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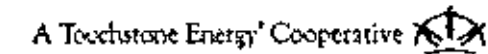

Comment Letter on
End-User Exception to Mandatory Clearing of Swaps

RIN 3038-AD10
Due February 22, 2011

The National Rural Utilities Cooperative Finance Corporation ("CFC") appreciates the opportunity to submit its views in connection with the CFTC's implementation of the end-user clearing exception provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("DFA") (the "End-User" rulemaking). We are also submitting comments in connection with the CFTC and SEC's "Definitions" rulemaking (RIN 3038-AD06 and 3235-AK65), some of which overlap with the comments we are providing in this letter.

CFC is a nonprofit cooperative entity owned by America's consumer-owned rural electric cooperatives (RECs). It was created by those RECs in 1969 to provide them with access to non-governmental market capital. We are end users of derivatives – chiefly over-the-counter interest rate swaps – which we use to hedge risks relating to the loans we make to our members.

While our member-owners are entities that would clearly qualify for the end-user exception to clearing under the DFA statutory language, the statute is less clear regarding the ability of an entity such as CFC to qualify for the exception. Therefore, we urge the CFTC to make clear through rulemaking that entities like CFC were not meant to be subjected to mandatory clearing.

As we explain further in this letter, CFC's use of derivatives is in alignment with the motivations underlying the end-user exemption from mandatory clearing. We do not use derivatives for speculative purposes, and we prudently manage the risks associated with our derivatives activities. Imposing clearing requirements on CFC's swaps would serve to raise costs to our members and, ultimately, to consumers, without sufficiently offsetting risk mitigation benefits. In addition, we note that imposing margin requirements on CFC would similarly increase costs when such requirements are not needed for the management of risk.

Background on CFC

CFC is a nonprofit cooperative entity owned by America's consumer-owned RECs. CFC was created by RECs through the National Rural Electric Cooperative Association (NRECA) in 1969 to provide financing to supplement the loan programs of the U.S. Department of Agriculture's Rural Utilities Service (RUS). Today, we continue the mission of providing our member electric cooperatives with a variety of loan programs. Our nearly 1,000 members serve 42 million rural consumers living in 47 states. Our funding programs help enable our members to provide electric power services to residents of rural America. At May 31, 2010, CFC had loans and guarantees outstanding of $18.4 billion to its rural electric members.

While CFC is the largest non-governmental lender to rural electric systems, CFC is not a depository institution – it is not, for instance, a bank, credit union, or industrial loan company.

The nature of our structure also means that we cannot issue traditional equity securities. Instead, CFC has retained earnings and certain long-term subordinated debt securities that our creditors and rating agencies have treated as the functional equivalent of core capital.

CFC uses over-the-counter swap contracts in the context of providing credit to our members, to allow us to tailor loans to our members' needs while mitigating the impact of changing interest rates. It is important to note that CFC does not enter into derivative transactions for speculative purposes. We are primarily a hold-to-maturity issuer of derivatives. We do not make a market in swaps. We do not enter into swaps that are not directly related to our own business, and do not trade in swaps for the purpose of profit-making. We enter into only the minimum number of derivatives necessary to hedge the risks associated with lending to our members.

We – and our members – depend on the flexibility and cost-effectiveness of the over-the-counter swaps environment. Because our swaps are not subject to clearing or margin requirements, we have the flexibility to tailor each contract to meet our particular needs and are able to keep costs low, rather than having to choose from a limited universe of standard contracts or take on the expense of posting collateral. As a result, our members benefit from having a variety of credit products and terms to choose from, and also pay lower rates and fees on their loans as a result. Those benefits can ultimately be passed on to the consumers our members serve.

- We have also attached as Attachment A a document we previously submitted in connection with our January 13, 2011 meeting with CFTC staff, "Views on Implementation of the Dodd-Frank Act," which includes a detailed description of CFC and its use of derivatives. We have also attached as Attachment B an excerpt also previously provided to you from CFC's most recent Annual Report on Form 10-K. These documents provide further background to the issues discussed in this comment letter.

<u>The DFA End-User Clearing Exception</u>

Section 2(h)(7) of the Commodity Exchange Act (CEA), as amended by DFA, provides that a swap otherwise subject to mandatory clearing is subject to an elective exception from clearing if one party to the swap is not a financial entity, is using swaps to hedge or mitigate commercial risk, and notifies the CFTC, in a manner set forth by the CFTC, how it generally meets its financial obligations associated with entering into noncleared swaps.

The DFA gives the CFTC authority to adopt rules governing the end-user clearing exception and to prescribe rules, issue interpretations, or request information from persons claiming the end-user clearing exception necessary to prevent abuse of the exception. The CFTC is also required to consider whether to exempt small banks, savings associations, farm credit system institutions, and credit unions from the definition of "financial entity."

Since the DFA statute does not allow a "financial entity" to claim the end-user exemption, we first focus our comments on the definition of "financial entity" and the reasons why CFC should not be considered to be such an entity.

"Financial Entity"

As we also discuss in our comment letter submitted in connection with the CFTC-SEC "Definitions" rulemaking, there are strong arguments that CFC should be excluded from the definition of "financial entity." The statute defines "financial entity" to include any entity that is "predominantly engaged in activities that are in the business of banking or financial in nature, as defined in section 4(k) of the Bank Holding Company Act." Such activities include lending. However, CFC should be excluded from the definition for the following reasons:

- **CFC is not the type of "financial entity" that Congress meant to be captured by the statutory definition.** CFC is not a bank, credit union, or savings and loan institution. Therefore, many of CFC's metrics and motivations do not conform to those of these more commonly known financial entities. CFC's activities can be distinguished from those of such institutions, which are engaged in the business of banking and/or other financial activities. By contrast, CFC's business is not focused on making profits or lending to the public. Rather, it is a nonprofit entity created for a public purpose, acting as the financing arm of its member RECs. The overarching purposes of the DFA is set forth at the outset of the legislation:

  > An act to promote the financial stability of the United States by improving accountability and transparency in the financial system, to end ``too big to fail", to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices . . .

  The extent of financial problems faced by the nation as the Congress crafted the DFA are described in its legislative history, hundreds of press reports, books, and articles, and in the Financial Crisis Inquiry Report (including the dissenting views). [1] The focus during the financial crisis was certainly never on nonprofits such as CFC, which is owned by, and created to serve, nonprofit rural electric cooperatives and their "public interest" goals as that phrase is used in the DFA.[2] The Financial Crisis Inquiry Report, including the dissenting views, did not raise any issues about, or even mention, those nonprofit "public power" systems which help deliver an essential product – electricity – to rural America.

  In fact, the preamble to the "Definitions" proposed rule notes that "some electricity services are provided as a public good rather than for profit" and invited comments on "whether there are special considerations, including without limitation special

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[1] The legislative history includes, *inter alia,* HOUSE REPORTS: No. 111-517 (Comm. of Conference); SENATE REPORTS: No. 111-176 (Comm. on Banking, Housing, and Urban Affairs) accompanying S. 3217; CONGRESSIONAL RECORD: Vol. 155 (2009): Dec. 9-11, considered and passed House. Vol. 156 (2010): May 20, considered and passed Senate, amended, in lieu of S. 3217. June 30, House agreed to conference report. July 13, 15, Senate considered and agreed to conference report. DAILY COMPILATION OF PRESIDENTIAL DOCUMENTS (2010): July 21, Presidential remarks; and "The Financial Crisis Inquiry Report," issued by Financial Crisis Inquiry Commission, Jan. 2011.

[2] See the "Public Interest Waiver" in section 722(f) of the Wall Street Transparency and Accountability Act of 2010, and section 201(f) of the Federal Power Act (16 USC 824(f)).

considerations arising from section 291(f) of the Federal Power Act, related to non-profit, public power systems such as rural electric cooperatives . . . ."[3]

CFC was created to provide an assured source of financing to its owners and creators, the RECs. During the financial crisis in 2008, CFC continued to lend at favorable rates to the RECs. As we noted in our earlier information submitted to the CFTC, neither CFC nor its REC owners engage in any speculative trading. The electric power cooperatives reported strong financial results during the economic crisis, in part, because their major product is electricity – the demand for which is extremely inelastic.[4]

- **CFC does not resemble other "financial entities" clearly meant to be covered by the statutory definition.** CFC's activities can be distinguished from those of such institutions, which are engaged in the business of banking and/or other financial activities. CFC's business, by contrast, is not focused on making profits or lending to the public. Rather, it is a nonprofit entity created for a public purpose, acting as the financing arm of its member RECs.

- **We suggest language such as the following to clarify the definition of "financial entity":**
  - "'Financial entity' does not include: a nonprofit tax-exempt cooperative that is not a depository institution and a majority of whose members are nonprofit tax-exempt cooperatives that are not financial entities."
  - "Each entity that believes it falls into this category shall describe in writing to the CFTC and the SEC the nature of its nonprofit, tax-exempt cooperative structure, and its associated public purpose."

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[3] 75 FR 80184 (Dec. 21, 2012).

[4] The full text of a July 2009 CFC report is attached as Attachment C. It discusses the strong year the electric cooperatives had in 2008. For example, that report notes that: " Median growth—in terms of both consumers and kwh sales—remained positive in 2008, and consumers were paying their bills on time. The consumer growth rate—the number of new consumers—was nearly 1 percent for distribution cooperatives. As a result, the consumer growth rate for distribution cooperatives remained nearly double that of municipal and investor-owned utilities, according to information from the U.S. Energy Information Administration. While electricity demand fluctuates in the short term in response to business cycles, weather events and prices, the median growth rate for kwh sales also remained positive in 2008 at 1.22 percent.

"Although the [nation] was in recession in 2008, distribution cooperative consumers continued to pay their bills. According to data from the [annual Key Ratio Trend Analysis] KRTA information, the number of accounts receivable written off as a percentage of operating revenue was only 0.18 percent—unchanged from the previous year. Moreover, the number of accounts receivable past due more than 60 days as percentage of operating revenue actually declined slightly from the prior year to 0.17 percent.

"Other key findings in the 2008 financial highlights of electric distribution cooperatives include the following KRTA *composite* numbers: The aggregate total megawatt hour (mwh) sales of all 819 rural electric distribution systems grew 1.91 percent in 2008 to reach 396,832,711 mwh. . . . Distribution cooperatives added a total of 267,042 new residential households in 2008."

- **CFC should qualify for the end-user clearing exception as an affiliate of end users.** DFA provides an affiliate exception to the "financial entity" definition that could apply to CFC. Under the affiliate exception, "An affiliate of a person that qualifies for [the end-user exception] may qualify for the exception only if the affiliate, acting on behalf of the person and as an agent, uses the swap to hedge or mitigate the commercial risk of the person or other affiliate of the person that is not a financial entity."

  As noted in the proposed rule, the CFTC has leeway in how it chooses to define "affiliate." We encourage the CFTC to choose to define this term, and to write the regulation implementing this provision of DFA, in a manner so as to allow activities such as CFC's to come under the affiliate exception. CFC enters into swaps *for the benefit of its members*, which we believe fits in well with the motivation behind the affiliate exception.

- CFC uses swaps to hedge risk that arises from lending to its members, which own CFC and control CFC on a "one member, one vote" basis, and thus could be characterized as affiliates of CFC.
- CFC's use of derivatives is done on behalf of its members because (1) those members own CFC and CFC exists only to serve its members; and (2) CFC's goal in using derivatives is to manage risks for all CFC members while allowing each individual member to obtain financing on terms it prefers.
- CFC's members also qualify for the end-user exception.
- Since our members are in the business of producing and distributing electricity, and not managing a derivative portfolio, CFC enters into derivatives contracts itself, since it has the professional expertise, credit rating, accounting functions, and banking relationships necessary to do so.
- The majority of CFC members will not be able to execute standalone derivatives themselves, because their banking relationships are with smaller regional banks that do not offer this service. Furthermore, a member would have to have either a short-term/long-term credit rating or an established banking relationship with a large money center bank in order to execute derivatives itself. Only the larger, more sophisticated CFC member cooperatives have the latter, and thus the majority of the cooperatives are at a disadvantage. CFC fills the void for smaller cooperatives looking for the same pricing flexibility and cost advantage that larger cooperative systems enjoy.

➢ **We suggest language such as the following to clarify the application of the affiliate exception:**
  - "For purposes of this section, an 'affiliate' of a person includes a nonprofit, tax-exempt cooperative (i) of which the person is a member, and (ii) which is not a depository institution."
  - "Each entity that believes it falls into this category shall describe in writing to the CFTC and the SEC the nature of its nonprofit, tax-exempt cooperative structure, and its associated public purpose."

