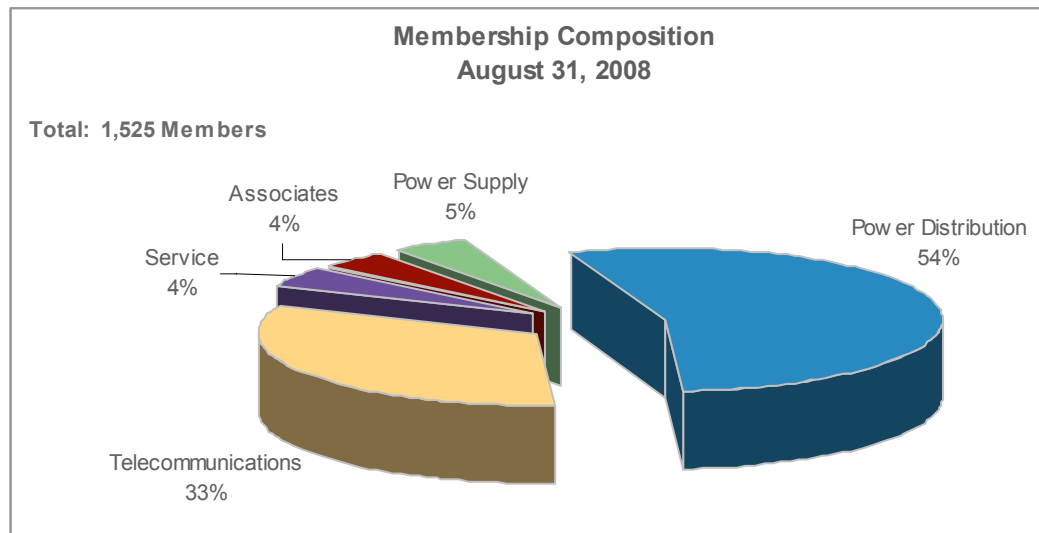
As of August 31, 2008, NRUC had 1,525 member cooperatives, including 898 rural electric utility system members, 498 telecommunications members, 66 service members, and 63 associate members. Of the 898 rural electric utility system members, 829 were distribution systems and 69 were generation and transmission systems.

This Credit Analysis provides an in-depth discussion of credit rating(s) for National Rural Utilities Cooperative Finance Corporation (NRUC) and should be read in conjunction with Moody's most recent Credit Opinion and rating information available on Moody's website. [Click here to link.](#)



**Moody's Investors Service**

## National Rural Utilities Cooperative Finance Corporation (NRUC)



Loans to telecommunication members are made through Rural Telephone Finance Cooperative (RTFC), a private cooperative association formed in September 1987 to provide financing to its rural telecommunications members and affiliates. NRUC manages the affairs of RTFC through a long-term management arrangement and provides RTFC with all of its financing.

Loans are also made through National Cooperative Services Corporation (NCSC), a private cooperative association, which provides specialized financing and services to entities owned, operated and controlled by RECs. NCSC borrows the funds that it lends either from NRUC directly, or from another creditor with a NRUC guarantee. NRUC manages the affairs of NCSC through a long-term management arrangement. Based upon a guarantee from NRUC, NCSC's senior unsecured long-term debt is rated A2 and its short-term rating for commercial paper is rated Prime-1, both of which carry the same rating as NRUC's senior unsecured debt and NRUC's short-term rating for commercial paper, respectively.

NRUC's goal as a not-for-profit cooperatively-owned finance company is to set rates at levels that will provide its members with the lowest cost financing while earning a minimum profit or margin consistent with defined financial targets to support its overall credit position. For example, loans and guarantees supplied to members are priced to cover its funding costs, general and administrative expenses, the loan loss provision, and a modest profit in order to maintain an adjusted times interest earned ratio (TIER) of at least 1.10 times. NRUC's adjusted TIER averaged 1.13 times over the past three fiscal years, and its adjusted TIER was 1.15 in fiscal 2008. In calculating adjusted TIER, NRUC appropriately includes SFAS 133 net cash settlement amounts in the cost of funds, since the amount of SFAS cash settlement represents the amount of cash that is actually received (or paid) by NRUC in a given period. Prior to the introduction of SFAS 133, the appropriate net amounts were also included in cost of funds. NRUC also appropriately removes the derivative forward value and SFAS 52 foreign currency adjustments when it calculates adjusted TIER. Since all of the foreign currency denominated debt issued by NRUC was repaid during fiscal year 2007, NRUC did not report any SFAS 52 foreign currency adjustments in 2008 results.

## National Rural Utilities Cooperative Finance Corporation (NRUC)

## Key Rating Factors

## Loan Portfolio is Heavily Weighted towards RECs

Loans by Segment	2007		2008		1Q' 2009	
	\$ 000	%	\$ 000	%	\$ 000	%
NRUC						
Distribution	12,827,772	71%	13,438,370	71%	13,614,736	70%
Generation & Transmission	2,858,040	16%	3,339,112	18%	3,519,985	18%
Statewide & Associate	119,478	1%	108,925	1%	107,743	1%
NRUC Total	15,805,290	87%	16,886,407	89%	17,242,464	89%
RTFC (Telecommunications)	1,860,379	10%	1,726,514	9%	1,705,004	9%
NCSC	462,538	3%	414,074	2%	415,016	2%
<b>Total</b>	<b>18,128,207</b>	<b>100%</b>	<b>19,026,995</b>	<b>100%</b>	<b>19,362,484</b>	<b>100%</b>

