Meeting between Federal Reserve Board staff and National Rural Utilities Cooperative Finance Corporation representatives Margin and Capital Requirements for Covered Swap Entities [R-1415] November 30, 2012

Participants: Sean Campbell; Mona Elliot; Anna Harrington; Stephanie Martin; and Chris Paridon (Federal Reserve Board)

Brad Captain, Thomas Kandel, Richard Larochelle, and John Suter (National Rural Utilities Cooperative Finance Corporation); Edward Barron (Greenberg Taurig); and Daniel Meade (Hogan Lovells)

Summary: National Rural Utilities Cooperative Finance Corporation ("CFC") representatives met with Board staff to discuss issues related to the proposed rule of the Board and other prudential regulators on margin and capital requirements for covered swap entities under Title VII of the Dodd-Frank Act.

CFC representatives discussed the possibility of an exemption from the margin requirements for CFC and requested an approach similar to the one contained in the CFTC's clearing exemption proposal. CFC argued for an exemption based on the fact that it acts as an extension of its non-profit member owners which would qualify as commercial end users. Further background information and arguments made by CFC in support of its position are described in the attached presentation.

Attachment

National Rural Utilities Cooperative Finance Corporation

National Rural Utilities Cooperative Finance Corporation (CFC)

Implementation of
Dodd-Frank Act
October 2012

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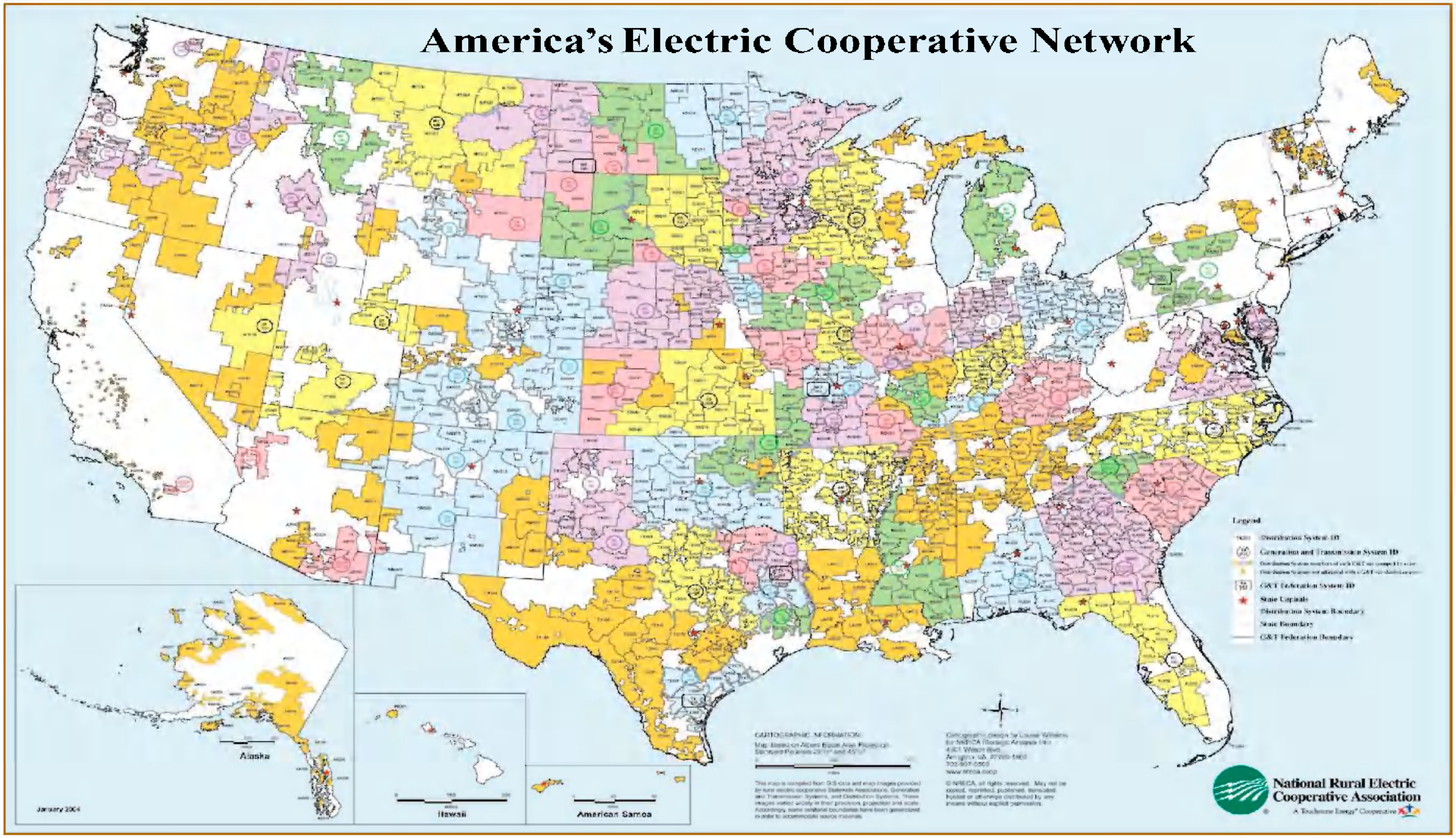
A. Introduction to CFC