- "For purposes of this section, 'acting on behalf of the person and as an agent' includes: (a) hedging or mitigating a risk that arises from financing provided to the person by an affiliate of that person; or (b) acting for the benefit of that person."

- **The exception for financing of a parent company's products should also apply to CFC's activities.** This exception excludes from the definition of "financial entity" entities whose primary business is providing financing, and who are using derivatives to hedge underlying commercial risks related to interest rate and foreign currency exposures, if 90% or more of those risks arise from the finance or lease of products, and if 90% or more of those products are manufactured by the parent company or another subsidiary of the parent.

- More than 90% of CFC's business consists of providing financing to its rural electric system member-owners and their related organizations.
- CFC uses derivatives to hedge interest rate risk related to its financing business.
- Collectively, CFC's member-owners are analogous to the "parent company" of CFC. While CFC is not a subsidiary of any other entity, it is a cooperative formed and sustained by the collective effort of its members to serve those members by providing them with financing.
- CFC's member-owners are in the business of generating and/or distributing electricity.
- Thus, CFC uses derivatives to hedge interest rate risks which arise from the financing of a product – electricity – which is manufactured and/or distributed by its nonprofit rural electric cooperative member-owners.

➢ **We suggest language such as the following:**
  - "For purposes of this section, 'Financing that facilitates the purchase or lease of products' shall include financing that facilitates the provision of electric service."
  - "For purposes of this section, 'manufacturing' includes the generation, transmission, and/or distribution of energy, such as electricity."
  - "For purposes of this section, 'parent company' shall include the members of a nonprofit tax-exempt cooperative that is not a depository institution."
  - "Each entity that believes it falls into this category shall describe in writing to the CFTC and the SEC the nature of its nonprofit, tax-exempt cooperative structure, and its associated public purpose."

<u>CFC's Derivatives Activities Do Not Raise the Concerns Underlying the Need for Clearing</u>

It is important to keep in mind that CFC's use of derivatives is similar to that of entities that do qualify for an exemption from clearing under DFA – in fact, we are owned solely by such entities. CFC uses derivatives to hedge or mitigate only our own commercial risk, in contrast to speculative users of derivatives, who make "bets" based on occurrences of events having no relation to the user's own business. CFC was created by rural electric cooperatives in 1969 for the purpose of providing financing to those cooperatives and, as a nonprofit, tax-exempt

cooperative, is limited in its ability to operate for any other purpose. We are owned by those electric cooperative entities that also use derivatives to hedge or mitigate their own commercial risk, and do qualify for DFA's end-user clearing exemption. We believe not extending such an exemption to nonprofit entities such as CFC would be an illogical result, because we exist solely to provide financing to those end users and we do not take speculative or investment positions.

Imposing clearing on CFC's swaps activities is not needed for the management of risk. As we discuss below, CFC actively and prudently manages the risk in its swaps activities without clearing. Moreover, imposing clearing on our swaps would impose costs that would be borne by our members and, ultimately, consumers, without generating sufficiently offsetting risk mitigation benefits. The agencies' proposal requested input regarding whether "special considerations are warranted with respect to the use of non-cleared swaps by . . . non-profit . . . entities engaged in electric power or energy activities." Congress itself has singled out our owner-members, the RECs, for special treatment as set forth in the "Public Interest Waiver" section on transactions between such entities in section 722(f) of DFA.

- **CFC does not enter into derivative transactions for speculative purposes.** We do not make a market in swaps. We do not enter into swaps that are not directly related to our own business, and do not trade in swaps for the purpose of profit-making. We enter into only the minimum number of derivatives necessary to hedge the risks described above. We are primarily a hold-to-maturity issuer of derivatives.

- **We prudently manage the risk posed by our counterparties.** We use rigorous criteria to choose our counterparties, which comprise a select group of well-known financial institutions that have investment-grade credit ratings. We understand that managing counterparty risk is paramount in the over-the-counter swaps environment, and have devoted significant resources to assessing and controlling such risk.

    - Each counterparty must be a participant in one of our revolving credit agreements.
    - The derivative instruments executed for each counterparty are based on key characteristics such as notional concentration, credit risk exposure, tenor, bid success rate, total credit commitment, and credit ratings.
    - Currently, our derivative counterparties have credit ratings ranging from AAA to BBB as assigned by Standard & Poor's Corporation and Aaa to Baa1 as assigned by Moody's Investors Service.
    - We have experienced only one instance of counterparty default over our entire 27-year history of using derivatives.

- **Imposing clearing would limit CFC's flexibility to match the amortization on a member loan, thus making more standardized swaps less effective in hedging our risk exposure.**

- **We prudently manage the amount of our exposure to any one counterparty.**

    - At May 31, 2010, the highest percentage concentration of total notional exposure to any one counterparty was 12% of total derivative instruments. The largest

amount owed to us by a single counterparty was $11 million, or 26% of the total exposure to us at May 31, 2010.

- Based on the fair market value of our derivative instruments at May 31, 2010, there were seven counterparties that would be required to make a payment to us, totaling $43 million, if all of our derivative instruments were terminated on that day.

- **We – and our members – depend on the flexibility and cost-effectiveness of the over-the-counter swaps environment.** Because our swaps are not subject to clearing or margin requirements, we have the flexibility to tailor each contract to meet our particular needs and are able to keep costs low, rather than having to choose from a limited universe of standard contracts or take on the expense of posting collateral. As a result, our members benefit from having a variety of credit products and terms to choose from, and also pay lower rates and fees on their loans as a result.

- **Transferring risk to a clearing organization is not needed, due to the effective risk management already inherent in our use of derivatives and the very limited nature of our transactions.** Margin requirements are not needed to address the risk posed by CFC's derivatives activities.

  - CFC works with a select universe of highly creditworthy counterparties, and we carefully choose our contract terms to fit the risks we need to hedge.
  - We have experienced only one instance of counterparty default over our 27-year history of using derivatives.
  - CFC only transacts with counterparties with which it has fully executed an ISDA Master Agreement and Schedule to Master Agreement.
  - All of CFC's ISDA Agreements contain a netting provision for payments and for settlement in the event of counterparty or CFC default. As previously discussed, CFC actively manages its derivative portfolio to minimize to the extent possible its net counterparty exposure. CFC does this primarily via trade allocation and individual counterparty notional concentration limits.
  - CFC's subordinated debt securities are available to absorb losses.
  - We have never defaulted on any obligation under a swaps contract.

- **CFC has the financial strength to meet its ongoing financial obligations associated with non-cleared swaps.**

  - As of January 7, 2011, our senior unsecured credit ratings from Moody's Investors Service and Standard & Poor's Corporation were A2 and A, respectively.
  - CFC maintains several sources of liquidity.
    - As of August 31, 2010, CFC had a total of $3.34 billion in credit available under three separate revolving credit facilities with a total of 23 banks. The credit facilities are used to provide back-up liquidity for CFC's short-term funding programs. There were no outstanding balances under the three credit facilities as of August 31, 2010.

- CFC has access to liquidity from private debt issuances through note purchase agreements with the Federal Agricultural Mortgage Corporation. All of the note purchase agreements with the Federal Agricultural Mortgage Corporation are revolving credit facilities that allow us to borrow, repay, and re-borrow funds at any time prior to the maturity date of the applicable agreement, provided that the principal amount at any time outstanding under each agreement is not more than the total available under such agreement, which was $913 million in the aggregate as of August 31, 2010.
- In November 2010, CFC finalized the documentation on an additional $500 million committed loan facility with the Federal Financing Bank that is guaranteed by the Department of Agriculture's Rural Utilities Service. CFC can draw down this committed amount at any time during the period ending three years from the commitment date.

- **Imposing margin requirements will increase the cost of capital to electric cooperatives that serve rural America.** Our ability to use over-the-counter swaps without margin or clearing requirements helps us to keep the costs of our lending operations low. We pass on the cost savings to our members, who pay lower rates and fees on their loans as a result. If we were required to post collateral for our swaps, our costs would rise, and the rates and fees we charge to our members would also have to rise.

  - It is difficult to predict the precise cost increase that would result for imposing margin requirements on CFC. This cost would vary based on a number of factors, including (1) whether collateral is required on a notional amount or on the net out-of-the-money position, (2) whether collateral is required for all swaps or only for swaps entered into after final regulations to implement DFA, and (3) the cost associated with pledging collateral, which will vary based on market costs. We have estimated the increases in interest rates to our member electric cooperatives to range from a low of 4 bps to 1,212 bps.

- **CFC's participation in clearing is not needed for the operation of clearinghouses to be effective.** We understand the perspective that, in order for the clearing system to work well, the system must have a sufficient volume of trades and participants. However, CFC's swaps volume is actually relatively low, and thus our absence from the clearing system should not have a major impact on its ability to function. As shown in the attached chart, we had only 7 trades in 2010, and have averaged only 15 trades a year since 1998.

  - Please see Attachment D for a list of swaps we have entered into since 1998 by year, number of trades, and notional amount.

<u>CFC's Swaps Activities Do Not Warrant the Imposition of Margin Requirements</u>

In addition to the clearing requirements that could potentially be imposed, we would like to note that imposing margin requirements on end users such as CFC is also not warranted. We

currently manage our derivatives activities without the need for margin and, as discussed above, have found our existing risk management methods to be successful.

- **Imposing margin requirements on end users such as CFC would run counter to explicit Congressional intent.** In a communication to Representatives Frank and Peterson, Chairman Lincoln (at that time Chair of the Senate Agriculture, Nutrition and Forestry Committee with jurisdiction over major aspects of the DFA) and then Banking Committee Chairman Dodd stated that it was not their intent that DFA impose margin requirements on end users. This is especially pertinent regarding non-profit cooperative entities with a "public interest" duty that imposes significant limitations on the types of transactions they can enter into. Further, CFC exists only to serve the nonprofit rural electric cooperative by lowering the financing costs that the rural electric cooperatives would otherwise have to pay. Further, CFC never uses swaps for speculative purposes. These points, and the other factors discussed in this document and other documents filed with the CFTC, distinguish the CFC from many other users of derivatives.

CFC urges the agencies to consider the regulatory and margin capital disparities for certain entities such as CFC if captured under the proposed rules. In the worst case, these disparities could lead to the elimination of small-to-midsize financial intermediaries that provide critical loan and finance functions to Main Street. We ask the agencies to recognize that not all financial institutions have identical financial, ownership and corporate structures, and to give further consideration to the practical consequences of giving identical treatment to all financial institutions, which have vast differences in risk profiles and public interest benefits.

CFC appreciates this opportunity to present our views in connection with the "End-User" rulemaking. Should you have any questions or need additional information, please contact Richard E. Larochelle, Senior Vice President of Corporate Relations, at (703) 709-6794 or Rich.Larochelle@nrucfc.coop.

