



NATIONAL RURAL UTILITIES COOPERATIVE FINANCE CORPORATION

*Powerful Financial Solutions*

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**For Immediate Release  
For Business Editors**

## **Press Release**

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## **CFC Initiates Foreclosure Action**

### **Recent Developments**

National Rural Utilities Cooperative Finance Corporation ("CFC") announced second quarter financial results for the period ending November 30, 2001. During this six month period CFC met its primary financial objective of a 1.12 Times Interest Earned Ratio (TIER). CFC generated operating margins for the second quarter of \$30.0 million and \$58.5 million for the six-month interim period. The loan loss allowance increased by \$109.8 million bringing the total loan loss allowance to \$416.5 million or 2.12% of gross loans and 1.92% of loans and guarantees as of November 30, 2001.

CFC is a private, not-for-profit cooperative association that provides supplemental financing and related financial service programs for the benefit of its members, which are primarily rural electric cooperatives and rural telecommunications cooperatives. CFC's goal, as a member owned cooperative, is not to maximize its earnings, but rather to set rates for its member borrowers at reasonable levels, consistent with market trends and sound financial practice.

CFC's operating earnings and ratios discussed exclude the effects related to SFAS 133, "Accounting for Derivative Instruments and Hedging Activities". CFC is neither a dealer nor a trader in derivative financial instruments and only enters into these agreements as part of an overall risk management strategy. CFC implemented SFAS 133 effective June 1, 2001. Detailed information about these adjustments can be found in CFC's form 10Q filed with the Securities and Exchange Commission on December 21, 2001.

### **CoServ**

On March 16, 2001, CFC and Denton County Electric Cooperative, Inc., d/b/a CoServ Electric ("CoServ") signed a master restructure agreement. The agreement restructures debt obligations of CoServ totaling \$906 million over the next 35 years, \$889 million of loans outstanding and \$17 million of unpaid interest through the closing date. All obligations under the agreement are secured by a first priority lien on substantially all of the assets and revenues of CoServ and its major subsidiaries. Substantially all of the obligations are cross-collateralized and have cross-default provisions.

CoServ provides retail electric service to residential and business customers in an area where there has been significant residential and commercial growth in and adjacent to its current service territory over the last few years. CoServ adopted a strategy to provide a broad range of utility and other related services to consumers both in its service territory and the newly developing areas adjacent to its service territory. The non-electric services are generally provided through its controlled affiliates, which have been funded primarily through advances from CoServ, and include natural gas, home-security, cable television and a variety of telecommunications services. CoServ has also made substantial loans to and equity investments in residential and commercial real estate development projects. CFC loans to CoServ are secured primarily by assets and revenues of the electric distribution and telecommunications systems and assignment of loans and equity investments in residential and commercial real estate development projects.

On September 27, 2001, CFC initiated litigation in the United States District Court for the Northern District of Texas (Dallas Division), asserting that CoServ was in default of the agreement and seeking injunctive and other relief. CFC initiated this action as a result of CoServ's noncompliance with the provision of the master restructure agreement that required the sale of telecommunications assets by September 30, 2001.

On November 30, 2001, CoServ voluntarily filed for Chapter 11 reorganization for some of its telephone and cable subsidiaries (debtors in possession). The Chapter 11 petition was filed in the United States Bankruptcy Court, Northern District of Texas, in Fort Worth, TX. CoServ took this action as part of a plan to sell the telecommunications assets. CoServ has stated that it does not believe that this action will affect the service it provides to its customers. On December 20, 2001, the court entered an order approving a CFC \$5 million loan facility with a three-month maturity to the debtors in possession. Advances under the facility are subject to certain conditions. CFC may withdraw unadvanced amounts at its discretion.

Under the master restructure agreement signed in March 2001, CoServ was required to pay \$7.5 million to CFC on December 31, 2001. CoServ did not make this payment. CoServ has stated that they do not intend to make the payment to CFC, even though they do have sufficient funds to make the payment. The CoServ payment default and voluntary Chapter 11 petition constitute a default under the master restructure agreement.

On January 9, 2002, CFC filed a complaint in the United States District Court for the Northern District of Texas against CoServ, and three of its wholly-owned subsidiaries, seeking (i) monetary damages, (ii) appointment of a receiver to operate CoServ's business operations, and (iii) foreclosure on certain of CoServ's assets. The lawsuit involves breach of contract claims arising out of CoServ's default under its various loan and security agreements with CFC. Contemporaneously with the filing of this complaint, CFC also began non-judicial foreclosure proceedings against CoServ with respect to its real estate, buildings and other assets.

## **Ratings**

CFC's long and short term debt and guarantees are rated by the three major credit rating agencies: Moody's Investor Service, Standard & Poor's Corporation and Fitch Investors Service. As a result of the increased exposure to CoServ and telecommunications systems, as well as the general negative outlook for electric utilities, all three of the rating agencies had CFC's ratings on negative outlook at second quarter end 2002 and fiscal year end 2001. As a result of the CoServ bankruptcy and continuing problems in the utilities markets, on December 3, 2001, Fitch Investors Service placed CFC on rating watch negative, on December 6, 2001, Standard & Poor's Corporation placed CFC on credit watch with negative implications, and on December 11, 2001, Moody's Investor Service placed CFC under review for possible downgrade.