CFC is an Important Source of Capital to Utilities in Rural America

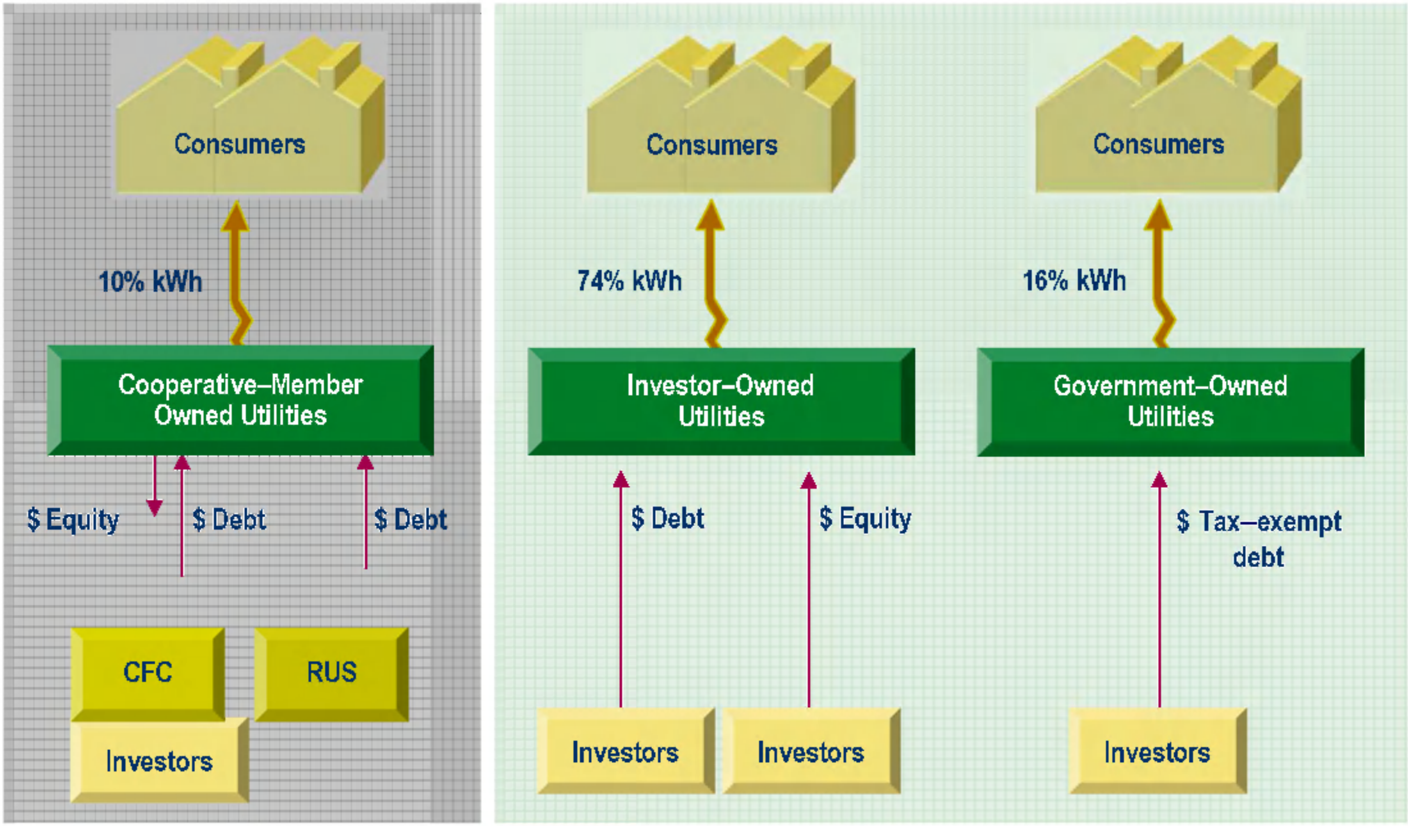
- **Member-owned cooperative association**
  – Established in 1969; owned by America's electric cooperatives
  – Private financing arm of America's rural utility systems
- **CFC's owners can qualify as commercial end users under DFA.**
- **CFC would qualify for an exemption from clearing under the CFTC's July 2012 proposed rule on "Clearing Exemption for Certain Swaps Entered Into by Cooperatives."**

CFC's Purpose is to Provide Financing so that Electric Cooperatives can Provide Electric Power to Rural America.



Electric Cooperatives: A Small But Important Segment of the Industry

- Generation primarily built to meet native load requirements of member distribution systems only — no merchant or independent power producer risk; limited nuclear plant investment.
- Access to federal power on a preferential basis.
- Distribution companies have defined service territories — largely residential and small commercial customers.
- Generally, co-ops are able to opt out of deregulation in applicable states.
- Low cost (T+12 bps) long-term funding from USDA/ RUS, treasury rate funding.
- Stable operations and industry outlook.



Data Source: NRECA, Strategic Analysis

CFC's Public Purpose

- **CFC is different from traditional financial service organizations.**
- **CFC focuses exclusively on providing capital to the rural utility industry.**
  - Management incentives are designed to reinforce its long-term mission and credit ratings
  - Cooperative structure and nonprofit tax-exempt status influences capital structure
  - High asset portfolio quality with low delinquency rate and high recovery rate
- **Electric cooperatives provide affordable and reliable electric power in the most rural areas of the USA.**
  - Provide essential service
  - Are managed in a conservative manner
  - For the most part, are not rate regulated
  - Consistently report strong metrics
  - Do not have motivation for speculative investments

CFC's Objective is to offer Cost-Based Financial Products, not to Maximize its Net Income.

Loan Options	
Lines of Credit	unsecured credit loans for short–term working capital needs.
Long–term Concurrent Financing	long–term financing of up to 35 years to supplement Rural Utilities Service (RUS) loans.
100% Long–term Financing	lending to independent borrowers (members that have chosen to leave the RUS program).
Letters of Credit	short–term lending that enhance the credit to trading partners and other suppliers.
PowerVision™	financing with a draw period of five years for electric plant or other approved purposes.
Associate Member Financing	lending to not–for–profit cooperative organizations that are owned, operated, or controlled by a National Rural distribution, G&T, statewide, or regional owner and that are providing non–electric services for the benefit of their consumers.
RUS Guaranteed Loans	available funding for electric facilities, with the RUS repayment guarantee helping to keep interest rates down.
Joint CFC–RUS Combustion Turbine Financing	provide funds to meet cash requirements prior to permanent financing from RUS.
Clean Renewable Energy Bonds (CREBs)	provides electric cooperatives and other not–for–profit utilities incentives to invest in renewable generation resources.