End-User Comment Letter

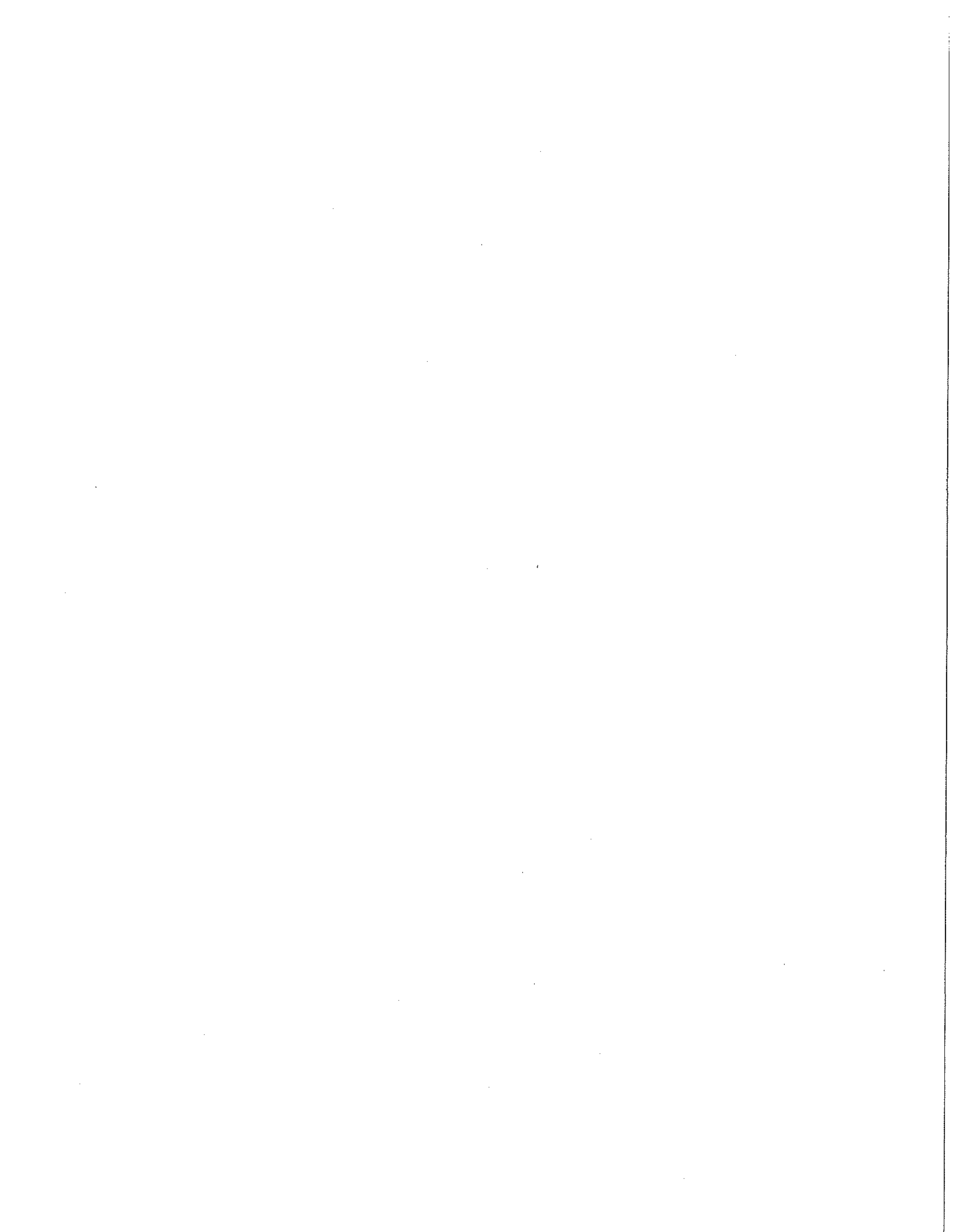
Listing of Attachments

Attachment A – CFTC Submission

Attachment B – Excerpt from NRUCFC 10-K

Attachment C - July 2009 CFC Report

Attachment D – Listing of Swaps (Derivatives) since 1998



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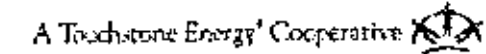


National Rural Utilities Cooperative Finance Corporation

Views on Implementation of the Dodd-Frank Act

The National Rural Utilities Cooperative Finance Corporation ("CFC") appreciates the opportunity to submit its views in connection with the CFTC's implementation of provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("DFA").

In particular, we would like to provide information about CFC's cooperative business model, social purpose, use of derivatives and capital structure. We hope the CFTC will consider these matters when crafting regulations so the important goals of the DFA may be achieved in a manner that does not result in unintended additional costs to CFC, its electric cooperative members or the 42 million consumers they serve.

In this paper, we provide:

- An introduction to CFC, as a nonprofit lender created and owned by America's consumer-owned rural electric cooperatives;
- An explanation of how and why CFC uses derivatives;
- An explanation of why we believe CFC should not be subject to margin or clearing requirements; and
- Our views on certain definitions within DFA that are subject to CFTC rulemaking, including "swap," "eligible contract participant," "swap dealer," "major swap participant," "substantial position," "commercial risk" and "highly leveraged relative to the amount of capital it holds."

We value the chance to discuss these matters with the CFTC in greater depth and answer any questions the Commission may have.

(1) Introduction to CFC

The National Rural Utilities Cooperative Finance Corporation ("CFC") is a nonprofit cooperative entity owned by America's consumer-owned electric cooperatives. CFC is not a bank, credit union or savings and loan institution. Therefore, many of CFC's metrics and motivations do not conform to those of these more commonly known financial entities.

We understand that the CFTC is currently soliciting public comments on the unique aspects of entities that serve a public purpose, such as rural electric cooperatives and other entities covered by Section 201(f) of the Federal Power Act, which includes entities such as CFC that are wholly owned by rural electric cooperatives.[1] As we discuss below, there are numerous reasons that entities such as CFC are unique among the entities that will be subject to the CFTC's DFA rules, and we encourage the CFTC to fully consider these reasons.

- **CFC was created by America's electric cooperatives to serve as their non-governmental financing arm.** CFC was created in 1969 by rural electric cooperatives through the National Rural Electric Cooperative Association ("NRECA") to provide financing to supplement the loan programs of the U.S. Department of Agriculture's Rural Utilities Service ("RUS"). Today, we continue the mission of providing our member electric cooperatives with a variety of loan programs.

- **CFC has a public purpose and mandate.** CFC was formed to meet the capital needs of America's consumer-owned electric cooperatives, which provide electricity as a public service, at affordable interest rates. Our provision of affordable loans to these cooperatives supports this public service.

- **CFC's principal purpose is to provide its members with financing so they can provide electric power services to rural Americans.** CFC is the largest non-governmental lender to rural electric systems.
    - CFC makes loans to members and also provides members with credit enhancements in the form of letters of credit and guarantees of debt obligations. At May 31, 2010, our total loans and guarantees outstanding were $20.5 billion.
    - In addition to providing the financing that supplements loans from the RUS, nearly 200 electric cooperatives across the United States rely solely on CFC for financing.

- **As a cooperative, CFC is owned by and exclusively serves its membership.** Our membership consists solely of not-for-profit entities, or subsidiaries or affiliates of not-for-profit entities. Our nearly 1,000 members serve 42 million consumers in 47 states.

    ➢ *Please see Attachment A for a map of our members' service areas.*

- **CFC's objective is to offer its members cost-based financial products and services consistent with sound financial management, rather than to maximize net income.**
    - CFC provides loans to members based on our cost of funds, not with a view to maximize net income. As a cooperative, any net earnings remaining after our obligations are satisfied belong to our members. As a result, we have been able to provide financing to our members at attractive interest rates. A key component of keeping costs low has been our ability to use over-the-counter derivatives to hedge interest rate risk.

[1] *See* 75 FR 80183-80184 (Dec. 21, 2010).

- **CFC derives our financial strength from the underlying high credit quality of our electric cooperative owners, the security supporting our loans, and our depth of understanding and long-term view of the market in which we operate.** Consistently, the capital markets have viewed electric cooperatives as low-risk businesses that are focused on providing essential services to rural consumers and that operate in a conservative, efficient manner. The ratings agencies also recognize the financial strength of the electric cooperatives.

- **As a cooperative, CFC's structure and financial metrics differ greatly from those of other types of companies.**
  - CFC's objectives differ from other types of lending entities. CFC's primary goal is to provide competitively priced capital to our members while maintaining financial strength and soundness.

- **Given CFC's cooperative structure and tax status, CFC cannot issue traditional equity securities.** Instead, CFC has retained earnings and certain long-term subordinated debt securities that our creditors and rating agencies have treated as the functional equivalent of core capital.
  - To assess performance, we use financial metrics that adjust certain numbers presented in our GAAP-based financial statements. These adjusted metrics are well understood and accepted by the major rating agencies as well as the analysts at the banks that provide us with revolving credit lines. We fully disclose these "adjusted" metrics and reconcile the metrics to GAAP-based metrics in our public filings with the U.S. Securities and Exchange Commission ("SEC"). These non-GAAP adjustments fall primarily into two categories: (1) adjustments related to the calculation of the TIER ratio and (2) adjustments related to the calculation of the leverage and debt-to-equity ratios. These adjustments, which are more fully explained later in this paper, reflect management's perspective on our operations and, in several cases, are used to measure covenant compliance under our revolving credit agreements. We believe that reliance on only GAAP numbers does not accurately reflect how our business is evaluated by CFC management, rating agencies and creditors. **In particular, CFC should not be viewed as overleveraged simply because it does not have a capital structure identical to that of a for-profit bank.** We urge the CFTC to recognize this reality as it progresses in its rulemaking activity.

<u>**How and Why Does CFC Use Derivatives?**</u>

CFC was created to ensure access to non-governmental market capital needed by rural utilities. In order to achieve this goal at the most attractive rates and in a manner tailored to the needs of rural utilities, CFC uses risk management and interest rate hedging products that would otherwise be expensive or unavailable to most of our members.

CFC's use of derivative hedging products allows our members to manage their interest rate risk efficiently and gives them flexibility in choosing different funding methods. Thus, CFC is an end user of derivatives, chiefly in the over-the-counter swaps environment. We use derivatives very

conservatively and not for speculative purposes; we use them to mitigate risks directly related to our business.

- **CFC uses derivatives to hedge market interest rate risk.** CFC uses over-the-counter swap contracts in the context of providing credit to our members, to allow us to tailor loans to our members' needs while mitigating the impact of changing interest rates. We do this through the use of a variety of types of swaps, from "plain vanilla" interest rate swaps to non-standard contracts.
    - For example, CFC may elect to match-fund a specific fixed-rate loan or a group of fixed-rate loans with an interest rate swap agreement that matches the exact terms of the loan(s) (e.g., principal amount, amortization schedule, payment dates, etc.). By match-funding the loan(s) with an interest rate swap, CFC eliminates the interest rate risk associated with the loan(s).

        - ➢ <u>*Please see Attachment B for a visual representation of how our typical interest rate swaps work.*</u>

        - ➢ <u>*Please see Attachment C for a table showing the number and amount of our swaps for each year since 1998.*</u>

- **CFC's use of derivatives reduces cost and increases flexibility for our members.** Our derivatives allow us to be flexible with loan structuring to accommodate our members' needs and help us provide them with low-cost capital.
    - For instance, CFC can use interest rate swap agreements to more cost effectively match-fund the cash flows of a specific loan or a pool of loans compared to options available in the public and private debt markets.
    - CFC offers our members loan products such as forward fixed-rate loans, accreting loans, principal deferral loans and loans with optionality that can most effectively and most economically be match-funded through the use of an interest rate swap agreement.
    - CFC uses interest rate swap agreements to change the interest rate mode of an underlying debt obligation to another interest rate mode that is either not available in the cash market or is more attractive or optimal than is available in the cash market.
        - ➢ As a lending institution, CFC needs to access both the public and private capital markets to raise capital to fund its loan portfolio. CFC issues long-term debt to refinance maturing debt or to support new loan growth. Based on the fixed/floating rate composition of CFC's loan portfolio, CFC will raise either fixed-rate or floating-rate debt.
        - ➢ CFC may elect to enter into an interest rate exchange agreement associated with a debt offering if an opportunity exists that will allow CFC to more economically issue debt in one interest rate mode and convert it to a different mode.
            - ▪ For instance, if CFC determines that it needs floating-rate debt, CFC will issue a fixed-rate bond and swap it back to a floating rate if this

provides a cheaper source of funding than issuing a "plain vanilla" floating-rate note.

- Other factors that will dictate the execution of interest rate exchange agreements include situations where certain desired funding structures are not able to be executed in the cash bond market in an optimal or economic fashion, such as amortizing loans, forward fixed starting loans and accreting loans.

➢ Our owners – rural electric cooperatives – and the consumers they serve benefit as a result of the lower cost and added flexibility that result from our use of derivatives.

- **CFC also has used cross-currency swaps to eliminate its exposure to exchange rate fluctuations when foreign currency denominated debt is issued.** CFC has, at times, issued debt denominated in a foreign currency in order to take advantage of pricing opportunities. In those situations, we will enter into a cross-currency exchange agreement at the time of the debt offering that converts the foreign currency obligation to a U.S. dollar obligation including both principal and interest payments.

- **CFC does not enter into derivative transactions for speculative purposes.** We do not make a market in swaps. We do not enter into swaps that are not directly related to our own business and do not trade in swaps for the purpose of profit-making. We enter into only the minimum number of derivatives necessary to hedge the risks described above. We are primarily a hold-to-maturity issuer of derivatives.