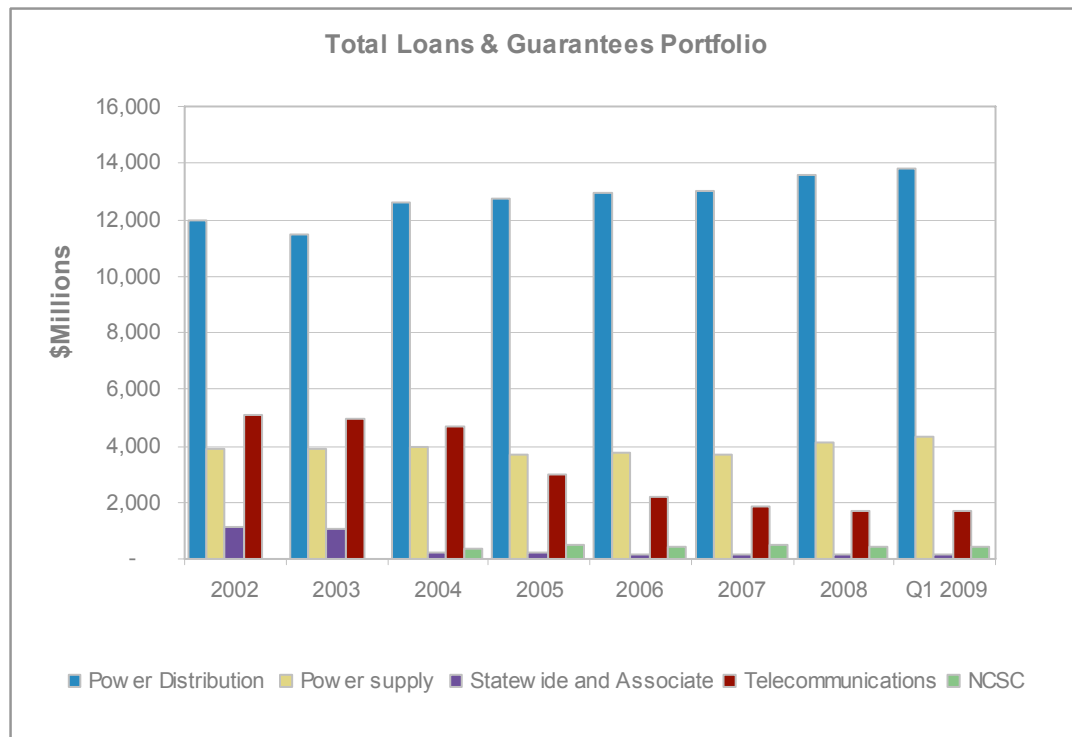
As depicted above, NRUC's loan portfolio is heavily weighted towards RECs. At August 31, 2008, nearly 90% of the loans made by NRUC were to RECs. Moreover, 70% of NRUC's loan portfolio represented loans to electric distribution cooperatives. Moody's considers this segment to be among the lowest risk segment across all electric utilities due to the highly predictable nature of the cooperative's cash flow, the monopoly status of this group, the pass-through mechanisms that typically exists at these entities, and the relatively predictable and steady capital investment requirements which often mirror service territory growth. NRUC is the dominant private lender in the US to this particular segment of the electric cooperative sector.

Loans to power supply cooperatives (also known generation and transmission cooperatives or G&Ts) make up the next largest segment concentration representing 18% of the loan portfolio at August 31, 2008. While this segment faces greater risks than the electric distribution cooperatives, the sector also features fairly predictable cash flow characteristics. Typically, power supply cooperatives have all-requirements long-term contracts with their member distribution cooperatives to sell electricity at agreed upon rates. These contracts enable the G&T to recover all of its cost of production and generally have pass-through mechanisms to recover changes in fuel related costs. These contracts serve as a basic underpinning of the G&T's credit quality and they provide a very predictable source of cash flow for debt service. Generally, the contracts extend beyond the final maturity date of the G&T's debt. Due to their size relative to most distribution cooperatives and their capital needs, which tend to be larger, all of the Moody's assigned public ratings in the cooperative sector are to generation and transmission cooperatives, with the average rating within this segment being A2 on an unsecured basis which is generally two notches higher than the average rating among investor-owned utilities in the US. While NRUC provides substantial capital to the segment, the RUS remains the dominant lender to this segment of the electric cooperative sector due to the size of the capital needs.

The last large segment represents loans made by RTFC to telecommunications borrowers. As discussed in greater detail in this report, loans to telecommunications borrowers have declined steadily since 2003 and now represent 9% of the total loan portfolio. While this sector carries greater risks than the electric distribution or generation and transmission segments, this portfolio tends to be shorter-dated than the other portfolios and most of the exposure is to rural local exchange carriers (RLECs) which represent the lowest risk group within this segment. Single obligor risk, a continuing concern at NRUC, has substantially subsided within the telecommunications portfolio over the past five years. In fact, among active performing telecommunications borrowers, the average outstanding loan at August 31, 2008 was less than \$10 million.

## National Rural Utilities Cooperative Finance Corporation (NRUC)

Moody's also observes that the majority of the loans through NCSC, which at August 31, 2008 stood at \$452 million, can be classified as additional REC exposure as most of the NCSC loan exposure represents direct loans to RECs or loans to entities which are guaranteed by RECs.