CFC Is Committed to Strong Corporate Governance

- Board of Directors consists of twenty–three persons elected from general membership:
  - Twenty general managers or directors from member systems.
  - Two from the industry's trade association, National Rural Electric Cooperative Association (NRECA).
  - One at–large position that meets the requirements of the audit committee financial expert (as defined by Section 407 of the Sarbanes–Oxley Act of 2002).
- No members of CFC management hold board seats.
- Elected member serves a 3–year term; limited to a maximum of 2 consecutive terms.
- Regularly meets in executive sessions; management may not attend.
- Maintains audit, finance advisory, executive, loan, and corporate relations committees.
- Audit committee consists of no less than seven board members. Meetings held up to 5 times a year with external and internal auditors in executive session without CFC management present.
- Board members affiliated with a cooperative requesting a loan or guarantee are not allowed to attend or participate in the decision–making process.

Background of NRUCFC

- National Rural Utilities Cooperative Finance Corporation is a member–owned, non–governmental organization that provides financial products to member systems.
  - The Company offers full–service financing, investment, and related services to its members, and offers a wide range of flexible, low–cost financing programs and interest rate options.
  - Headquartered in Dulles, Virginia, outside of Washington, D.C., the Company raises funds for loan programs with support of its owners' equity and investments through the sale of multiple financing vehicles in the private and public financial markets.
  - The Company is governed by a 23–member board made up of cooperative utility directors and managers. It has approximately 230 employees, including well seasoned regional credit portfolio managers.
- Points to Remember:
  - Primary objective is to provide its utility members/owners with an assured source of capital at the lowest reasonable loan and guarantee rates consistent with sound financial performance.
  - Has no exposure to residential mortgages, mortgage–backed securities, collateralized loan or debt obligations, or structured investment vehicles. Financial derivatives only utilized for interest rate and currency hedging.
  - NRUCFC is a member–owned finance company. CFC is not a bond insurance company.
  - Largest non–governmental lender to rural utility industry in the U.S.A with over $19 billion of gross loans outstanding, and its owners have invested over $4.5 billion in a wide array of securities at May 31, 2012.
  - NRUCFC has securities listed on NYSE and is a "Well-Known and Seasoned Issuer" in the public markets. The company is subject to the Sarbanes-Oxley law and is in compliance with all applicable requirements.

B. How and Why CFC Uses Derivatives

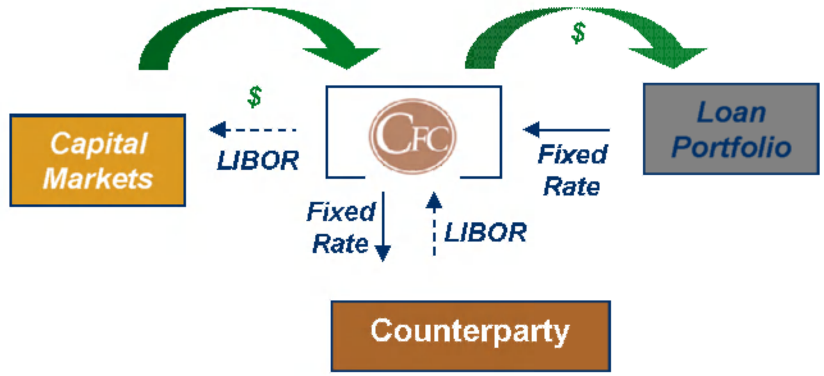
How & Why CFC Uses Derivatives

- **Derivative use is limited to plain vanilla interest rate exchange agreements. Since 1983, CFC has executed derivatives for the following reasons:**
  - To practice good risk management
  - To match-fund its fixed and variable loan pools and manage the size of its warehouse/prefund position
  - To provide flexibility in loan structuring and match cash-flows that may have deferral periods, accretions and other types of amortizations
  - To mitigate interest rate risk on forward starting loans
  - To create lower cost synthetic fixed/floating liabilities vs. issuance in the cash market
  - To limit exposure to exchange rate fluctuations when foreign currency denominated debt is issued. (None currently outstanding.)

CFC uses Derivatives to Hedge Market Interest Rate Risk

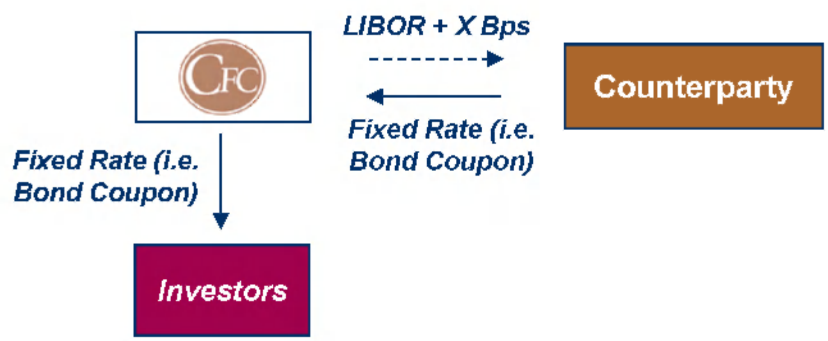
- In this example, CFC receives fixed interest from an aggregate loan portfolio but pays floating LIBOR to capital market investors. This mismatch in interest rate creates exposure, prompting CFC to swap the fixed rate from its loan portfolio to floating.