- **We prudently manage the risk posed by our counterparties.** We use rigorous criteria to choose our counterparties, which comprise a select group of well-known financial institutions that have investment-grade credit ratings. We understand that managing counterparty risk is paramount in the over-the-counter swaps environment and have devoted significant resources to assessing and controlling such risk.
    - o Each counterparty must be a participant in one of our revolving credit agreements. The derivative instruments executed for each counterparty are based on key characteristics such as notional concentration, credit risk exposure, tenor, bid success rate, total credit commitment and credit ratings.
    - o Currently, our derivative counterparties have credit ratings ranging from AAA to BBB as assigned by Standard & Poor's Corporation and Aaa to Baa1 as assigned by Moody's Investors Service.
        - ➢ *Please see Attachment D for a breakdown of our swap portfolio by rating as of May 31, 2010.*
    - o We have experienced only one instance of counterparty default over our entire 27-year history of using derivatives.

- **We prudently manage the amount of our exposure to any one counterparty.**
    - o At May 31, 2010, the highest percentage concentration of total notional exposure to any one counterparty was 12 percent of total derivative instruments. The largest

amount owed to us by a single counterparty was $11 million, or 26 percent of the total exposure to us at May 31, 2010.
  - Based on the fair market value of our derivative instruments at May 31, 2010, there were seven counterparties that would be required to make a payment to us, totaling $43 million, if all of our derivative instruments were terminated on that day.

- **We – and our members – depend on the flexibility and cost effectiveness of the over-the-counter swaps environment.** Because our swaps are generally not subject to clearing or margin requirements, we have the flexibility to tailor each contract to meet our particular needs and are able to keep costs low, rather than having to choose from a limited universe of standard contracts or take on the expense of posting collateral. As a result, our members benefit from having a variety of credit products and terms to choose from and also pay lower rates and fees on their loans as a result.

(2) CFC Should Be Exempt from DFA's Margin and Clearing Requirements

CFC understands that the goals of DFA's swaps provisions include minimizing systemic risk, increasing transparency and promoting market integrity. We recognize the need for disclosure and reporting of both our existing derivatives and any new contracts entered into, and agree with the need for safety and transparency in these markets.

We also note, though, that DFA is not meant to impede the ability of end users to use swaps to hedge their own commercial risk, such as CFC does. We also observe that CFC's derivatives activities do not entail systemic risk and that the concerns underlying the derivatives provisions of DFA are already being addressed in how we manage our swaps activity. Thus, imposing margin and clearing requirements on end users such as CFC is not needed for risk management purposes and would result in increased costs to consumers.

- **CFC's use of derivatives is similar to that of entities that do qualify for an exemption from clearing under DFA. In fact, we are owned solely by such entities.** CFC uses derivatives "to hedge or mitigate commercial risk" – and only our own commercial risk, in contrast to speculative users of derivatives who make "bets" based on occurrences of events having no relation to the user's own business. We are owned by entities that also use derivatives to hedge or mitigate their own commercial risk and do qualify for DFA's end user clearing exemption. We believe not extending such an exemption to entities such as CFC would be an illogical result because we exist solely to provide financing to those end users. In addition, the ways we use derivatives parallel the activities of captive finance companies explicitly exempted in DFA.

- **Transferring risk to a clearing organization is not needed due to the effective risk management already inherent in our use of derivatives.** Margin requirements are not needed to address the risk posed by CFC's derivatives activities.
  - CFC works with a select universe of highly creditworthy counterparties, and we carefully choose our contract terms to fit the risks we need to hedge.

- We have experienced only one instance of counterparty default over our 27-year history of using derivatives.
- CFC only transacts with counterparties with which it has fully executed an ISDA Master Agreement and Schedule to Master Agreement.
- All of CFC's ISDA agreements contain a netting provision for payments and for settlement in the event of counterparty or CFC default. As previously discussed, CFC actively manages its derivative portfolio to minimize to the extent possible its net counterparty exposure. CFC does this primarily via trade allocation and individual counterparty notional concentration limits.

- **CFC has the financial strength to meet its ongoing financial obligations associated with non-cleared swaps.**
  - As of January 7, 2011, our senior unsecured credit ratings from Moody's Investors Service and Standard & Poor's Corporation were A2 and A, respectively.
  - CFC maintains several sources of liquidity.
    - As of August 31, 2010, CFC had a total of $3.34 billion in credit available under three separate revolving credit facilities with 23 banks. The credit facilities are used to provide back-up liquidity for CFC's short-term funding programs. There were no outstanding balances under the three credit facilities as of August 31, 2010.
    - CFC had access to liquidity from private debt issuances through note purchase agreements with the Federal Agricultural Mortgage Corporation. All of the note purchase agreements with the Federal Agricultural Mortgage Corporation are revolving credit facilities that allow us to borrow, repay and re-borrow funds at any time prior to the maturity date of the applicable agreement, provided that the principal amount at any time outstanding under each agreement is not more than the total available under such agreement, which was $913 million as of August 31, 2010.
    - In November 2010, CFC finalized the documentation on an additional $500 million committed loan facility with the Federal Financing Bank that is guaranteed by the Department of Agriculture's Rural Utilities Service. CFC can draw down this committed amount at any time during the period three years from the commitment date.

- **Imposing margin requirements will increase the cost of capital to electric cooperatives that serve rural America.** Our ability to use over-the-counter swaps without margin or clearing requirements allows us to keep the costs of our lending operations low. We pass on the cost savings to our members, who pay lower rates and fees on their loans as a result. If we were required to post collateral for our swaps, our costs would rise, and the costs we charge to our members also would have to rise.
  - It is difficult to predict the precise cost increase that would result for imposing margin requirements on CFC. This cost would vary based on a number of factors, including (1) whether collateral is required on a notional amount or on the net out-of-the-money position, (2) whether collateral is required for all swaps or only for swaps entered into after final regulations to implement DFA and (3) the cost associated with

pledging collateral, which will vary based on market costs. We have estimated the increases in interest rates to our member electric cooperatives to range from a low of 4 basis points to 1,212 basis points.

- ➢ *Please see Attachment E for our estimate of additional costs based on a range of assumptions.*

- **Imposing margin requirements, in particular, on end users such as CFC would run counter to explicit Congressional intent.** In a communication to Representatives Frank and Peterson, Senators Lincoln and Dodd stated that it was not their intent that DFA impose margin requirements on end users. We agree that DFA should not be read so as to inhibit the ability of end users to use swaps to address risks related to their own businesses — productive uses of swaps rather than speculative ones.

With regard to any margin requirements that are ultimately imposed, we suggest the following approaches.

- **Margin should not be required for existing swaps.** Imposing margin on existing swap contracts would add a significant new cost that was not accounted for when the loans that are being match-funded with interest rate swap agreements were priced. To change existing contracts would impose an unfair and unanticipated cost burden on end users such as CFC.

- **Swaps entered into after enactment of DFA and prior to issuance of final regulations should be allowed a transition period.** Ideally, such swaps would be treated the same as swaps entered into prior to enactment of DFA and allowed to be grandfathered out of both margin and clearing requirements. Otherwise, the same issue of changing the terms of existing contracts would again arise. However, at the very least, we believe a transition period that allows parties a reasonable time to phase in the increased costs of compliance would be a fair approach.

    - We believe that six years would be a reasonable transition period to phase in the increased costs of compliance for swaps entered into after enactment of DFA and prior to issuance of final regulations. A phase-in period of six years would reduce the negative impact of unaccounted-for transaction costs.

        - ➢ Our swap portfolio has a weighted average life of 6.2 years as of August 31, 2010. Of the 50 percent pay-fixed swaps within our existing portfolio, 30 percent have a remaining life of greater than six years with the longest tenor stretching out to June 30, 2042.

- **Flexibility should be allowed in the nature of collateral that may be required or permitted.** For example, non-cash collateral should be acceptable, including lines of credit and other facilities.

- **For new swaps entered into after the effective date of final regulations, margin requirements should be based on the issuer's net out-of-the-money position per swap counterparty.** This is a logical measurement to use, as it represents the resulting cost if the swap had to be unwound. If notional amounts are used to determine margin requirements, the cost of compliance could be dramatically higher.

(3) Definitions and Concepts Subject to CFTC Rulemaking

We appreciate the opportunity to explain how we believe CFC should be viewed regarding a number of key terms within DFA that are subject to CFTC rulemaking. Here, we focus on the following terms:

- "Swap"
- "Eligible contract participant"
- "Swap dealer" and "Major swap participant" definitions
    - "Swap dealer"
    - "Major swap participant"
    - "Substantial position"
    - "Commercial risk"
    - "Highly leveraged relative to the amount of capital it holds"

"Swap": A Forward Rate Lock Should not be Considered a "Swap" Subject to Clearing and Margin

We understand that the DFA allows some flexibility in excluding certain contracts from the very detailed definition of "swap" in the DFA. We believe that the forward rate locks we offer our members should not be included in that definition. These are contracts with our borrowers that protect the borrower from interest rate fluctuations; they are not derivatives contracts.

- **A forward rate lock is a simple letter agreement between CFC and the borrower used to protect a borrower against rising or volatile interest rates.** Any cost charged is either in the form of an interest-rate adder or an up-front fee.

- **A forward rate lock is not structured like a swap.** In a forward rate lock agreement with a member, the member may pay for the privilege of being protected from interest rate fluctuations. CFC's obligation is to honor the locked-in rate for the underlying loan. There is no notional amount or index used as the basis for a mutual exchange of cash flows as there is with an interest rate swap agreement. If the member revokes the commitment, the member will be charged an administrative fee plus an obligation to make CFC whole.

"Eligible Contract Participant": CFC Should Continue to Be Considered Eligible to Enter Into Swaps Not Traded on an Exchange

Section 723 of DFA states, "It shall be unlawful for any person, other than an eligible contract participant, to enter into a swap unless the swap is entered into on, or subject to the rules of, a board of trade designated as a contract market under section 5" of the Commodity Exchange Act ("CEA"). CFC should be deemed to be an "eligible contract participant" able to use non-exchange-traded swaps. At the very least, the CFTC should refrain from defining "eligible contract participant" in any way that would disqualify CFC from using swaps that are not traded on an exchange.

- **CFC already qualifies as an "eligible contract participant" under existing law.** Under the CEA, the statutory definition of "eligible contract participant" includes "a corporation, partnership, proprietorship, organization, trust, or other entity...that has total assets exceeding $10,000,000" that is "acting for its own account" (7 USC § 1a(12)(A)(v)(I). CFC currently has more than $20 billion in assets. Moreover, the CEA allows the CFTC to include in the definition "any other person that the Commission determines to be eligible in light of the financial or other qualifications of the person" (7 USC § 1a(12)(C)).

- **CFC's prudent use of swaps as an end user merits continued access to the over-the-counter market.** As discussed throughout this paper, CFC's use of swaps does not raise the types of concerns that would merit disqualifying us from using over-the-counter swaps. CFC uses swaps only to hedge commercial risk. We work with a select universe of highly creditworthy counterparties and carefully choose our contract terms to suit the risk we need to hedge.

"Swap Dealer" and "Major Swap Participant" Definitions

We believe CFC does not logically fit into the concept of a "swap dealer" and is not an entity that Congress intended to subject to the restrictions, requirements and related costs that would be imposed on such entities. In particular, we caution that the term "highly leveraged relative to the amount of capital it holds" should not be defined or interpreted based solely on U.S. GAAP measurements or standard tests of bank capital. Such tests could inadvertently sweep CFC into the definition of "major swap participant," as CFC does not have the capital structure of a for-profit bank. For example, due to our cooperative structure and tax status, we cannot issue common equity as a publicly traded banking organization would.

- "**Swap Dealer**." DFA generally defines "swap dealer" as "any person who— (i) Holds itself out as a dealer in swaps; (ii) Makes a market in swaps; (iii) Regularly enters into swaps with counterparties as an ordinary course of business for its own account; or (iv) Engages in any activity causing the person to be commonly known in the trade as a dealer or market maker in swaps[.]"
    - **CFC does not make a market in swaps, nor do we engage in proprietary trading activities.** CFC uses swaps solely to hedge interest rate risk associated with the loans we make to our members.
    - **We enter into swaps not as investments for our own account, but to hedge risks arising from the loans we make to our members.** We caution that the concept of

"regularly enter[ing] into swaps with counterparties as an ordinary course of business for its own account" should not be defined in such a way that would capture entities that merely enter into a large volume of swaps, or that regularly enter into swaps, while their purpose for doing so is non-speculative and is done to hedge or mitigate their own commercial risk.