When one includes guarantees, the components of the portfolio do not materially change. As of August 31, 2008, NRUC's loans and guarantees with RECs represented 90% of the portfolio with distribution RECs approximating 68% and power supply RECs being at 21%. Moody's observes that most of NRUC's guarantees are issued for the benefit of one of its power supply borrowers. Loans and guarantees exposure to the rural telecommunications sector accounted for only 8% of NRUC's total loans and guarantees at August 31, 2008, representing a substantial decline from year-end 2003 when loans and guarantees exposure to the rural telecommunication sector was 23% of NRUC's total loans and guarantees. As discussed in greater detail below, 88% of NRUC's exposure in the rural telecommunications portfolio is to RLECs. Moody's views this shift in the portfolio towards RECs and away from the rural telecommunications sector as being supportive to NRUC's overall credit quality and to the quality of the loan portfolio.

### Outstanding Credit Quality of NRUC's Loan Portfolio

Overall, NRUC has an excellent loan loss experience. Since the cooperative's inception in 1969, only \$181 million in cumulative net losses have been taken. The low write-off loan history demonstrates the historically high credit quality of NRUC's portfolio, the strength of the collateral typically pledged to NRUC, and the ability of the NRUC to take a long-term view concerning debt restructuring due to its unique relationship with its customer base and the fact that NRUC is a not-for-profit organization.

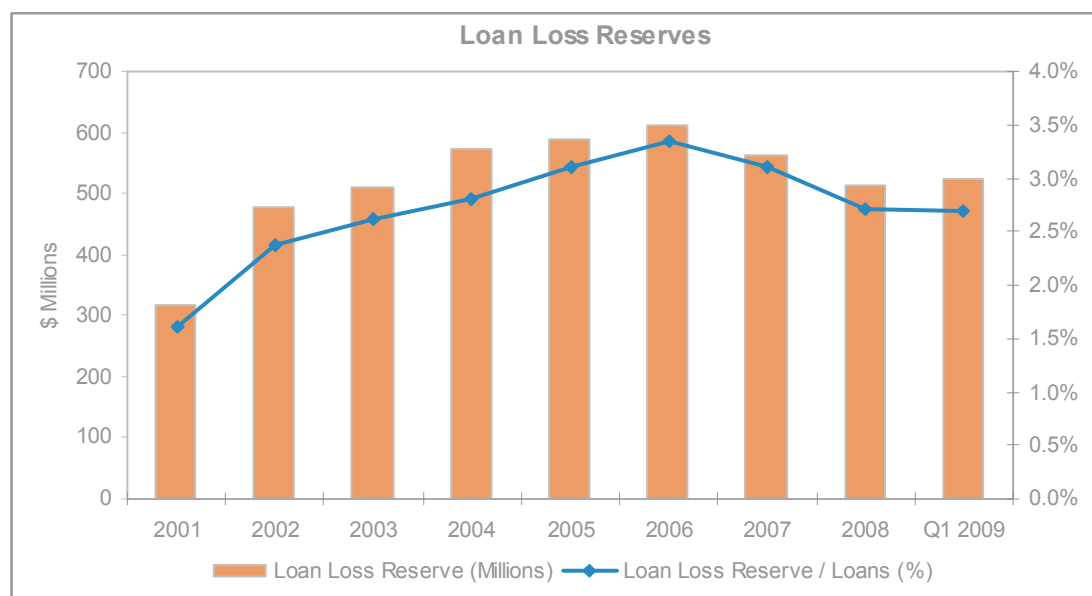
At August 31, 2008, nearly 90% of NRUC's total loan portfolio is secured while 96% of NRUC's long-term loan portfolio is secured. Loans are typically secured on a parity with other secured lenders (primarily RUS), if any, by all assets and revenues with certain exceptions typical for utility mortgages. This strong collateral position has helped to provide high recovery values for NRUC in past problem loan debt restructurings and often enables NRUC to receive the payment of interest and principal while a borrower is operating in bankruptcy. The majority of NRUC's unsecured loans relate to short-term lines of credit with RECs.

## National Rural Utilities Cooperative Finance Corporation (NRUC)

Loan Security												
(\$ Amounts in Billions)	At May 31, 2007				At May 31, 2008				At August 31, 2008			
	Sec.	%	Uns.	%	Sec.	%	Uns.	%	Sec.	%	Uns.	%
Total Loans by Segment												
CFC	14.5	92%	1.3	8%	15.0	89%	1.9	11%	15.1	88%	2.1	12%
RTFC	1.7	89%	0.2	11%	1.5	88%	0.2	12%	1.5	86%	0.2	14%
NCSC	0.4	86%	0.1	14%	0.4	87%	0.1	13%	0.3	86%	0.1	14%
<b>Total Loans</b>	<b>16.6</b>	<b>91%</b>	<b>1.6</b>	<b>9%</b>	<b>16.9</b>	<b>89%</b>	<b>2.2</b>	<b>11%</b>	<b>16.8</b>	<b>87%</b>	<b>2.4</b>	<b>13%</b>

### Sizeable Loan Loss Reserve Mitigates Problem Credit Exposure

Since fiscal year 2001, NRUC has materially increased its loan loss reserve. At August 31, 2008, the loan loss reserve stood at \$523 million, representing 2.7% of total loans. NRUC has also established a \$14 million reserve for guarantees issued by NRUC on behalf of members' debt.