Pay-Fixed Swap



- In this example, CFC issues fixed rate notes and uses the proceeds to pay down Commercial Paper. CFC then swaps the fixed notes to floating so as to maintain its floating exposure and achieve a lower cost of funds.

Pay-Floating Swap



CFC Swap Portfolio at May 31, 2012

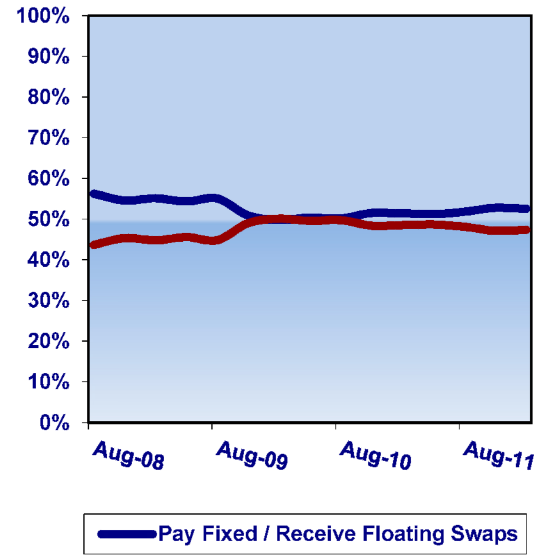
Swap Type	Notional	Trade Count	Remaining Weighted Life (Yrs)	Mark-to-Market
Pay 1ML/Receive Fixed	200,000,000	2	4.6	41,123,835
Pay 3ML/Receive Fixed	3,520,440,025	33	4.8	294,461,143
CFC Pay Floating Total	3,720,440,025	35	4.8	335,584,978
Pay Fixed/Receive 3M Libor	5,371,366,344	81	9.2	(595,907,272)
Pay Fixed/Receive CP	184,735,000	5	15.9	(68,415,902)
CFC Pay Fixed Total	5,556,101,344	86	9.4	(664,323,174)
CFC Swap Portfolio Total	9,276,541,369	121	7.6	(328,738,196)

Interest Rate Management

- **Credit and market risk associated with the derivatives portfolios is offset and managed through the following:**
  - Highly rated, diverse counterparties consisting of participants in CFC's revolving credit facilities
  - Transactions are awarded on multi–tranche basis to ensure competitive pricing and to allow benchmark comparison when calculating fair values
  - Notional limits per counterparty
  - Offsetting trades executed with individual counterparties to reduce overall net credit exposure
  - Counterparty rating triggers embedded for long-dated swap tenors
  - Netting/resetting provisions
  - CFC has fully executed ISDAs with every swap counterparty
  - Complete legal review of all swap confirms on executed trades
  - Thorough external and internal audit review of overall swap portfolio management and supporting documentation

Portfolio Mix – Risk Mitigating Execution

- **Quarterly mark-to-market (MTM) change is range bound due to offsetting trades executed (Pay Fixed vs. Pay Floating) at roughly 50/50 mix over time**
- **Other key interest rate risk mitigating features:**
  - Notionals managed to 15% threshold
  - Offsetting swap trades in aggregate and by Counterparty
  - 56% of portfolio amortizing
  - Short weighted average life of 7.55 yrs – 46% of outstanding trades are through half their lives (e.g. smaller MTM movements due to limited time frame for interest rate movement and number of remaining cash-flows are less.)



Year	Number of Trades	Winning Counterparties	Swap Type	Notional Amount (Mil)	WAL (yrs)
FY2008	5	6	Pay Fixed	354	12.8
FY2008	2	5	Pay Floating	575	8.6
FY2009	4	8	Pay Fixed	220	18.8
FY2009	2	9	Pay Floating	1,400	4.3
FY2010	3	6	Pay Fixed	505	7.5
FY2010	8	18	Pay Floating	1,576	6.9
FY2011	5	9	Pay Fixed	600	10.2
FY2011	0	0	Pay Floating	-	-
FY2012	4	6	Pay Fixed	498	12.2
FY2012	2	2	Pay Floating	269	13.2
FY2013	5	5	Pay Fixed	455	28.7
FY2013	2	3	Pay Floating	230	11.1

CFC Enters into Swaps with Highly Rated Counterparties

SWAP PORTFOLIO BY RATING 5.31.2012

S&P RATINGS				MOODY'S RATINGS			
Range	Number of Banks	Notional	% of Portfolio	Range	Number of Banks	Notional	% of Portfolio
AAA to AA-	5	3,375,658,804	35.9%	Aaa to Aa3	8	4,185,745,389	44.5%
A+ to A-	11	4,792,550,840	50.9%	A1 to A3	8	4,074,731,111	43.3%
BBB+ to BBB	2	1,242,202,692	13.2%	Baa1 to Baa2	3	1,150,675,836	12.2%
NR	1	740,000	.01%				
	19	**9,411,152,336**	**100%**		**19**	**9,411,152,336**	**100%**

CFC Enters into a Limited Number of Swaps Each Year

Deal Count	Year	Notional
42	1998	1,334,710,896
11	1999	974,350,000
32	2000	3,998,853,500
40	2001	7,617,378,573
21	2002	6,514,500,000
45	2003	4,433,402,643
14	2004	1,058,531,800
35	2005	3,247,134,500
20	2006	1,451,878,525
31	2007	2,945,218,401
25	2008	2,203,708,000
17	2009	1,558,201,100
14	2010	1,091,684,925
6	2011	450,000,000
14	2012	1,364,577,016

C. CFC Should be Exempt from DFA's Margining & Clearing Requirements

CFC Should be Exempt from the Margining and Clearing Requirements of DFA.

