

Credit Opinion: National Rural Utilities Coop. Finance Corp.

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Herndon, Virginia, United States

Ratings

Category	Moody's Rating
Outlook	Stable
Senior Secured	A1
Senior Unsecured	A2
Subordinate	A3
Commercial Paper	P-1
Other Short Term	P-1

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Key Indicators

National Rural Utilities Coop. Finance Corp.

	LTM	Q1 2007	2006	2005	2004	2003	2002
Loans (\$millions) [1]	18,338	18,361	18,972	20,489	19,484	20,047	
Adjusted Capital Funds (\$millions) [1][2]	1,991	1,995	2,033	2,169	2,163	2,084	
Adjusted TIER (x) [1][3]	1.09	1.11	1.14	1.12	1.17	1.12	
Adjusted Debt / Adjusted Capital Funds (x) [1][2]	7.93	8.01	8.19	8.30	7.91	8.29	
Adjusted Debt+ QUICS / Adjusted Capital Funds (x) [1][2]	8.18	8.26	8.53	8.55	8.21	8.57	
Loan Loss Reserve (\$millions) [1][4]	611	611	590	574	511	478	
Loan Loss Reserve / Loans (%) [1][4]	3.33%	3.33%	3.11%	2.80%	2.62%	2.38%	
Adjusted Short Term Debt / Adjusted Capitalization (%) [1][2]	6.48%	7.14%	15.2%	6.5%	4.8%	12.1%	

[1] Fiscal year ends May 31st [2] Members' Equity is adjusted for SFAS 133 and SFAS 52 [3] Net margin adjusted to exclude derivative forward value and foreign currency adjustments. Cost of funds adjusted to include derivative cash settlements. [4] Excludes loss reserves for guarantee portfolio of \$13, \$15, \$16, \$19, \$54, \$28, and \$15 million for Q1 2007, 2006, 2005, 2004, 2003, and 2002 respectively.

Note: For definitions of Moody's most common ratio terms please see the accompanying [User's Guide](#).

Opinion

Company Profile

National Rural Utilities Cooperative Finance Corporation (CFC) is a non-bank financial institution exclusively serving rural electric, service, and telecommunication utilities. CFC 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. CFC has 210 employees and is based in Herndon, Virginia.

Rating Rationale

The A1 senior secured debt rating of CFC is based on its excellent competitive position, including an ability to raise margins on member loans; management's strong track record; and the quality of its loan portfolio, which has an outstanding loan loss history and a strong collateral position.

The rating also considers the degree of single obligor exposure within the loan portfolio; the reliance on debt to fund its business; and the credit quality of some of CFC's larger credit exposures. To that end, the rating factors in the problem loan exposure with ICC, CoServ, and VarTec.

Key Ratings Factors

1. Loan pricing flexibility enables CFC to reset margins sufficient to maintain its targeted coverage ratios while adding to its loan loss reserve.

A key support to CFC's credit quality is the ability of CFC to reset margins sufficient to maintain its targeted adjusted TIER of 1.10x. CFC manages this important aspect of their business by having terms and conditions in virtually all of their customer's loan documents that allow for a variety of repricing mechanisms. Additionally, basis risk is typically not a concern as the funding options afforded to CFC's borrowers equate to CFC's actual funding costs. Furthermore, CFC's operating costs continue to remain low and controllable though its costs have risen over time as a share of outstanding loans. CFC's ability to execute on this strategy is aided by the dominant position that CFC 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.

2. Outstanding credit quality of CFC's loan portfolio, including its loan loss history, and its strong collateral position on 91% of its loans.

CFC has an excellent loan loss experience. Only \$117 million in cumulative net losses have been taken in the company's 37 year operating history, and in the past five years, \$35 million in cumulative net losses have been recorded. The low write-off loan history demonstrates the historically high credit quality of CFC's portfolio, the strength of the collateral typically pledged to CFC, management's experience in resolving difficult credit situations, and the ability of the CFC to take a long-term view concerning debt restructuring due to its unique relationship with its customer base and the fact that CFC is a not-for-profit organization. Moody's notes that CFC's approach also has the potential to delay resolution of problems relative to other financial institutions.

About 91% of CFC's loan portfolio are secured and usually are secured by all assets and revenues with certain exceptions typical for utility mortgages. This strong collateral position has helped to provide high recovery values for CFC in past problem loan debt restructurings and often enables CFC to receive the payment of interest and principal while a borrower is operating in bankruptcy.

3. Increase in loan loss reserve provides a cushion for managing problem credits and more objective loan loss methodology has improved overall risk management.

Since fiscal year 2000, CFC has materially increased its loan loss reserve. At August 31, 2006, the loan loss reserve stood at \$611 million, an increase of \$398 million over that timeframe. CFC has also established a \$13 million reserve for guarantees issued by CFC of members' debt. The increased loan loss reserve represents 3.11% of total loans and is a significant increase from 1.28% of total loans in 2000.

Non-performing loans totaled \$538 million and restructured loans totaled \$624 million at August 31, 2006. Of the \$611 million of loan loss reserves at August 31, 2006, approximately \$451 million was dedicated to the impaired loan category. In light of the size of the impaired loan portfolio and the concentration that exists among large non-performing and restructured loans, Moody's does not expect CFC to materially lower its loan loss reserve in the near term, particularly while these exposures remain outstanding.

Since 2003, CFC 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.