On December 2, 2008, NRUC announced in an 8-K filing that for the quarter ending November 30, 2008, it expects to record a loss provision ranging from \$90 million to \$140 million primarily related to loans to Innovative Communication Corporation (ICC), a bankrupt borrower. The anticipated increase to the loss provision is primarily due to the significant disruptions in the capital markets, which have contributed to a decrease in the fair value of the collateral supporting the impaired loans. NRUC will report the loss provision for the quarter in the November 30, 2008 Form 10-Q, which will be filed with the SEC on or before January 14, 2009. Such an increase will raise the loan loss reserve to the \$610 million and \$660 million range. Moody's observes that notwithstanding the expected increase to the loan loss reserve, NRUC is likely to ultimately record a loss on the ICC loan exposure that will be material relative to NRUC's historical cumulative level of recorded net losses (\$181 million).

On December 5, 2008, Moody's affirmed NRUC's ratings with a stable outlook reflecting the one-time non-cash nature of the impairment associated with a pre-existing non-performing credit, the continued ability of NRUC to generate operating cash margins from the remainder of its loan portfolio, the recent initiatives taken by NRUC's management to bolster the cooperative's capital structure, and the continued credit strength of the overall loan portfolio.

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For more information on this rating action, please refer to the press release dated December 5, 2008 which can be found on [moody.com](http://moody.com)

At August 31, 2008, non-performing loans totaled \$492 million and restructured loans totaled \$570 million. Moody's notes that NRUC continues to receive timely quarterly debt service payments on all of the \$570 million of restructured loans. NRUC has classified non-performing loans and certain restructured loans as being impaired loans pursuant to SFAS 114. Of the \$523 million of loan loss reserves at August 31, 2008, approximately \$326 million was dedicated to the impaired loan category. In light of the size of the impaired loan portfolio and the single obligor concentration that exists among the borrowers in this impaired loan category, Moody's does not expect NRUC to materially reduce its loan loss reserve until final disposition of the debt restructurings occur.

Since 2003, NRUC has implemented a more objective loan loss methodology to determine the loan loss allowance for the general portfolio. Factors impacting the methodology include internal risk ratings of each loan, the maturity of each loan, the business segment of each loan, expected defaults based upon historical default rates, and expected recovery rates. Additionally, NRUC allocates additional reserves for entities with large exposures.

### Loan Pricing Flexibility Enables NRUC to Reset Margins

A key support to NRUC's credit quality is the ability of NRUC to reset margins sufficient to maintain its targeted adjusted TIER of 1.10x. NRUC manages this important aspect of its business by having terms and conditions in virtually all of their customer's loan documents that allow for a variety of re-pricing mechanisms. Additionally, basis risk is typically not a concern as the funding options afforded to NRUC's borrowers equate to NRUC's actual funding costs. For example, most variable rate loans reset monthly with the loan pricing being based on NRUC's actual variable-rate funding cost. The remaining fixed rate loan portfolio is funded with a variety of instruments whose average maturities match closely to the re-pricing tenors of the fixed rate loan portfolio. For example, a cooperative may borrow a fixed rate loan from NRUC with a final maturity date of fifteen years, and an initial re-pricing date of three years. While a fifteen year loan, NRUC will fund the loan with a three year funding instrument such that the re-pricing date of the loan matches closely the maturity date of the funding instrument. On the re-pricing date, if, for example, the cooperative re-prices the loan for two years, NRUC would fund that obligation with a new two year funding instrument. Over the next three fiscal years, approximately \$3.7 billion or 24% of NRUC's fixed rate loan portfolio will re-price based upon the terms and conditions set forth in the specific loan documents.

NRUC's ability to execute on this strategy is further aided by the dominant position that NRUC enjoys with the majority of its customer base and by the relative freedom of its electric borrowers to set rates as necessary to cover their expenses and maintain required covenants. In contrast to investor-owned utilities, about 70% of the RECs are unregulated, which allows them to reset utility rates as necessary without significant regulatory intervention. Another 20% of the RECs operate under streamlined regulation, which allows for the resetting of rates within the guidelines of an established formula. State public utility commissions regulate the remaining 10% of the RECs, which limit their flexibility and can result in regulatory lag.

NRUC's operating costs continue to remain low though NRUC's operating costs increased by 16.5% (\$9 million) during fiscal year 2008 due to additional headcount and higher medical expenses as well as increased expenditures for the acceleration of information systems projects. While operating costs have increased in 2008, the ratio of operating costs to loans was 34 basis points for fiscal year 2008, which when compared to other financial institutions remains extremely low.

## National Rural Utilities Cooperative Finance Corporation (NRUC)

### **As a Not-for-Profit, Margins and Profitability are Less Relevant**

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Given NRUC's status as a not-for-profit cooperative association and its operating objective to provide interest rates to its members at the lowest reasonable cost, operating margin and earnings profitability metrics have limited value from a ratings driver perspective. To that end, profitability comparisons and market share comparisons to other financial institutions also have limited value, particularly given NRUC's narrowly defined market and unique franchise position. However, within the market that NRUC serves, it enjoys a dominant position.