- ➢ Rather, the CFTC should explicitly carve out such productive uses of swaps with language such as the following:

  - *Regularly enters into swaps with counterparties as an ordinary course of business for its own account, __excluding swaps entered into to hedge or mitigate commercial risk.__*

- "__Major Swap Participant.__" DFA generally defines a "major swap participant" to mean "any person who is not a swap dealer, and— (i) Maintains a substantial position in swaps for any of the major swap categories as determined by the [CFTC], excluding— (I) Positions held for hedging or mitigating commercial risk; and (II) Positions maintained by any employee benefit plan [...]; (ii) Whose outstanding swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets; or (iii)(I) Is a financial entity that is highly leveraged relative to the amount of capital it holds and that is not subject to capital requirements established by an appropriate Federal banking agency; and (II) Maintains a substantial position in outstanding swaps in any major swap category as determined by the [CFTC]."
  - o **CFC's use of swaps does not raise the concerns underlying the "major swap participant" concept.** DFA's concept of "major swap participant" – and the regulatory regime to which such entities will be subject – is driven by concerns that such entities' swap activities put the larger economy at risk, and thus require increased supervisory oversight.

- "__Substantial position.__"
  - o **CFC's swaps positions should not be considered a "__substantial position__" for purposes of the major swap participant definition.** The CFTC is directed to define "substantial position" at the threshold that it deems to be prudent for the effective monitoring, management and oversight of entities that are systemically important or can significantly affect the financial system of the United States. In crafting the definition, the CFTC is to consider the entity's relative position in uncleared versus cleared swaps and may take into consideration the value and quality of collateral held against counterparty exposures. We believe the CFTC should consider the fact that 100 percent of our swaps are held to hedge or mitigate commercial risk – chiefly, interest rate risk – and that our counterparty risk is extremely well managed.

  - o **Positions for hedging or mitigating commercial risk should be excluded for calculating a "substantial position" for "major swap participant" purposes.** Under the first prong of the "major swap participant" definition, swap transactions

that hedge "commercial risk" are excluded. We believe that provision also should be incorporated into the third prong, as it is just as relevant for "financial entities" as for other types of entities. The mere fact that an entity is primarily engaged in lending – and thus falls under the "financial entity" definition – should not mean that entity should be penalized for holding positions in swaps that serve solely to mitigate the entity's own commercial risk and do not serve any speculative purpose.

- "**Commercial risk.**" "Commercial risk" is not defined in DFA, and the CFTC is not required to define the term through rulemaking. However, defining the term is important, as the term is used in two key areas of DFA. First, the term is used in determining whether an entity holds a "substantial position" in swaps for purposes of the "major swap participant" definition. Second, the term is used in the end user clearing exemption providing that a non-cleared swap must be used to "hedge or mitigate commercial risk." Additionally, as we have proposed above, the term should be used in the context of the definition of "swaps dealer."

    - **"Commercial risk" should be defined to include any legitimate risk incurred in connection with operating a business and should explicitly include interest rate risk and currency risk.** Managing these two types of risks is integral to conducting CFC's business and is not associated with proprietary or speculative trading. We encourage the CFTC to view the concept of hedging or mitigating commercial risk as one in which there is a direct link between the derivative contract and managing the risks associated with an entity's *own* business, as opposed to speculative swaps based on risks of parties unrelated to the end user. Thus, we propose language such as the following:

        - **"Commercial risk" means any risk incurred by a person or entity in connection with its own business, including (1) interest rate risk; (2) currency risk; ..."**

- **"Highly leveraged relative to the amount of capital it holds." We fully recognize** that the failures of certain financial firms in recent history have resulted, at least in part, from problems with overleverage. However, we caution against applying a bank-like or GAAP-based capital adequacy regime to a nonprofit cooperative lender such as CFC, which has a structure that is very different from other types of financial companies and is able to manage its risk without the need for the types of capital requirements applicable to certain other types of companies, such as depository institutions. While CFC is not subject to the capital requirements to which banks are subject, many of our capital instruments are the functional equivalent of bank regulatory capital and should be considered as such.

    - **Given CFC's cooperative structure and tax status, CFC cannot issue traditional equity securities.** Instead, CFC has retained earnings and certain long-term subordinated debt securities that creditors and rating agencies have treated as the functional equivalent of core capital. Insisting on a strict GAAP measure of capital

would put CFC at an unfair disadvantage relative to for-profit entities that can freely issue common equity.

- **CFC's adjusted equity is composed of (1) members' equity and (2) certain long-term, subordinated debt obligations.**

  - Members' Equity. This amount consists of (1) fees paid by members; (2) an education fund, to which CFC contributes less than 1 percent of net earnings each year and which is used to support cooperative education programs; (3) a members' capital reserve, which constitutes retained earnings that have not been allocated to any member but could be so allocated in the future; (4) unallocated net loss; and (5) allocated net income.

  - Long-Term Subordinated Debt. CFC issues several forms of long-term subordinated debt that it includes in its adjusted equity:
    - *Subordinated Deferrable Debt* — These instruments are sold on the New York Stock Exchange and have a par value of $25.00 and a maturity of 40 years. CFC may defer interest for up to 20 quarters.
    - *Membership Subordinated Certificates* — Members of CFC may be required to purchase these certificates as a condition of membership. They are unsecured and pay interest at 5 percent semi-annually that is deferrable if CFC cannot make payments on other senior debt. All other debt is senior to these certificates, and members cannot call them before maturity. The certificates are non-transferable and have an original maturity of 100 years. The weighted average maturity for all membership subordinated certificates outstanding at May 31, 2010, was 66 years.
    - *Loan and Guarantee Subordinated Certificates* — Members obtaining long-term loans, certain short-term loans or guarantees were generally required to purchase additional loan or guarantee subordinated certificates with each such loan or guarantee based on the members' debt-to-equity ratio with CFC. CFC loans are typically 35-year loans, and the certificates tied to a loan carry the same maturity as the loan. In the event of a loan default, CFC has a right of offset on these certificates. Effective June 1, 2009, CFC changed its equity policies. Under current policy, most members requesting standard loans are not required to buy subordinated certificates as a condition of a loan or guarantee. Members meeting certain criteria or members requesting large facilities may be required to purchase member capital securities (described below) or other subordinated certificates as a condition of the loan.
    - *Member Capital Securities* — CFC began offering member capital securities to its voting members during the 2009 fiscal year. Member capital securities are subordinate to CFC's existing and

future senior indebtedness and all existing and future subordinated indebtedness of CFC that may be held by or transferred to non-members of CFC, but rank equally to the membership subordinated certificates. Members can voluntarily purchase these securities. They have a 35-year maturity and are callable at par at CFC's option five years from the date of issuance and anytime thereafter.

- **The membership subordinated certificates, loan and guarantee certificates, and member capital securities that CFC issues are the functional equivalent of core capital, and are treated as such by our creditors and rating agencies.** Like common equity and noncumulative perpetual preferred stock, these debt instruments are available to absorb losses. These debt instruments do not have redemption features that would permit a holder to withdraw funds before maturity and have long-dated maturities. Further, all of the membership subordinated instruments give CFC the right to offset the member's investment in the instrument against any amounts the member may owe CFC. This offset right has been utilized by CFC to mitigate loan losses. <u>Because of these features, rating agencies and existing creditors have equated these instruments to core capital</u>.

  - CFC's loan and guarantee subordinated certificates also may be viewed as the functional equivalent of nonwithdrawable accounts or pledged deposits. Current Office of Thrift Supervision ("OTS") capital regulations (12 CFR § 567.5(a)(iv)) recognize nonwithdrawable accounts and pledged deposits of mutual savings associations as components of core capital. The loan and guarantee subordinated certificates are established in connection with a loan and must remain outstanding during the term of the loan.

- **Given our unique capital structure, we have developed certain ratios that management, creditors and rating agencies use to analyze our financial condition.** For example, CFC's revolving credit agreements require CFC to maintain an "adjusted leverage ratio" of no more than 10-to-1. This and other ratios used by CFC are described below.

  - <u>Adjusted TIER</u>. This ratio measures CFC's ability to cover the interest expense on our debt obligations. The TIER ratio equals the sum of our interest expense plus net income, divided by interest expense. CFC's revolving credit agreements require that we achieve an adjusted TIER over the six most recent quarters of 1.025 and prohibit us from retiring patronage capital unless we have achieved an adjusted TIER of 1.05 in the preceding fiscal year. The adjusted TIER ratio adds derivative cash settlements to interest expense, adds noncontrolling interest net income to total net income, and removes derivative forward value and foreign

currency adjustments from total net income. Our adjusted TIER was 1.12 for the year ended May 31, 2010.

- Adjusted Leverage Ratio. This ratio measures the sum of total liabilities and total guarantees divided by total equity. We make adjustments based upon the terms of our revolving credit agreements. Adjustments include (1) the subtraction from debt used to fund total liabilities of loans guaranteed by the U.S. Department of Agriculture's RUS; (2) the subtraction from debt and addition to equity of instruments that have equity-like characteristics (membership subordinated subscription certificates, loan and guarantee subordinated certificates, and subordinated deferrable debt); and (3) the exclusion from total liabilities and total equity of the effect of non-cash foreign currency adjustments and non-cash adjustments under ASC Topic 815, Derivatives and Hedging. Our adjusted leverage ratio was 6.34-to-1 as of May 31, 2010.

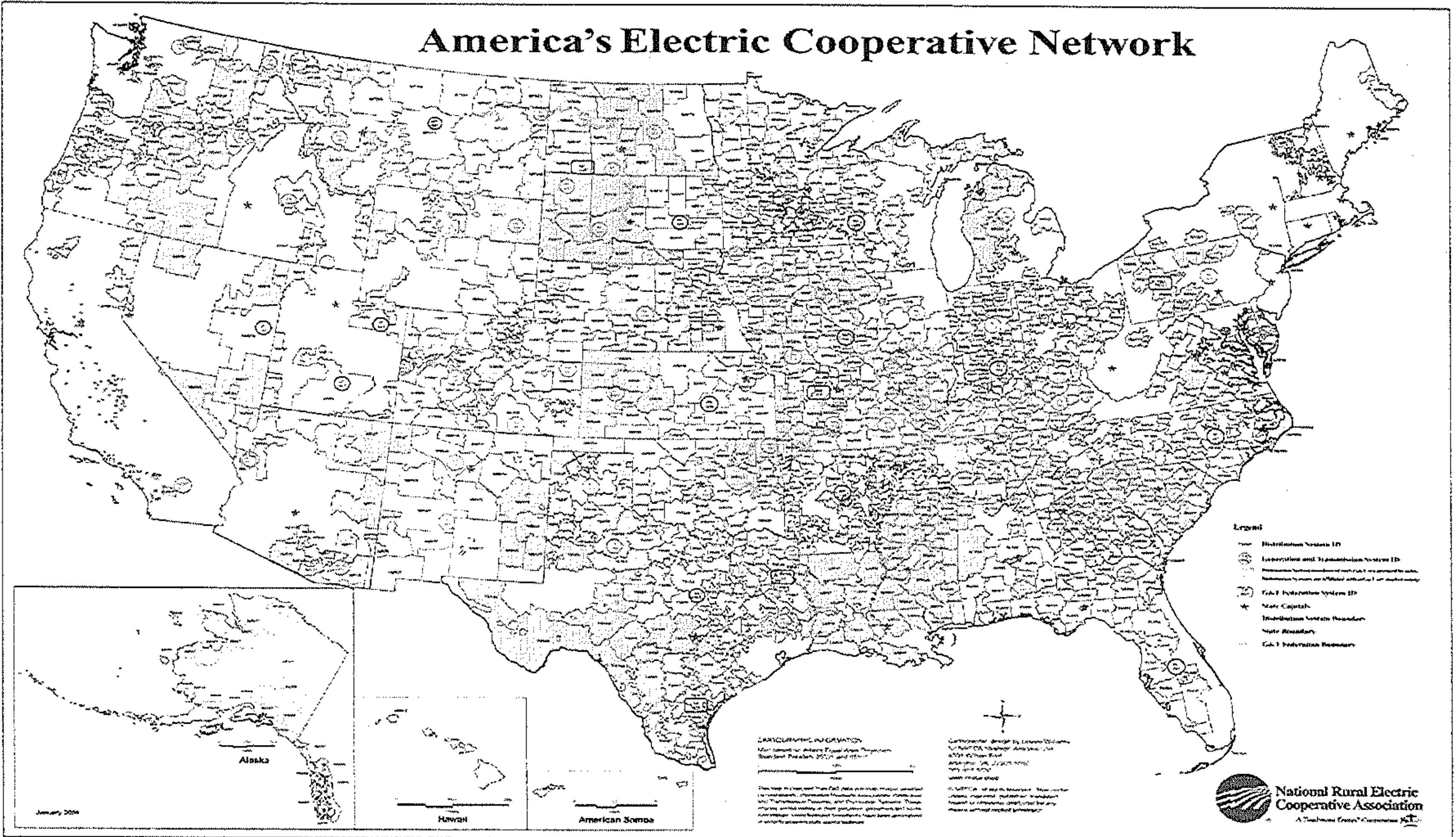
- Adjusted Debt-to-Equity Ratio. This ratio measures total liabilities divided by total equity. The only difference between this ratio and the adjusted leverage ratio is the inclusion of guarantees in the leverage ratio basis. At May 31, 2010, our adjusted debt-to-equity ratio was 5.93-to-1 as compared with a debt-to-equity ratio of 33.33-to-1 based on GAAP.