4. Single obligor risk remains an ongoing concern

CFC's market dominance has resulted in a loan portfolio that covers the majority of the RECs; and in a large number of cases, CFC is the principal source of financing for these entities. Furthermore, CFC's electric loan portfolio is long dated, not very liquid, and historically were not syndicated or distributed to other potential lenders. Moody's considered these items as higher risk factors in recent times, particularly given the amount of leverage on CFC's balance sheet and CFC's reliance on the capital markets to fund its business. Moody's views positively CFC's syndication efforts within the past to reduce single obligor exposure particularly among its large telecommunication exposures. Moreover, efforts to reduce large single obligor exposure among RECs have been advanced by the introduction of a whole loan sales program for eligible electric borrowers. Another positive development has been the implementation of portfolio and credit guidelines including industry as borrower limits to address the ongoing concern of borrower concentrations. Although single obligor risk continues, Moody's notes the

progress that CFC has made in recent years to address this concern.

5. Sizeable problem loan exposure remains a rating constraint

Two of the largest concentrations are to borrowers whose loans are classified as being either restructured (CoServ) or non-performing (ICC). Loan and guarantee exposure to CoServ and ICC total \$563 million and \$489 million respectively, at August 31, 2006. All loans with CoServ have been on a non-accrual status since January 1, 2001 and CoServ continues to make scheduled quarterly payments to CFC under the terms of the bankruptcy settlement agreement. Such payments continue to be applied to principal reduction.

On June 1, 2004, RTFC filed a lawsuit against ICC for failure to comply with the terms of the loan agreement. Since February 1, 2005, CFC has treated this loan as non-performing. Subsequent lawsuits were filed and RTFC reached a settlement with ICC in April 2006. On July 31, 2006, ICC filed for bankruptcy protection. Uncertainty about the outcomes of the ICC exposure remains a key rating constraint.

6. Loan and guarantee portfolio declines due to a substantial reduction in loans to the telecommunications sector.

At August 31, 2006, CFC's total loans to members stood at \$18.3 billion versus almost \$19 billion at fiscal year end 2005, a decline of around \$630 million or almost 3.3%, due primarily to several large prepayments of loans with telecommunication borrowers while loans to power supply and distribution REC borrowers increased. Since 2004, loan and guarantee exposure to the telecommunication sector has reduced by more than \$2.5 billion to slightly more than \$2.0 billion at August 31, 2006. CFC expects loan portfolio growth to remain relatively flat due to additional prepayments expected from telecommunication borrowers balanced against some growth from REC borrowers. Moody's views this shift in the portfolio towards RECs and away from the rural telecommunication sector as being supportive to CFC's overall credit quality and to the quality of the loan portfolio.

7. High concentration across two industry sectors

At August 31, 2006, approximately 86% 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 CFC. The uncertainty caused by deregulation and technological advances, both of which could impact RECs, remain long-term challenges for CFC. A more near-term challenges for RECs are increasing in fuel prices, increased operating expenses, including pension related obligations, and higher than average customer growth. 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 RECs.

About 11% of CFC's loans and guarantees are with rural telecommunication companies. As mentioned, CFC has made great strides in reducing its exposure to this industry segment, particularly during fiscal year 2005 and 2006. While exposure to the rural telecommunication sector has declined measurably, CFC's exposure to this sector remains substantial as total loans and guarantees at August 31, 2006 stood at slightly more than \$2.0 billion.

8. CFC is reliant on the short-term and long-term capital markets for funding its business and for refinancing maturing debt.

Like most 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, investments from CFC members provide about \$3.68 billion of capital for CFC representing 19% of total assets at May 31, 2006. Of the \$3.68 billion, \$1.64 billion represented short-term debt funding through \$1.36 billion in members' commercial paper and \$276 million in members' contributions to the daily liquidity fund, both funding sources that Moody's considers to be "core funding".

Subsequent to fiscal year 2005, CFC executed agreements resulting in a \$2.5 billion loan facility under the Rural Electric Development Loan and Guarantee (REDLG) program. Under this program, CFC is eligible to borrow up to the amount of the outstanding loans that it has issued concurrent with RUS loans. The REDLG and Farmer Mac transactions provide than \$2.5 billion of new capital for CFC from a new highly dependable investor base which helps to mitigate the ongoing refinancing risk associated with CFC's reliance on the short-term and long-term capital markets.

9. Leverage remains high and must be managed

Due to the nature of its composition, CFC does not have common stock in its capital structure. Instead, RECs, as a condition of CFC membership, are required to purchase deeply subordinated capital term certificates. CFC's equity, after increasing materially during fiscal year 2003, has declined somewhat during the last 3 fiscal years due to large repayments of existing loans. While total debt also declined during 2006, the trend in CFC's leverage during the past three years has been slowly improving. Moody's believes that CFC's longer term credit quality would benefit from lower levels of debt, particularly given the lack of liquidity on the asset side of the balance sheet.

Rating Outlook

CFC's stable outlook considers a continuation of fairly modest loan growth with low risk electric distribution cooperatives representing an increasing portion of its portfolio, maintenance of a significant loan loss reserve, a continued trend in the relative size of telecom loan portfolio, and a reasonable outcome for the exposures to CoServ, VarTec, and in particular, ICC.

What Could Change the Rating - Up

In light of the uncertainty surrounding the outcome for a large non-performing loan, the existence of single obligor exposure, and the relatively high leverage, an upgrade of the existing rating in the near-term is less likely. Longer term, sustainable improvements in the portfolio, resolution of problem loans, particularly the ICC exposure, in combination with a conservative balance sheet strategy and continued efforts towards reducing single obligor exposure could lead to positive implications for the rating.

What Could Change the Rating - Down

Conversely, an unfavorable resolution for CFC's two large troubled credits (ICC or CoServ) or the appearance of a large new troubled credit could place downward pressure on the rating.

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