Notwithstanding this view, adjusted net interest income for fiscal year 2008 increased by \$15.7 million over fiscal year 2007 reflecting an increase in NRUC's average loan volume of \$207 million. Similarly, through the first three months of fiscal year 2009, NRUC's adjusted net interest income increased by \$17.7 million over the same period in fiscal year 2008 reflecting the impact of year-over-year average loan growth of over \$1 billion (all to RECs) off-set by lower borrowing costs due to interest rates being cut by the Federal Reserve.

Given the potential size of the above mentioned impairment charge (\$90 million to \$140 million) relative to NRUC's annual net income in a typical year, Moody's expects net income and adjusted TIER in FY 2009 to be negatively impacted; however, the charge is non-cash and does not signal an inability by NRUC to continue to generate appropriate margins for a not-for-profit finance cooperative.

### **Strong Track Record of Managing Credit Restructurings**

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NRUC has a demonstrated track record of being able to effectively manage difficult credit situations. As discussed above, some of this track record can be attributed to the strong security position associated with the vast majority of NRUC's loans. Additionally, its status as a not-for-profit cooperative entity allows management to take a longer-term view towards restructuring in difficult credit situations; although Moody's notes that this also has the potential to delay resolution of problems, relative to other financial institutions.

### **CoServ: Restructured Loan Remains on Track**

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At August 31, 2008, approximately \$512 million of NRUC's restructured loans were to CoServ, a large electric distribution cooperative located in Denton, Texas. While all loans with CoServ have been on a non-accrual status since January 1, 2001, CoServ continues to make scheduled quarterly payments to NRUC under the terms of the bankruptcy settlement agreement with such payments being applied towards principal reduction. Moody's believes that NRUC will continue to account for this loan as a restructured asset for the foreseeable future.

### **Steady Improvement in Risk Management**

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Over the past several years, NRUC has strengthened its risk management capabilities. In addition to implementing a risk scoring matrix and setting exposure limits for each borrower, NRUC also retains an independent bank consulting firm to provide an annual independent assessment of the functioning of the risk rating system. Additionally, NRUC has increased its ability to syndicate new and existing loan transactions and has developed expertise in selling portfolios of loans to targeted investors. Together, these efforts have provided greater liquidity to the asset side of the balance sheet and have helped to reduce single obligor risk.

With respect to single obligor risk, NRUC has reduced its total loan and guarantee outstandings to its top ten largest borrowers to \$3.66 billion representing 18% of NRUC's total loan and guarantees portfolio at August 31, 2008. By comparison, at May 31, 2004, NRUC's top ten largest borrowers had total loan and guarantee outstandings of \$4.7 billion representing 21% of NRUC's total loan and guarantee portfolio. Additionally, as mentioned above, due to efforts taken by NRUC management to reduce exposures in the telecommunications loan portfolio, single obligor risk largely exists in the electric portfolio only as the average loan outstanding among active telecommunications performing borrowers was less than \$10 million per borrower at August 31, 2008.

## National Rural Utilities Cooperative Finance Corporation (NRUC)

Although single obligor risk is likely to persist, a portion of this risk is mitigated by the portfolio's geographic and regulatory diversification. No single state exposure was larger than 16% of total loans at May 31, 2008. In Texas, NRUC's largest state exposure, the loans are spread among 108 cooperatives, with the largest being the \$539 million exposure to CoServ. In addition, cooperatives largely serve residential customers, thereby adding further diversity and stability to the ultimate source of cash flow.

### High Concentration across Two Industry Sectors

As previously mentioned, at August 31, 2008, approximately 90% of the company's loans and guarantees were made to RECs. As such, trends in the rural electric utility's aggregate credit quality directly impacts NRUC. Among the challenges facing RECs is the higher cost of operating their business given increases in certain fuel prices as well as ongoing increases in other operating expenses, including pension related obligations. Also, since many of the larger generation cooperatives rely on coal as a primary fuel source for generation, substantial incremental increases in capital requirements for related environmental expenditures are expected, particularly given the view that some form of carbon legislation will eventually be enacted at either the federal or state level. Moody's fully expects any incremental cost of carbon legislation will be passed along to distribution cooperatives.

Additionally, in recent years, many of the REC systems have experienced higher than average customer growth in their respective service territory. While higher customer growth enables RECs to more efficiently spread any incremental costs across more customers, it also results in higher capital expenditures for generation, transmission, and distribution investments, all of which will need to be recovered from the RECs' customers. We observe that the economic recession is likely to impact both customer growth and electric demand which could impact financial results, the level of capital investment, and the quality of customer receivables. Moreover, we further believe that implementing a rate increase during a period of economic stress may prove to be a material challenge over the intermediate term which could lead to weaker credit metrics for RECs. In the end, the RECs' ability to seamlessly pass along higher operating and capital costs to their customer base is an important factor in maintaining credit quality across the RECs and at NRUC.

As depicted below, loan and guarantee exposure with RLECs remains the largest component of NRUC's rural telecommunications exposure. While the degree of competition experienced by RLECs is less intense than other sectors of the telecommunication space, the degree of competition for borrowers in this portfolio is far greater than what has occurred within the electric side of the business. Additionally, uncertainty continues surrounding the future of universal service funds (USF) and inter-carrier access fees, both of which are important revenue streams for RLECs. While NRUC anticipates that changes may occur in the way in which USF is funded and distributed as well as the manner in which access fees are determined, NRUC does not believe that any changes would materially impact the credit quality of its current telecommunication loan portfolio.