- **"Adjusted" equity should be used to evaluate our capital adequacy, not our GAAP numbers.** We make certain adjustments to financial measures in assessing our financial performance that are not in accordance with GAAP. These non-GAAP adjustments fall primarily into two categories: (1) adjustments related to the calculation of the TIER ratio and (2) adjustments related to the calculation of the leverage and debt-to-equity ratios. These adjustments reflect management's perspective on our operations and are used to measure covenant compliance under our revolving credit agreements.

- **In short, CFC's capital structure should not be viewed as overleveraged simply because it does not mirror the capital structure of for-profit banks.** For-profit banks are inherently subject to different risks and are organized to achieve different financial goals than the risks and goals applicable to CFC. We urge the CFTC to recognize this reality as it progresses in its rulemaking activity.

We appreciate the opportunity to provide this information about CFC. For any questions or additional information, please contact Rich Larochelle, Senior Vice President, at 703-709-6794 or Rich.Larochelle@nrucfc.coop.

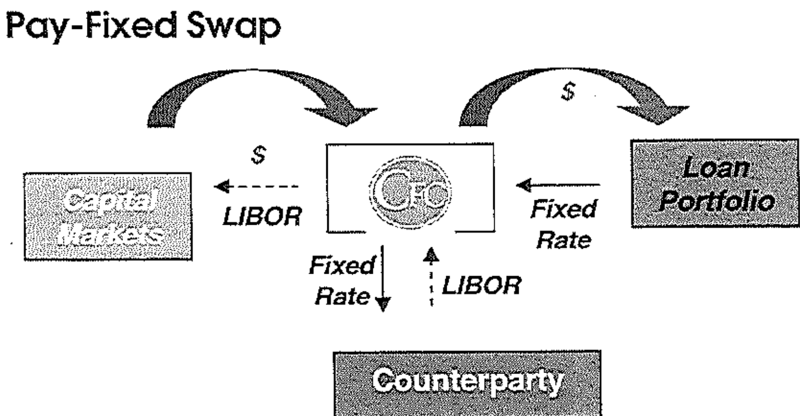
Attachment A



How CFC uses Interest Rate Swaps

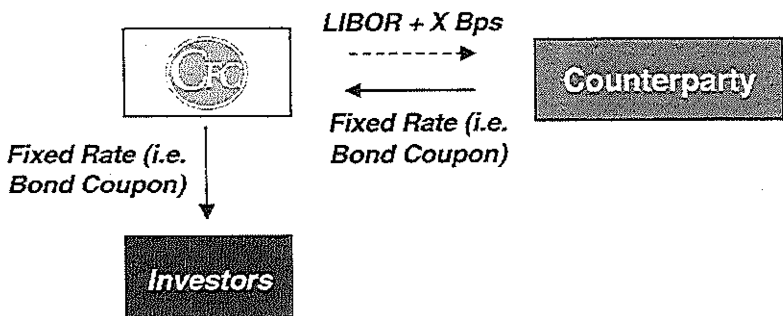
- In this example, CFC receives fixed interest from an aggregate loan portfolio but pays floating LIBOR to capital market investors. This mismatch in interest rate creates exposure, prompting CFC to swap the fixed rate from its loan portfolio to floating.

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



Attachment C

CFC's use of Derivatives, 1998 - 2010

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

Attachment D

CFC's Swap Portfolio by Rating as of May, 2010

S&P RATINGS					MOODY'S RATINGS			
Range	Number of Banks	Notional	% of Portfolio		Range	Number of Banks	Notional	% of Portfolio
AAA to AA-	5	2,435,992,325	22%		Aaa to Aa3	13	7,885,335,946	70%
A+ to A	12	8,069,939,046	72%		A1 to A2	5	2,800,005,425	25%
BBB to BBB+	2	508,346,000	5%		Baa1	2	508,346,000	5%
NR	1	179,410,000	2%					
	20	11,193,687,371	100%			20	11,193,687,371	100%

Attachment E

Projected Additional Costs of Margin Requirements to CFC and Electric Co-ops

Regulatory Requirement	Net MTM Collateral		Notional Collateral (at 15% of Swaps)	
	2.5% Cost Drag	**6.0% Cost Drag**	**2.5% Cost Drag**	**6.0% Cost Drag**
A. If Pledging Required for all Swaps, including those existing prior to DFA.	26 bps	63 bps	505 bps	1,212 bps
B. If Pledging Required only on swaps issued after DFA regulations.	4 bps	11 bps	23 bps	55 bps

* Assumes $1 Billion in new loans to spread these additional costs.

Non-GAAP Financial Measures

We make certain adjustments to financial measures in assessing our financial performance that are not in accordance with GAAP. These non-GAAP adjustments fall primarily into two categories: (1) adjustments related to the calculation of the TIER ratio and (2) adjustments related to the calculation of the leverage and debt to equity ratios. These adjustments reflect management's perspective on our operations, and in several cases, adjustments used to measure covenant compliance under our revolving credit agreements. Therefore, we believe these are useful financial measures for investors. We refer to our non-GAAP financial measures as "adjusted" throughout this document.

Adjustments to Net Income and the Calculation of the TIER Ratio

Our primary performance measure is TIER. TIER is calculated by adding the interest expense to net income prior to the cumulative effect of change in accounting principle and dividing that total by the interest expense. TIER is a measure of our ability to cover interest expense requirements on our debt. We adjust the TIER calculation to add the derivative cash settlements to the interest expense and to remove the derivative forward value and foreign currency adjustments from total net income. Adding the cash settlements back to the interest expense also has a corresponding effect on our adjusted net interest income. We make these adjustments to our TIER calculation for covenant compliance on our revolving credit agreements. The revolving credit agreements require us to achieve an average adjusted TIER ratio over the six most recent fiscal quarters of at least 1.025 and prohibit the retirement of patronage capital unless we have achieved an adjusted TIER ratio of at least 1.05 for the preceding fiscal year.

We use derivatives to manage interest rate and foreign currency exchange risk on our funding of the loan portfolio. The derivative cash settlements represent the amount that we receive from or pay to our counterparties based on the interest rate indexes in our derivatives that do not qualify for hedge accounting. We adjust the reported interest expense to include the derivative cash settlements. We use the adjusted cost of funding to set interest rates on loans to our members and believe that the interest expense adjusted to include derivative cash settlements represents our total cost of funding for the period. For computing compliance with our revolving credit agreement covenants, we are required to adjust our interest expense to include the derivative cash settlements. TIER calculated by adding the derivative cash settlements to the interest expense reflects management's perspective on our operations and therefore, we believe that it represents a useful financial measure for investors.

The derivative forward value and foreign currency adjustments do not represent our cash inflows or outflows during the current period, and therefore do not affect our current ability to cover our debt service obligations. The derivative forward value included in the derivative losses line of the statement of operations represents a present value estimate of the future cash inflows or outflows that will be recognized as net cash settlements for all periods through the maturity of our derivatives that do not qualify for hedge accounting. Foreign currency adjustments represent the change in value of foreign denominated debt resulting from the change in foreign currency exchange rates during the current period. The derivative forward value calculation is based on future interest rate expectations that may change daily, creating volatility in the estimated derivative forward value. The change in foreign currency exchange rates adjusts the debt balance to the amount that would be due at the reporting date. At the issuance date, we enter into a foreign currency exchange agreement for all foreign-denominated debt that effectively fixes the exchange rate for all interest and principal payments. For making operating decisions, we subtract the derivative forward value and foreign currency adjustments from our net income when calculating TIER and for other net income presentation purposes. The covenants in our revolving credit agreements also exclude the effects of derivative forward value and foreign currency adjustments. In addition, since the derivative forward value and foreign currency adjustments do not represent current period cash flows, we do not allocate such funds to our members and, therefore, exclude the derivative forward value and foreign currency adjustments from net income when making certain presentations to our members and in calculating the amount of net income to be allocated to our members. TIER calculated by excluding the derivative forward value and foreign currency adjustments from net income reflects management's perspective on our operations and therefore, we believe that it represents a useful financial measure for investors.

The accounting for derivative financial instruments and foreign currency adjustments also affect our total equity. The derivative forward value and foreign currency adjustments flow through the consolidated statements of operations as income or expense, increasing or decreasing the total net income for the period. The total net income or net loss for the period represents an increase or decrease, respectively, to total equity. As a result of implementing

the accounting for derivative financial instruments, our total equity includes other comprehensive income, which represents unrecognized gains and losses on derivatives. The other comprehensive income component of equity related to derivatives that qualify for hedge accounting does not flow through the consolidated statements of operations. As stated above, the derivative forward value and foreign currency adjustments do not represent current cash inflow or outflow. The other comprehensive income is also an estimate of future gains and losses and as such does not represent earnings that we can use to fund our loan portfolio. Financial measures calculated with total equity, excluding the accounting for derivative financial instruments and foreign currency adjustments, reflect management's perspective on our operations and therefore, we believe represent a useful measure of our financial condition.

The following table provides a reconciliation between interest expense and net interest income, and these financial measures adjusted to include the impact of derivatives. Additionally, it provides a reconciliation of net income and this financial measure adjusted to exclude the impact of derivatives and foreign currency adjustments for the five years ended May 31, 2010.

Due to the adoption of new accounting standards for noncontrolling interests on June 1, 2009, minority interest (noncontrolling interest) net income is included in total net income on the consolidated statement of operations. As a result, it is not necessary to adjust net income to include minority interest (noncontrolling interest) net income as it was in prior periods. As required, we reflected changes in the presentation and disclosure of noncontrolling interest in our consolidated financial statements, including the adjusted net income and adjusted TIER calculations, for all periods presented.

	For the year ended May 31,				
	2010	2009	2008	2007	2006
(dollar amounts in thousands)					
Interest expense	$ (912,111)	$ (935,021)	$ (931,268)	$ (991,754)	$ (977,200)
Derivative cash settlements	(23,304)	112,989	27,033	86,442	80,883
Adjusted interest expense	$ (935,415)	$ (822,032)	$ (904,235)	$ (905,312)	$ (896,317)
Net interest income	$ 131,524	$ 135,743	$ 120,125	$ 47,896	$ 18,682
Derivative cash settlements	(23,304)	112,989	27,033	86,442	80,883
Adjusted net interest income	$ 108,220	$ 248,732	$ 147,158	$ 134,338	$ 99,565
Net income (loss) prior to cumulative effect of change in accounting principle	$ 110,547	$ (73,770)	$ 39,646	$ 14,145	$ 102,586
Derivative forward value	(2,696)	160,017	98,743	79,281	(28,805)
Foreign currency adjustments	-	-	-	14,554	22,594
Adjusted net income	$ 107,851	$ 86,247	$ 138,389	$ 107,980	$ 96,375

TIER using GAAP financial measures is calculated as follows:

$$\text{TIER} = \frac{\text{Interest expense + net income prior to cumulative effect of change in accounting principle}}{\text{Interest expense}}$$

Our adjusted TIER is calculated as follows:

$$\text{Adjusted TIER} = \frac{\text{Adjusted interest expense + adjusted net income}}{\text{Adjusted interest expense}}$$

The following table presents our TIER and adjusted TIER:

For the year ended May 31,

	2010	2009	2008	2007	2006
TIER (1)	1.12	-	1.04	1.01	1.10
Adjusted TIER	1.12	1.10	1.15	1.12	1.11

(1) For the year ended May 31, 2009, we reported a net loss of $74 million; therefore, the TIER for this period results in a value below 1.00.