- **CFC is owned by and functions as a private financing arm for entities that are commercial end users eligible for exemption.**
- **Transferring Risk to a Clearing Organization is not needed**
  - CFC effectively manages its derivatives portfolio
  - CFC has the financial strength to meet obligations associated with non-cleared Swaps:
    - CFC is rated at A+ level for senior secured debt
    - CFC has never missed any payment on an obligation
    - CFC has substantial liquidity
    - CFC's portfolio strength is due to the nature of its membership

CFC's Credit Rating History

Senior Secured Debt		
Year	Moody's Investors Service	Standard & Poor's Corporation
1972-1973	A	A
1974	A	A+
1975-1978	A	AA
1979-1984	Aa	AA
1985-1989	Aa2	AA
1990	Aa3	A+
1991-1993	Aa3	A+
1994-2000	Aa3	AA
2001	Aa3	AA-
2002-2012	A1	A+

Liquidity Management

- **At May 31, 2012, CFC had the following projected liquidity sources available:**

Liquidity Source ($ in millions)	5/31/2012
Cash and Cash Equivalents	$191
Excess Commercial Paper Capacity [1]	$371
Guaranteed Underwriter Program	$580
Farmer Mac Revolving Funding Availability [2]	$2,735
Total Funding Sources	$3,877
Scheduled Loan Amortization & Other Repayments [3]	$1,725
Total Liquidity	$5,602
Scheduled L-T Debt Maturities [3]	($1,247)
Excess Liquidity	$4,355

[1] CFC uses its bank lines as backup liquidity for its commercial paper issuance

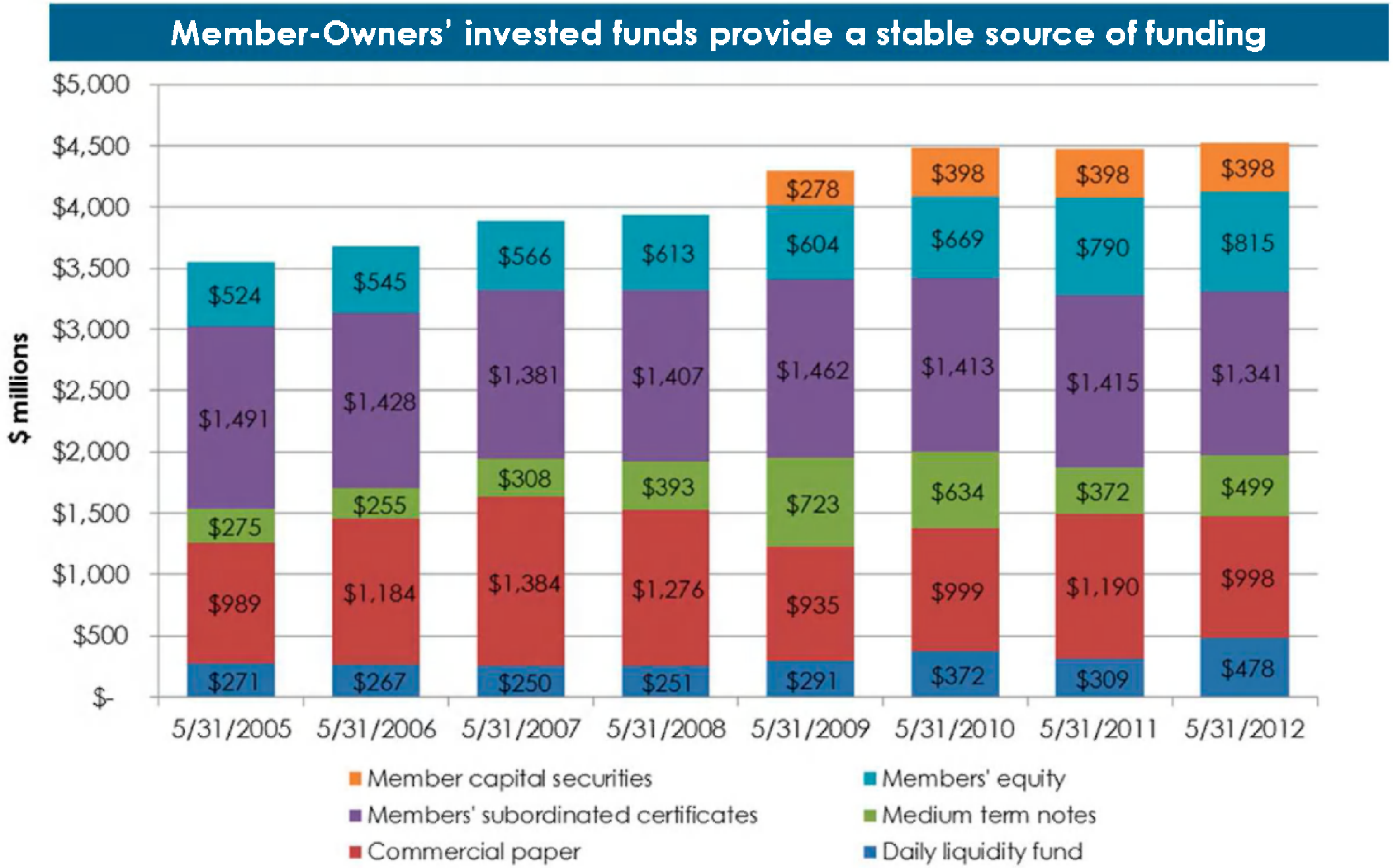
[2] Subject to market conditions for debt issued by Farmer Mac

[3] Scheduled loan amortization and other repayments and L-T debt maturities over the next 12 months