### RTFC Segment Loans and Guarantees

(Dollar amounts in millions)	2004		2005		2006		2007		2008		Q1 2009	
Rural local exchange carriers	3,615	78%	2,358	79%	1,815	84%	1,630	88%	1,518	88%	1,501	88%
Wireless providers	267	6%	211	7%	5	0%	4	0%	5	0%	5	0%
Cable television providers	176	4%	169	6%	179	8%	155	8%	153	9%	153	9%
Long distance carriers	340	7%	135	5%	89	4%	9	0%	-	0%	-	0%
Fiber optic network providers	168	4%	67	2%	41	2%	37	2%	17	1%	11	1%
Competitive local exchange	62	1%	45	2%	28	1%	21	1%	30	2%	32	2%
Other	15	0%	7	0%	5	0%	4	0%	4	0%	3	0%
<b>Total</b>	<b>4,643</b>	<b>100%</b>	<b>2,992</b>	<b>100%</b>	<b>2,162</b>	<b>100%</b>	<b>1,860</b>	<b>100%</b>	<b>1,726</b>	<b>100%</b>	<b>1,705</b>	<b>100%</b>

## National Rural Utilities Cooperative Finance Corporation (NRUC)

Moody's also observes that the next largest category after RLEC exposure is RTFC's exposure to cable television providers. Moody's understands that virtually all of this exposure is attributed to one borrower that is currently has a large non-performing loan with RTFC. To the extent that NRUC is able to successfully resolve the exposure to this troubled borrower, virtually all of NRUC's exposure to the telecommunications will represent exposure to RLECs

### Reliance on the Capital Markets for Funding

Like many finance companies, CFC is highly reliant upon access to the short-term and long-term capital markets for funding its business and for refunding debt maturities. In addition to operating cash flow and member loan repayments which should average more than \$1 billion a year from 2009 through 2013, investments from NRUC members provide about \$3.88 billion or about 18.6% of total assets (less derivatives) at August 31, 2008. Of the \$3.88 billion, \$1.446 billion represented short-term debt funding through \$1.179 billion in members' commercial paper and \$267 million in members' contributions to the daily liquidity fund, both funding sources that Moody's considers to be "core funding".

Longer-term needs are satisfied through the issuance of secured collateral trust bonds (CTB), unsecured medium term notes (MTNs), and subordinated deferrable debt. In recent years, NRUC's arrangement under the Rural Electric Development Loan and Guarantee (REDLG) program and with Federal Agricultural Mortgage Corporation (Farmer Mac) represent additional private sources of capital for NRUC which helps mitigate the ongoing refinancing risk associated with NRUC's reliance on the short-term and long-term public capital markets.

### Leverage Remains High and Must Be Managed

Capitalization Ratios	2001	2002	2003	2004	2005	2006	2007	2008
Funded Debt / Adjusted Member's Equity*	8.8x	8.3x	7.9x	8.3x	8.2x	8.0x	8.0x	8.1x
Adjusted Funded Debt / Adjusted Member's Equity**	9.0x	8.6x	8.2x	8.6x	8.5x	8.3x	8.1x	8.3x
Adjusted Funded Debt (inc. Guarantees) / Adjusted Member's Equity (inc. Loss Reserve)***	8.7x	7.7x	7.2x	7.2x	7.0x	6.7x	6.7x	7.0x

\* Moody's defines the Funded Debt to Adjusted Members' Equity ratio as being the sum of the Notes Payable and Long Term Debt on NRUC's balance sheet divided by the sum of the Members' Subordinate Certificates and Members' Equity adjusted for SFAS 133.

\*\* Moody's defines the Adjusted Funded Debt to Adjusted Members' Equity ratio as being the sum of the Notes Payable and Long Term Debt (including Subordinated Deferrable Debt) on NRUC's balance sheet divided by the sum of the Members' Subordinate Certificates and Members' Equity adjusted for SFAS 133.

\*\*\* Moody's defines the Adjusted Funded Debt (including Guarantees) to Adjusted Members' Equity (including Loss Reserves) ratio as being the sum of the Notes Payable, Long Term Debt (including Subordinated Deferrable Debt) and Guarantees in NRUC's financial statements divided by the sum of the Members' Subordinate Certificates, Members' Equity adjusted for SFAS 133, and the Loan and Guarantee Loss Reserve.

Due to the nature of its composition, NRUC does not have common stock in its capital structure. Instead, most RECs, as a condition of NRUC membership, are required to purchase deeply subordinated capital term certificates in the amount equal to 1% of the member's revenue for a 15-year period. These capital term certificates bear below-market interest rates and have maturities of up to 100 years. When members either borrow from NRUC or obtain a guarantee, they may be required to purchase similar subordinated obligations (long-term certificates or subordinated term certificates) in amounts ranging from 2.0-13.5% of the credit exposure that matches the maturity of the borrowing or guarantee. For analytical purposes, Moody's treats the combination of allocated but unretired margins, membership fees, education fund, members' capital reserve, and member subordinated certificates as equity.

NRUC's leverage, after improving somewhat since fiscal year 2003, has edged upwards as adjusted funded debt/ adjusted members' equity at May 31, 2008 and August 31, 2008 reached 8.3x and 8.5x, respectively. The increase at August 31, 2008 was due to the declaration of patronage capital to members which typically occurs during the first quarter of each fiscal year. Moody's anticipates that leverage will increase further following the expected addition to the loan loss reserve for ICC of between \$90 million and \$140 million.