Adjustments to the Calculation of Leverage and Debt to Equity Ratios

Our adjusted leverage and debt to equity ratios include adjustments to:

- subtract debt used to fund loans that are guaranteed by RUS from total liabilities;
- subtract from total liabilities, and add to total equity, debt with equity characteristics issued to our members and in the capital markets; and
- exclude the non-cash impact of derivative financial instruments and foreign currency adjustments from total liabilities and total equity.

For computing compliance with our revolving credit agreement covenants, we are required to make these adjustments to our leverage ratio calculation. The revolving credit agreements prohibit us from incurring senior debt in an amount in excess of 10 times the sum of equity, members' subordinated certificates, minority interest (noncontrolling interest) and subordinated deferrable debt, as defined by the agreements. In addition to the adjustments we make to calculate the adjusted leverage ratio, guarantees to our member systems that have an investment-grade rating from Moody's Investors Service and Standard & Poor's Corporation are excluded from the calculation of the leverage ratio under the terms of the revolving credit agreements.

We are an eligible lender under the RUS loan guarantee program. Loans issued under this program carry the U.S. government's guarantee of all interest and principal payments. Therefore, we have little or no risk associated with the collection of principal and interest payments on these loans. Therefore, we believe there is little or no risk related to the repayment of the liabilities used to fund RUS guaranteed loans and we subtract such liabilities from total liabilities to calculate our leverage and debt to equity ratios. For computing compliance with our revolving credit agreement covenants, we are required to adjust our leverage ratio by subtracting liabilities used to fund RUS guaranteed loans from total liabilities. The leverage and debt to equity ratios adjusted to subtract debt used to fund RUS guaranteed loans from total liabilities reflect management's perspective on our operations and therefore, we believe that these are useful financial measures for investors.

Members have been required to purchase subordinated certificates as a condition of membership and as a condition to obtaining a loan or guarantee. The subordinated certificates are accounted for as debt under GAAP. The subordinated certificates have long-dated maturities and pay no interest or pay interest that is below market, and under certain conditions we are prohibited from making interest payments to members on the subordinated certificates. For computing compliance with our revolving credit agreement covenants, we are required to adjust our leverage ratio by subtracting members' subordinated certificates from total liabilities and adding members' subordinated certificates to total equity. The leverage and debt to equity ratios adjusted to treat members' subordinated certificates as equity rather than debt reflect management's perspective on our operations and therefore, we believe these are useful financial measures for investors.

We also sell subordinated deferrable debt in the capital markets with maturities of up to 39 years and the option to defer interest payments. The characteristics of subordination, deferrable interest and long-dated maturity are all equity characteristics. For computing compliance with our revolving credit agreement covenants, we are required to adjust our leverage ratio by subtracting subordinated deferrable debt from total liabilities and adding it to total equity. The leverage and debt to equity ratios adjusted to treat subordinated deferrable debt as equity rather than debt reflect management's perspective on our operations and therefore, we believe these are useful financial measures for investors.

We record derivative instruments at fair value on our consolidated balance sheets. The fair values are estimates of the future gains and losses we may incur related to derivatives. The amounts do not represent current cash flows and are not available to fund current operations. For computing compliance with our revolving credit agreement

covenants, we are required to adjust our leverage ratio by excluding the non-cash impact of our derivative accounting from liabilities and equity. The leverage and debt to equity ratios adjusted to exclude the impact of our derivative accounting from liabilities and equity reflect management's perspective on our operations and therefore, we believe these are useful financial measures for investors.

As a result of issuing foreign denominated debt and the accounting standards for derivative financial instruments, which discontinued the practice of recording the foreign denominated debt and the related currency exchange agreement as one transaction, we must adjust the value of such debt reported on the consolidated balance sheets for changes in foreign currency exchange rates since the date of issuance based on the accounting for foreign currency translation. At the time of issuance of all foreign denominated debt, we enter into a foreign currency exchange agreement to fix the exchange rate on all principal and interest payments through maturity. The adjustments to the value of the debt on the consolidated balance sheets are reported on the consolidated statements of operations as foreign currency adjustments. The adjusted debt value at the reporting date does not represent the amount we will ultimately pay to retire the debt unless the current exchange rate is equal to the exchange rate in the related foreign currency exchange agreement or the counterparty fails to honor its obligations under the agreement. For computing compliance with our revolving credit agreement covenants, we are required to adjust our leverage ratio by excluding the impact of foreign currency valuation adjustments from liabilities and equity. The leverage and debt to equity ratios adjusted to exclude the effect of foreign currency translation reflect management's perspective on our operations and therefore, we believe these are useful financial measures for investors.

The following table reconciles the liabilities and equity on the consolidated balance sheets to the amounts used to calculate the adjusted leverage and debt to equity ratios as of the five years ended May 31, 2010.

Due to the adoption of new accounting standards for noncontrolling interests on June 1, 2009, minority interest (noncontrolling interest) is reported as equity on the consolidated balance sheets. As a result, it is not necessary to adjust equity to include minority interest (noncontrolling interest) in the leverage and debt to equity ratio as it was in prior periods. As required, we have reflected the changes in presentation and disclosure of noncontrolling interest in our consolidated financial statements for all periods presented in this Form 10-K, including the leverage and debt to equity ratios as of the five years ended May 31, 2010.

	May 31,				
(dollar amounts in thousands)	2010	2009	2008	2007	2006
Liabilities	$19,556,448	$20,463,605	$ 18,699,169	$17,843,151	$18,373,319
Less:					
Derivative liabilities	(482,825)	(493,002)	(171,390)	(71,934)	(85,198)
Foreign currency valuation account	-	-	-	-	(244,955)
Debt used to fund loans guaranteed by RUS	(237,356)	(243,997)	(250,169)	(255,903)	(261,330)
Subordinated deferrable debt (1)	(311,440)	(311,440)	(311,440)	(486,440)	(636,440)
Subordinated certificates	(1,810,715)	(1,740,054)	(1,406,779)	(1,381,447)	(1,427,960)
Adjusted liabilities	$16,714,112	$17,675,112	$ 16,559,391	$15,647,427	$15,717,436
Total equity	$ 586,767	$ 519,100	$ 680,212	$ 732,030	$ 806,302
Less:					
Prior year cumulative derivative forward value and foreign currency adjustments	121,560	(38,457)	(137,200)	(231,035)	(224,824)
Year-to-date derivative forward value (income) loss	(2,696)	160,017	98,743	79,281	(28,805)
Current period foreign currency adjustments	-	-	-	14,554	22,594
Accumulated other comprehensive income (2)	(7,489)	(8,115)	(8,827)	(12,204)	(13,208)
Plus:					
Subordinated certificates	1,810,715	1,740,054	1,406,779	1,381,447	1,427,960

Subordinated deferrable debt (1)	311,440	311,440	311,440	486,440	636,440
Adjusted equity	$ 2,820,297	$ 2,684,039	$ 2,351,147	$ 2,450,513	$ 2,626,459
Guarantees	$ 1,171,109	$ 1,275,455	$ 1,037,140	$ 1,074,374	$ 1,078,980

(1) At May 31, 2007 and 2006, includes $175 million and $150 million, respectively, of subordinated deferrable debt classified in short-term debt.
(2) Represents the accumulated other comprehensive income related to derivatives.

The leverage and debt to equity ratios using GAAP financial measures are calculated as follows:

$$\text{Leverage ratio} - \frac{\text{Liabilities + guarantees outstanding}}{\text{Total equity}}$$

$$\text{Debt to equity ratio} - \frac{\text{Liabilities}}{\text{Total equity}}$$

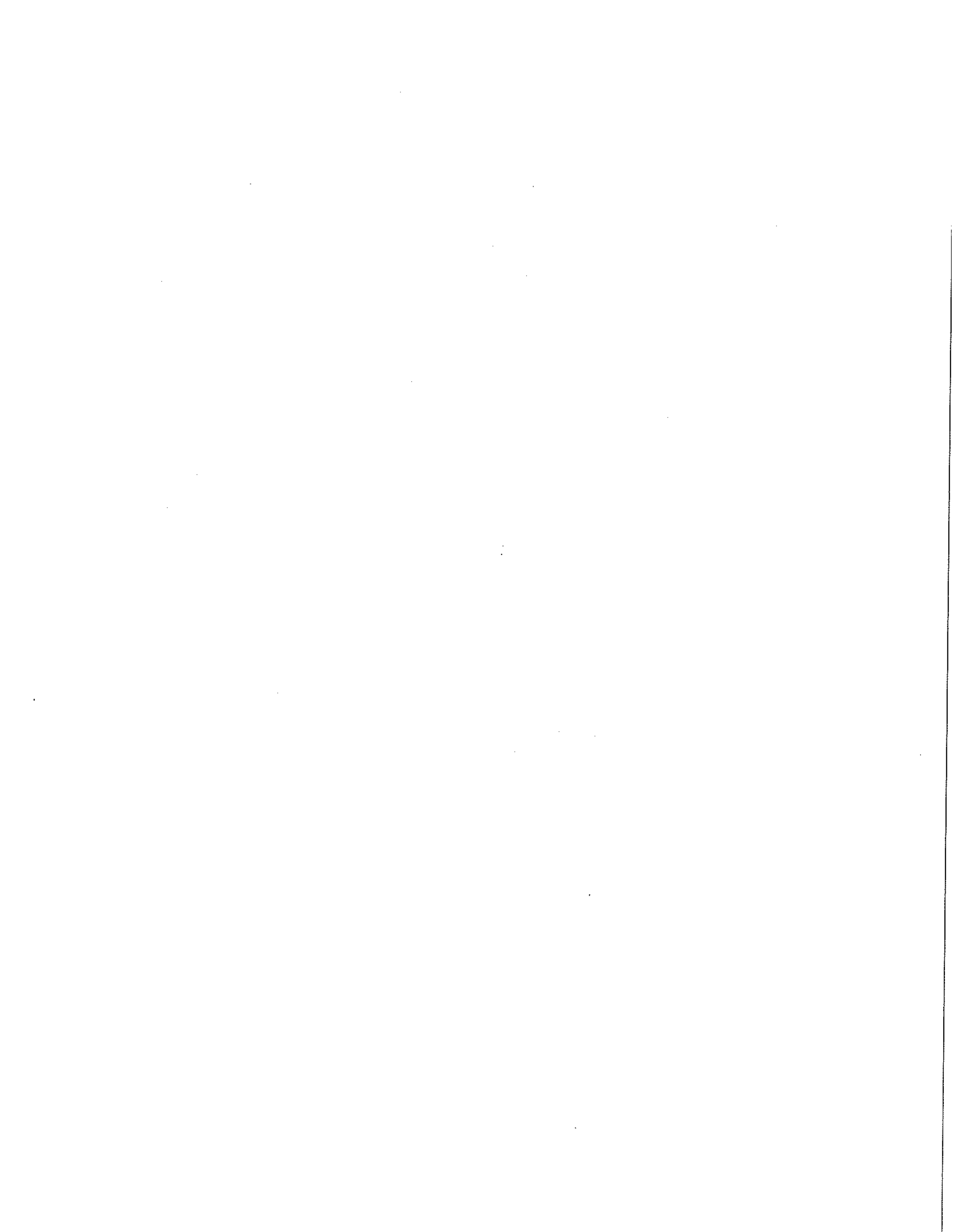
The adjusted leverage and debt to equity ratios are calculated as follows:

$$\text{Adjusted leverage ratio} - \frac{\text{Adjusted liabilities + guarantees outstanding}}{\text{Adjusted equity}}$$

$$\text{Adjusted debt to equity ratio} - \frac{\text{Adjusted liabilities}}{\text{Adjusted equity}}$$

The following table provides the calculated ratio for leverage and debt to equity, as well as the adjusted ratio calculations, as of the five years ended May 31, 2010.

	May 31,				
	2010	2009	2008	2007	2006
Leverage ratio	35.33	41.88	29.01	25.84	24.13
Adjusted leverage ratio	6.34	7.06	7.48	6.82	6.40
Debt to equity ratio	33.33	39.42	27.49	24.37	22.79
Adjusted debt to equity ratio	5.93	6.59	7.04	6.39	5.98



Attachment C

Electric Distribution Cooperatives Report Strong Financial Results During Economic Downturn

For Release: July 31, 2009

Contact: Mike O'Brien (703) 709-6709, Andrew Don (703) 709-6869

HERNDON, VA—National Rural Utilities Cooperative Finance Corporation (National Rural) (NYSE: NRU) (NYSE: NRN) (NYSE: NRC) announced today final results from its annual Key Ratio Trend Analysis (KRTA), an annual assessment of financial trends among electric distribution cooperatives nationwide. This year's KRTA shows that distribution cooperatives maintained their overall financial strength during challenging economic times.