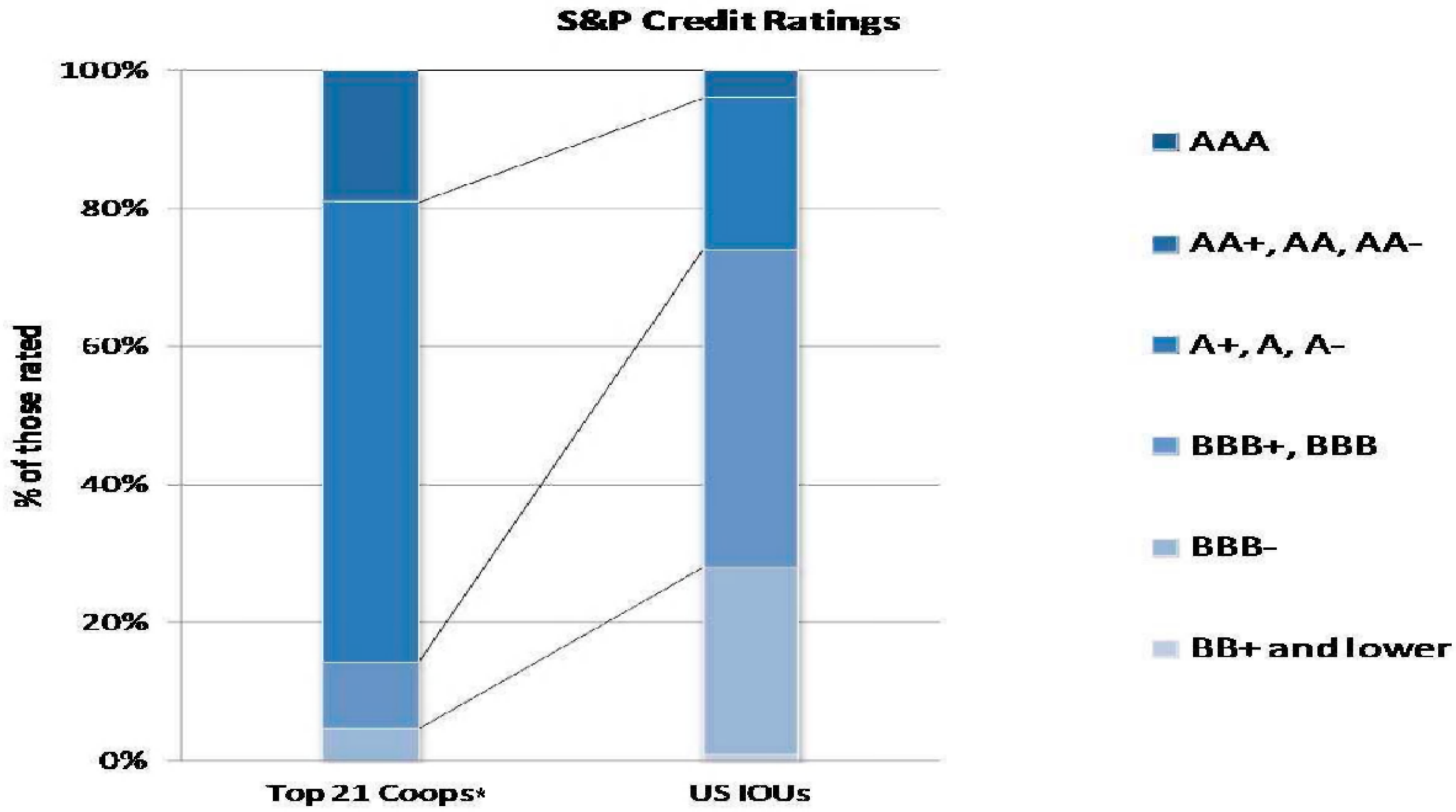
- **CFC is a well-known seasoned issuer and believes it has adequate access to both long-term and short-term global funding options.**

Strong Member Support

- **At May 31, 2012, CFC's members provided more than $4.5 billion in capital to CFC.**