On January 8, 2002, Standard & Poor's lowered their ratings of CFC's senior and senior unsecured debt, guarantees, quarterly income capital securities, and commercial paper one notch with a negative outlook. CFC's ratings have been removed from creditwatch by Standard & Poor's.

## **Operating Results**

CFC continued to generate strong operating results through the six-month period ended November 30, 2001. The operating margin for the six-month period was \$58.5 million as compared to \$101.9 million for the same period in fiscal year 2001. However, during the first two quarters of fiscal year 2002, CFC increased the loan loss allowance by \$109.8 million as compared to \$15.8 million in the first half of fiscal year 2001. The loan loss allowance at November 30, 2001 of \$416.5 million represents 2.12% of total loans outstanding and 27.2% of total non-

performing and restructured loans. During this same period CFC was able to maintain a times interest earned ratio of 1.12.

CFC's leverage and debt to equity ratios continued to decrease as compared to fiscal year end 2001. The leverage ratio was 6.92 at November 30, 2001 as compared to 7.69 at May 31, 2001. CFC's debt to adjusted equity ratio was 5.35 representing a decrease from 6.05 at fiscal year end. The decrease to both ratios is the result of the increase retention of members' equity and subordinated certificates, the increase to the balance of the loan loss reserve as well as the reduction to the amount of debt required to funds loans outstanding. The balance of members' equity and subordinated certificates increased by \$27 million or 1.4% to \$2,003 million at November 30, 2001.

On September 4, 2001, CFC's board of directors authorized the retirement of \$98 million of allocated net margins to CFCs members. This amounts to 70% of the net margin allocated for fiscal 2001 and one-ninth of the net margins allocated for fiscal years 1991, 1992, and 1993. The \$98 million includes \$25 million allocated to RTFC.

## Portfolio

CFC's loan volume has decreased slightly during the first six months of fiscal year 2002 and portfolio is expected to remain relatively constant through the remainder of fiscal year 2002. Total loans outstanding at November 30, 2001 were \$19,664 million as compared to \$19,684 million at fiscal year end 2001. Loans outstanding to Electric borrowers increased by \$38 million, while loans outstanding to Telco borrowers decreased by \$58 million. CFC's unsecured loans totaled \$1,606 million or 8% of gross loans outstanding.

At November 30, 2001 and May 31, 2001, CFC had non-performing loans in the amount of \$18 million and \$1 million respectively. All loans classified as non-performing were on a non-accrual status with respect to the recognition of interest income. At November 30, 2001, CFC had restructured loans in the amount of \$1,511 million with \$553 million on accrual status with respect to the recognition of interest income. CFC accrued a total of \$19 million of interest income on restructured loans during the first two quarters of fiscal year 2002. CFC classified \$1,529 million of the amount described as impaired pursuant to the provisions of SFAS 114, Accounting by Creditors for Impairment of a Loan and SFAS 118, Accounting by Creditors for Impairment of a Loan – Income Recognition and Disclosures. CFC reserved \$148 million of the loan loss allowance for such impaired loans based on a comparison of the present value of the expected future cash flows associated with the loan and/or the estimated fair value of the collateral securing the loan to the recorded investment in the loan.

## Capital

CFC was active in the capital markets during the first six months of fiscal year 2002. During the first six months of fiscal year 2002, CFC issued more than \$2.7 billion in floating rate debt in order to replace maturing floating rate Dealer Medium Term Notes and some Dealer Commercial Paper. By issuing longer dated debt, CFC was able to effectively term-out some of its variable rate funding. Also as a result of these new issues, Dealer Commercial Paper decreased to less than 22% of total debt outstanding as of November 30, 2001. In October, CFC issued \$175 million in 49-year fixed rate Quarterly Income Capital Securities (QUICS) traded under the symbol NRS at a coupon rate of 7.4%. The issue is callable at par after five years. On December 31, 2001, CFC redeemed \$125 million in QUICs with a coupon of 8.00% traded under the symbol NRU. Prefunding the early redemption of series NRU with the lower cost NRS is one way CFC is taking advantage of the lower interest rate environment to lock in lower cost funding.

The following Table presents CFC's credit ratings at January 9, 2002.

	<u>Moody's Investors Service</u>	<u>Standard &amp; Poor's Corporation</u>	<u>Fitch Investors Service</u>
<b>Direct:</b>			
Collateral trust bonds	Aa3	A+	AA
Domestic and European medium-notes	A1	A	AA-
Quarterly income capital securities	A2	BBB+	A+
Domestic and European commercial paper	P-1	A-1	F-1+
<b>Guarantees:</b>			
Leveraged lease debt	A1	A	AA-
Pooled bonds	Aa3	A	AA-

Other bonds	A1	A	AA-
Short-term	P-1	A-1	F-1+

The ratings listed above have the meaning as defined by each of the respective rating agencies, and they are not recommendations to buy, sell or hold securities and are subject to revision or withdrawal at any time by the rating organizations.

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