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Mitigating the likely increase in leverage is the fact that NRUC has recently implemented a program to sell new equity capital securities to its members. This offering could raise \$300 million to \$500 million and will likely occur over an intermediate period of time. Moody's views this initiative as a credit supportive transaction.

### Problem Loans at \$492 Million: A Rating Constraint

NRUC's loan exposure to ICC, which is operating in bankruptcy, represents virtually all of NRUC's current non-performing loans (\$484 million). Uncertainty about the final outcome of the ICC bankruptcy remains a key rating constraint. Progress has been made to resolve this matter during calendar year 2007 and 2008, including the appointment by the bankruptcy court of a trustee to exercise control over the common stock of ICC, which could facilitate a refinancing or sale of ICC and its assets. We do believe that a framework for resolution could occur during calendar year 2009, although it is still uncertain as to the final disposition of this large exposure. Moody's understands that a substantial portion of NRUC's existing loan loss reserve is earmarked for a potential ICC loan loss. As such, we believe that the incremental \$90 million - \$140 million loan loss provision likely to be taken during the second quarter of NRUC's fiscal year should largely address any potential future loan loss taken by NRUC on the ICC loan.

### Liquidity

NRUC's has a short-term rating of Prime-1 for its commercial paper, for the guaranteed commercial paper issued by NCSC, variable rate tax-exempt demand bonds, and extendible commercial notes. As discussed above, NRUC remains reliant on the capital markets as its funding source as NRUC's internal cash flow contribution from its loan portfolio is relatively modest when compared to its funding requirements, given the long-dated nature of the loan portfolio. NRUC's primary internally funded sources include operating cash flow and scheduled amortization payments from borrowers which are expected to average \$1 billion annually over the next five years.

During fiscal year 2008 and through first quarter 2009, NRUC raised \$2.0 billion of Collateral Trust Bonds in the capital markets, of which \$700 million was priced at 5.45%, \$900 million at 5.5%, and remaining \$400 million at floating rates. Additionally, NRUC borrowed \$400 million for five years from Farmer Mac at a spread over Libor. Subsequent to fiscal first quarter end, NRUC completed two additional capital raising transactions. In September 2008, NRUC borrowed \$500 million under the REDLG program for three years at an all-in cost of Treasuries plus 57.5 basis points. In October 2008, NRUC raised \$1 billion in the capital markets from the sale of 10.375% Collateral Trust Bonds due 2019. Proceeds from these financings were used to refinance maturing debt, to repay short-term outstanding debt, and for general corporate purposes. Moody's observes that as a cost-plus lender, NRUC has incorporated the higher cost funding experienced during the October financing in the loan pricing available to members.

NRUC has established a goal of maintaining its dealer commercial paper and bank bid notes at no more than 15% of total debt. At August 31, 2008, dealer commercial paper and bank bid notes totaled approximately 12% of total debt outstanding. NRUC expects outstanding dealer commercial paper and bank bid notes to remain below 15% during FY 2009.

NRUC limits the amount of commercial paper issued to the amount of back-up liquidity provided by its revolving credit agreements so that there is at least 100% coverage of outstanding commercial paper. NRUC's bank facilities aggregate \$3.411 billion and represent NRUC's principal form of liquidity support. Moody's observes that NRUC had \$239 million of credit commitments from a subsidiary of Lehman Brothers Bank (LBB) and the \$3.411 billion is adjusted for the LBB exposure. Of the \$3.411 billion in committed bank facilities, nearly 60% of the credit facilities have a multi-year maturity. Approximately \$1.049 billion of the facilities expire on March 16, 2012, and \$967 million of the facilities expire on March 22, 2011. The remaining \$1.395 billion of these commitments expire by March 13, 2009, although any borrowings outstanding under the 364-day facility can be converted into a one-year term loan. While Moody's expects NRUC to be able to extend this expiring facility for another year, it is likely to be at higher pricing than the current arrangement.

The credit facilities do not contain a MAC clause but have financial covenants which are set at levels that provide substantial cushion. The agreements require an adjusted TIER average of 1.025 for the last six

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quarters (excluding any non-cash adjustments for SFAS 133/52). NRUC was comfortably in compliance with this covenant at August 31st. As discussed earlier, NRUC runs its business and sets margins to maintain an adjusted TIER of at least 1.10x (excluding any non-cash adjustments for SFAS 133/52). While the recent announcement concerning the additional loan reserves at ICC will negatively affect NRUC's adjusted TIER, NRUC will remain in compliance with the 1.025x covenant in the revolvers. Also, the agreements require a senior debt to equity ratio, as defined in the bank agreement, to not be more than 10x (excluding any non-cash adjustments for SFAS 133/52). At August 31, 2008, NRUC was comfortably in compliance with this covenant. Moody's also observes that the bank agreements prohibit the retirement of patronage capital unless NRUC has achieved an adjusted TIER ratio of at least 1.05x for the preceding fiscal year.