Rating Comparison – Co-ops vs. IOU's

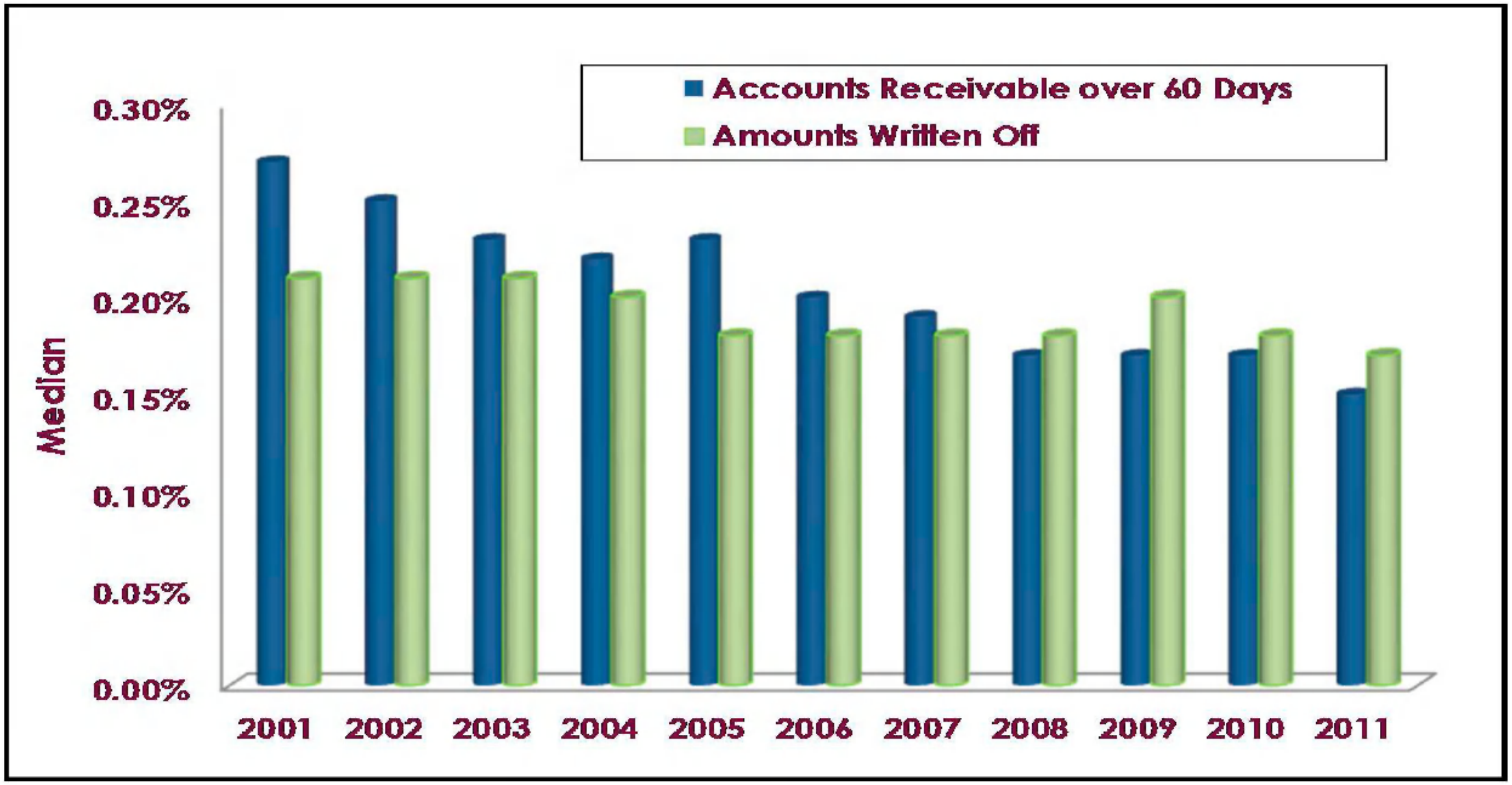


Source: Scott Madden Management Consultants (June 2012)

Defined here as those with assets over $1 billion or annual revenue over $500 million.

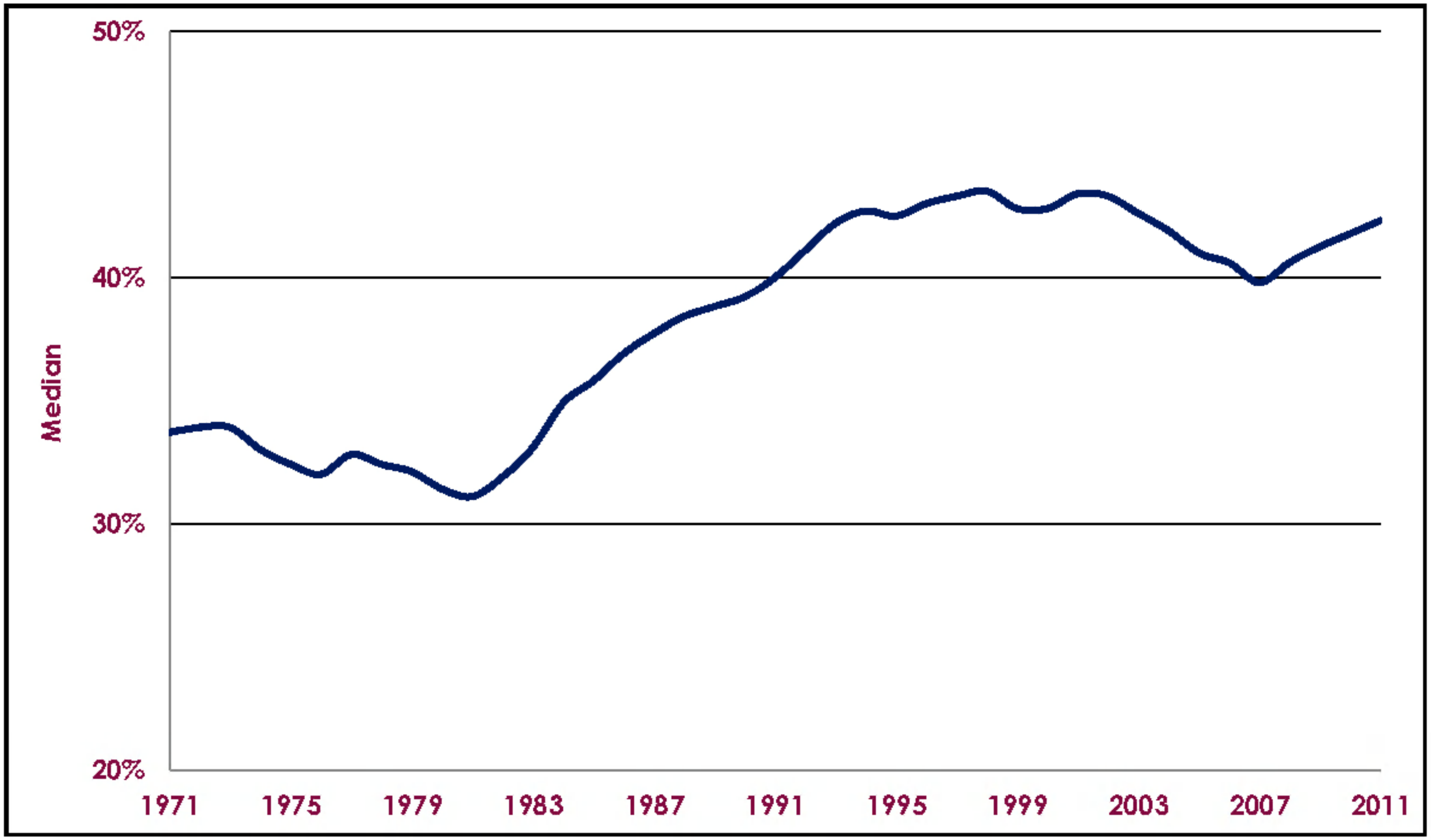
Co-op Ratepayers Have a Strong History of Reliable and Timely Payments of Electric Bills