Given NRUC's short-term rating for commercial paper with Moody's, Standard and Poor's (S&P), and Fitch, NRUC is an eligible issuer of commercial paper under the Commercial Paper Funding Facility (CPFF) established by the Federal Reserve on October 7, 2008. On October 21, 2008, NRUC received notification that it had been approved to participate in the CPFF, and on October 27, 2008, NRUC became eligible to participate in the program for up to an amount of \$3.083 billion. Moody's understands that NRUC has issued commercial paper under the CPFF.

Refinancing needs for calendar year 2009 include \$245 million of floating rates notes maturing in July 2009 and \$1.25 billion of notes due in August 2009. Moody's expects NRUC to meet these financing requirements through internal sources, loan repayments, and capital market offerings, particularly under its CTB indenture and medium-term note program.

### Loan Portfolio Is Match Funded

NRUC's policy is to avoid bearing interest rate risk by match funding assets with offsetting liabilities and through interest rate derivatives. Small mismatches occur from time to time, because NRUC delays funding long-term fixed rate assets until enough have been accumulated to create economical transaction sizes. It is NRUC's policy to match fund asset and liability re-pricing terms within a range of 3% of total assets excluding derivative assets. At August 31, 2008, fixed rate assets funded with variable rate debt were \$514 million and represented less than 3% of total assets (excluding derivative assets). NRUC uses derivatives to convert a portion of variable rate funding to fixed rate, to change the basis of floating LIBOR rates to a U.S. commercial paper index rate, and to hedge currency risk. At August 31, 2008, outstanding notional principal on interest rate derivatives was \$13.627 billion.

### Derivative Accounting Adds Volatility to GAAP Results

As a result of implementing SFAS 133, NRUC has experienced and will continue to experience increased volatility in reported GAAP results. The company enters into these exchange agreements as part of its risk management strategy. As interest rates in the capital markets increase or decrease, the fair value of these derivative instruments changes. SFAS 133 requires companies to record the fair value of its derivative assets and liabilities on its balance sheet. NRUC uses 'mark to market' accounting (rather than hedge accounting) for almost all of its derivative transactions thereby increasing income statement volatility. For example, the change in the fair value of derivatives for the years ended May 31, 2008, 2007 and 2006 was a loss of \$99 million, a loss of \$79 million, and a gain of \$29 million.

Moody's evaluation of adjusted TIER, leverage, and cash flow eliminates all non-cash SFAS 133 adjustments.

### Rating Triggers

At August 31, 2008, there were rating triggers associated with \$9.234 billion notional amount of interest rate exchange agreements. The rating triggers are based on NRUC's senior unsecured credit rating from Moody's and S&P. If NRUC's rating for senior unsecured debt from either agency falls below the level specified in the agreement, the counterparty may, but is not obligated to, terminate the agreement. Upon termination, both parties would be required to make all payments that might be due to the other party. If NRUC's senior unsecured rating from Moody's or S&P declines to Baa1 or BBB+, respectively, the counterparty may terminate agreements with a total notional amount of \$1.919 billion. If NRUC's senior unsecured rating from

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Moody's or S&P falls below Baa1 or BBB+, respectively, the counterparty may terminate the agreement on the remaining total notional amount of \$7.314 billion.

At August 31, 2008, NRUC had a derivative fair value of \$37.4 million, comprised of \$37.9 million that would be due to NRUC and \$0.5 million that NRUC would have to pay if all interest rate exchange agreements at the level of Baa1 or BBB+ and above were terminated, and a derivative fair value of negative \$6.9 million comprised of \$29.1 million that would be due to NRUC and \$36 million that NRUC would have to pay if all interest rate exchange agreements with a rating trigger below the level of Baa1 or BBB+ were to terminated.

## Corporate Governance

NRUC's board of directors is comprised of twenty-three members. According to the company's by-laws, twenty of the directors must be either general managers of the member cooperatives or directors of the member systems. Two of the directors are designated by the National Rural Electric Cooperative Association, a national lobbyist group for rural electric cooperatives. During fiscal year 2004, NRUC modified its by-laws to add one additional director to its board. This position must be filled by an at-large director, who must satisfy the requirements of an audit committee financial expert as defined by Section 407 of the Sarbanes-Oxley Act of 2002 and must be elected from the general membership. This at-large position can be filled at the discretion of the board.

During 2007, NRUC filled the at-large directorship seat that had been designated for a director with audit committee financial expertise as defined by Section 407 of the Sarbanes-Oxley Act of 2002. The newly seated director, a director of the East Kentucky Power Cooperative, is a highly credentialed CPA, a Certified Forensic Accountant and has experience as a director of a publicly-traded bank. In Moody's opinion, while filling its by-law mandate, the board's financial expertise has been greatly strengthened; however, Moody's believes that given the nature and size of the financial transactions that underpin NRUC's business, the selection of additional directors with corporate accounting or financial services industry experience would be beneficial.

No member of NRUC management holds a board seat. Each board member serves a three-year term and is limited to a maximum of two consecutive terms. In contrast to a public company, where voting is in proportion to the share of ownership, each full member cooperative is entitled to one vote irrespective of the size of its capital contribution. In addition, NRUC is not subject to regulation by any federal or state authorities as a bank would be.

## Moody's Related Research

### Credit Opinions:

- National Rural Utilities Cooperative Finance Corporation, December 2008

### Rating Methodology:

- U.S. Electric Generation & Transmission Cooperatives, May 2006 (97324)
- Analyzing the Credit Risks of Finance Companies, October 2000 (60730)

*To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.*

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Report Number: 113484

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