Percentage of Total Operating Revenue

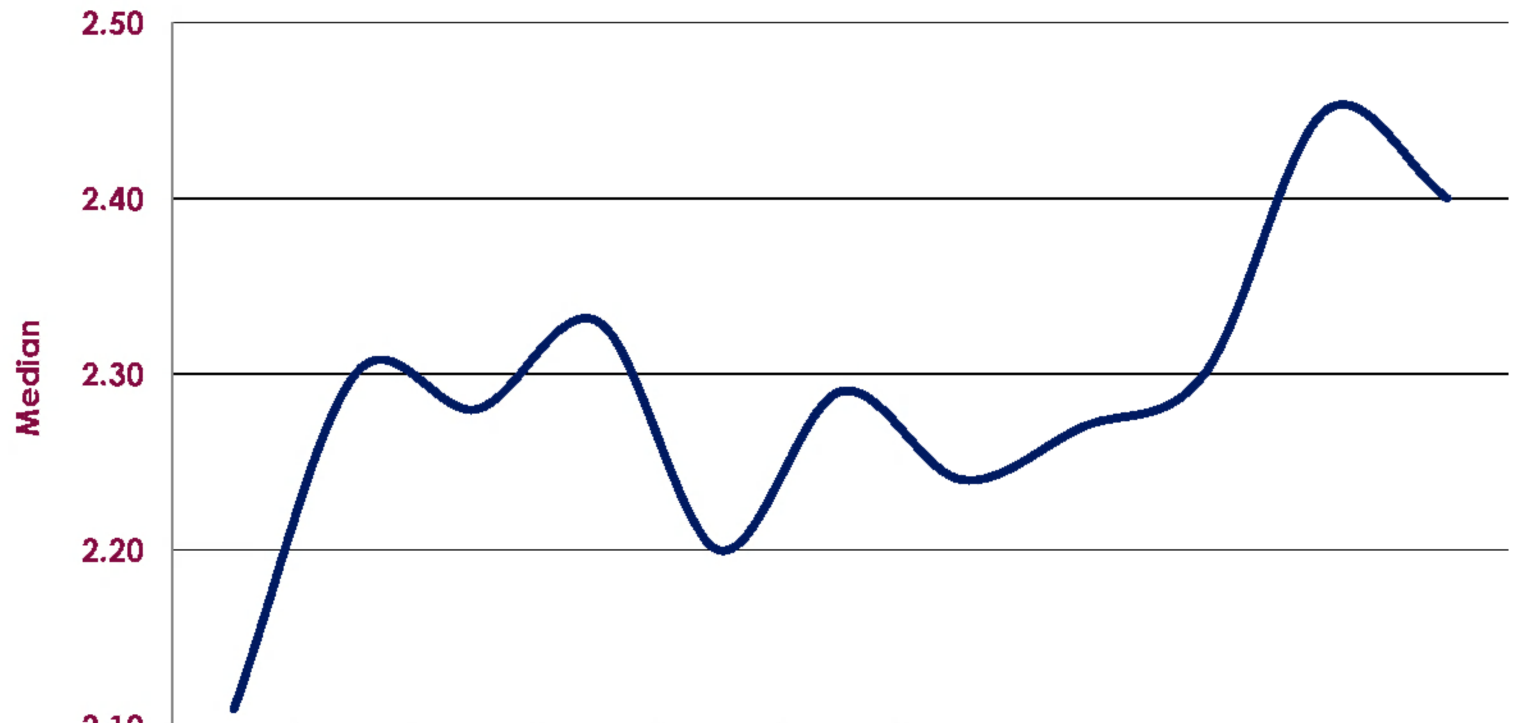


Equity of Rural Electric Distribution Systems

Equity % of Assets



Times Interest Earned Ratio (TIER) for Electric Distribution Co-ops



	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
TIER	2.11	2.30	2.28	2.33	2.20	2.29	2.24	2.27	2.30	2.45	2.40

RUS requires a 1.25 TIER, high 2 of most recent 3 years. CFC requires a 1.35 MDSC, high 2 of most recent 3 years.

D. Key Points

Key Points on CFC's Use of Derivatives

- CFC never uses derivatives to speculate
- Strong portfolio of low risk loans to rural electric utility cooperatives that provide an essential service
- Strong liquidity
- History of effectively managing derivatives portfolio
- Limited number of derivative transactions each year

Key Points (Continued)

- CFC lends only to its members, not to the general public and is not engaged in the business of banking in a manner akin to depository institutions or other for profit financial entities.
- CFC was created and is owned by nonprofit entities for which it serves as a non-governmental financing arm–-essentially an extension of its nonprofit member-owners.
- The Rural Electric Cooperatives that own CFC qualify for the commercial end user exemption.

CFC Requests that Bank Regulators Consider CFTC's Proposed "Cooperative Exemption" and Exempt Eligible Cooperatives from Collateral Requirements

- **CFTC's proposed Cooperative Exemption is:**
  - Narrowly defined, applicable to about 10 entities
  - Based on pass-through of exemption available to CFC members that are commercial end users
  - Exempt cooperatives are not required to post collateral for uncleared swaps