"The nation's electric distribution cooperatives again reported strong financial results. They did a good job of piloting their systems through difficult economic waters in 2008. Revenue kept pace with higher costs and margins remained strong, keeping financial ratios stable," said National Rural Governor and CEO Sheldon C. Petersen.

The KRTA report is based on data submitted by 819 distribution cooperatives for the year ending Dec. 31, 2008. Petersen identified three major findings in the data:

Revenues kept pace with rising fuel costs in 2008. Total operating revenue per kilowatt hour (kwh) sold shows a nearly 6.5-percent increase compared with 2007, an indication that distribution cooperatives are taking the necessary steps—using fuel adjustments or increasing rates—to meet expenses.

During 2008, distribution cooperative wholesale power and other costs increased, with power costs per kwh sold increasing 7.2 percent over the prior year while total operating expenses per kwh sold went up 2.9 percent. "Overall, revenue increases were sufficient to overcome rising costs," Petersen said.

Primary financial ratios—such as equity as a percent of assets, times interest earned ratio (TIER), modified debt service coverage (MDSC)—and aggregate cash and cash equivalent numbers remained stable. The equity as a percent of assets median ratio for 2008 remained healthy at 40.62 percent.

TIER was up slightly at 2.27; this is well above the 1.25 TIER required by systems that borrow from the USDA Rural Utilities Service. MDSC, National Rural's primary coverage ratio, was 1.82, well above the 1.35 level required by National Rural.

In addition, theaggregate cash and cash equivalents for distribution cooperatives totaled a strong $2.8 billion at Dec. 31, 2008. "The primary financial ratios and total cash levels remained healthy and stable," Petersen said.

Median growth—in terms of both consumers and kwh sales—remained positive in 2008, and consumers were paying their bills on time. The consumer growth rate—the number of

new consumers—was nearly 1 percent for distribution cooperatives. As a result, the consumer growth rate for distribution cooperatives remained nearly double that of municipal and investor-owned utilities, according to information from the U.S. Energy Information Administration. While electricity demand fluctuates in the short term in response to business cycles, weather events and prices, the median growth rate for kwh sales also remained positive in 2008 at 1.22 percent.

Although the was in recession in 2008, distribution cooperative consumers continued to pay their bills. According to data from the KRTA information, the number of accounts receivable written off as a percentage of operating revenue was only 0.18 percent—unchanged from the previous year. Moreover, the number of accounts receivable past due more than 60 days as percentage of operating revenue actually declined slightly from the prior year to 0.17 percent.

Other key findings in the 2008 financial highlights of electric distribution cooperatives include the following KRTA *composite* numbers:

The aggregate total megawatt hour (mwh) sales of all 819 rural electric distribution systems grew 1.91 percent in 2008 to reach 396,832,711 mwh.

In 2008, total mwh sales by class of service showed residential consumers at 56 percent, commercial accounts at 19 percent, industrial accounts at 20 percent, irrigation at about 2 percent and other at about 2 percent.

Distribution cooperatives added a total of 267,042 new residential households in 2008.

Distribution cooperatives' gross utility plant investment totaled more than $78 billion in 2008.

The following *median* numbers also are included in the 2008 KRTA data:

Total operating revenue per kwh sold in 2008 increased to 97.15 mills. (One mill equals one-tenth of one cent.)

Total operatingexpenses per kwh sold in 2008 rose slightly to 19.60 mills.

Total margins per kwh sold in 2008 rose slightly to 6.13 mills.

About CFC

National Rural Utilities Cooperative Finance Corporation (CFC) is a cooperative that serves the nation's rural utility systems, the majority of which are electric cooperatives. With $20 billion in assets, National Rural provides its member-owners with an assured source of market-priced capital and financial products and services.

CFC's use of Derivatives, 1998 - 2010

Year	Deal Count	Notional
1998	42	1,334,710,896
1999	11	974,350,000
2000	32	3,998,853,500
2001	40	7,617,378,573
2002	21	6,514,500,000
2003	45	4,433,402,643
2004	14	1,058,531,800
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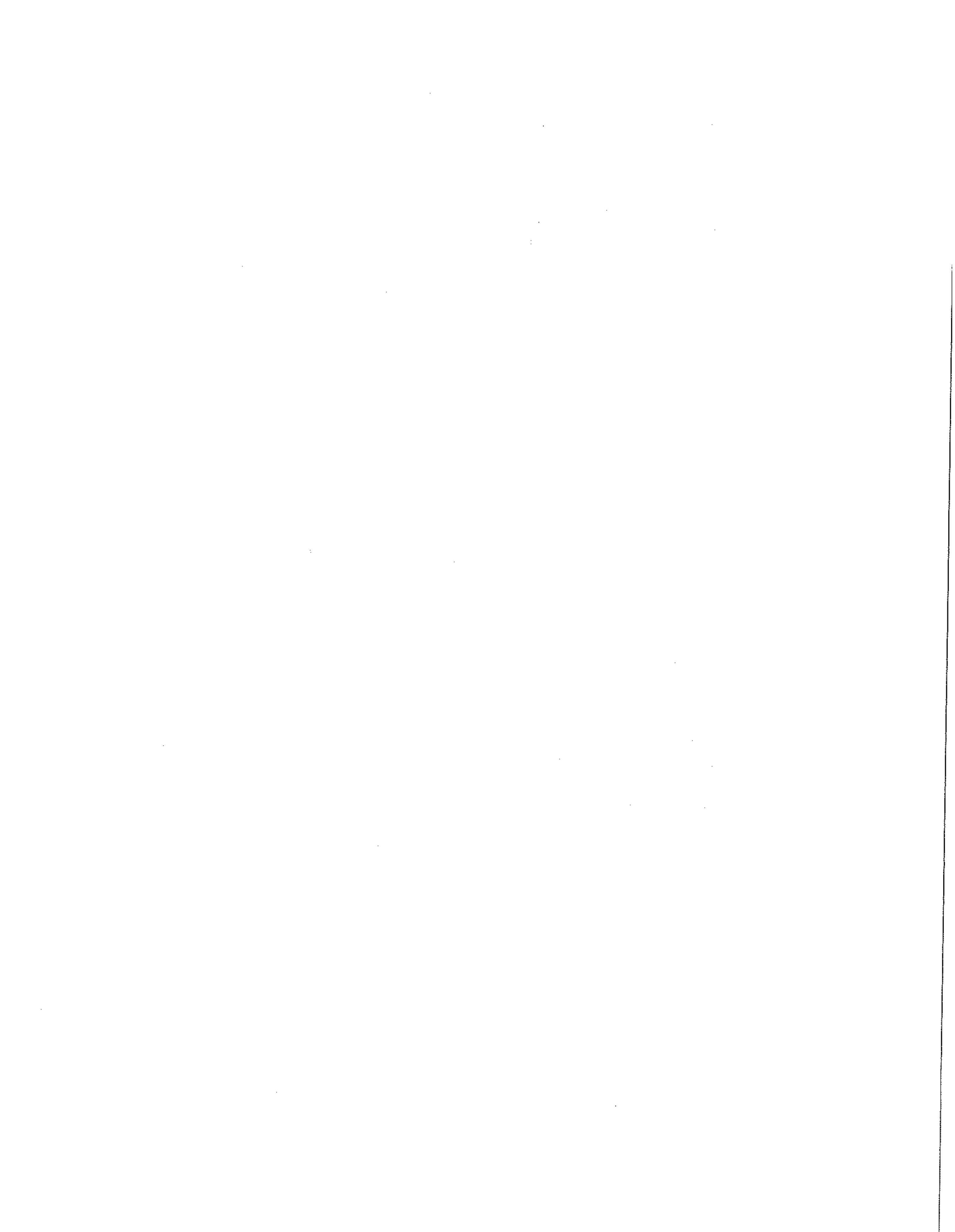

National Rural Utilities
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A Touchstone Energy® Cooperative

Follow-Up Communication to CFTC

The National Rural Utilities Cooperative Finance Corporation (CFC) greatly appreciated the opportunity to meet with CFTC staff on January 13, 2011 to discuss our views regarding the CFTC's Dodd-Frank Act (DFA) rulemaking initiatives. We are providing this additional information to follow up on certain questions and issues raised at that meeting.

As we noted to CFTC staff on January 13, we also plan to submit formal comment letters in connection with the CFTC rulemakings on Definitions and on the End-User Exception to Mandatory Clearing of Swaps, both due by February 22, 2011.

We welcome the opportunity to answer any additional questions the CFTC may have based on this document, and are available for further discussions in advance of our submission of comments on February 22.

- **CFC's use of "adjusted equity" and "adjusted leverage."**

  As we discussed at the January 13 meeting, CFC uses certain non-GAAP financial measures: "adjusted equity" and "adjusted leverage." We suggest that these alternative measures be considered in lieu of – or in addition to – the GAAP-based measures the CFTC has proposed to use when assessing whether a financial entity is "highly leveraged relative to the amount of capital it holds."[1] After our meeting, we provided CFTC staff with relevant excerpts from our most recent filing with the Securities and Exchange Commission (SEC) on Form 10-K showing our use of the "adjusted equity" and "adjusted leverage" measures.

  At the meeting, CFTC staff inquired as to when we began using these adjusted measures. From the inception of CFC in 1969, all of our debt indentures have treated member subordinated certificates as equity for purposes of covenant compliance, and ratings agencies have given equity credit for our member subordinated certificates. We implemented SFAS 133, Accounting for Derivative Instruments and Hedging Activities, on June 1, 2001 and started reporting these measures throughout fiscal year 2002, starting in the August 31, 2001 10-Q.

  In addition, as we have discussed, because of our cooperative and tax structure, CFC is prohibited from issuing common equity to the public. Instead, CFC has issued long-dated subordinated debt securities, primarily to our member-owners, and these securities are included as part of CFC's "adjusted equity" for purposes of calculating CFC's adjusted leverage ratio. CFC's creditors and rating agencies have treated these long-term subordinated debt securities as the functional equivalent of core capital.

[1] The CFTC has proposed to define "highly leveraged" as "the existence of a ratio of an entity's total liabilities to equity in excess of [8 to 1 or 15 to 1] as measured at the close of business on the last business day of the applicable fiscal quarter. For this purpose, liabilities and equity should each be determined in accordance with U.S. generally accepted accounting principles."

We request that the CFTC modify its proposed definition of "highly leveraged" to take into account these subordinated debt securities, particularly for a cooperative entity like CFC that is prohibited from issuing common equity, is not a depository institution, and has an established practice of reporting adjusted leverage ratios that include its long-dated subordinated debt securities as part of its adjusted equity.

We believe that the long-dated subordinated debt instruments held by our member-owners (i.e., our membership subordinated certificates, loan and guarantee certificates, and member capital securities) should be treated as the functional equivalent of regulatory capital.

As we have noted, there is precedent for this in the bank regulatory context; banks and other depository institutions are allowed to include instruments other than common equity when calculating their regulatory capital. For instance, the capital regulations of the Office of Thrift Supervision (OTS) currently permit mutual savings associations to include pledged deposits and nonwithdrawable accounts in Tier 1 capital to the extent that such accounts or deposits have no fixed maturity date, cannot be withdrawn at the option of the accountholder, and do not earn interest that carries over to subsequent periods.[2] The capital regulations of the Office of the Comptroller of the Currency (OCC) also currently allow the inclusion of hybrid securities, which possess features of both debt and equity, in Tier 2 capital without limit and in Tier 1 to a limited extent.[3] These securities must meet the following requirements:

- The instrument must be unsecured, subordinated to the claims of depositors and general creditors, and fully paid-up;
- The instrument must not be redeemable at the option of the holder prior to maturity, except with prior regulatory approval;
- The instrument must be available to participate in losses while the issuer is operating as a going concern (in this regard, the instrument must automatically convert to common stock or perpetual preferred stock, if the sum of the retained earnings and capital surplus accounts of the issuer shows a negative balance); and
- The instrument must provide the option for the issuer to defer principal and interest payments, if
  - The issuer does not report a net profit for the most recent combined four quarters, and
  - The issuer eliminates cash dividends on its common and preferred stock.[4]

[2] 12 CFR § 567.5(a)(1)(iv).
[3] *See* 12 CFR part 3 App. A (National banks may include in Tier 2 capital "Hybrid capital instruments, without limit. Hybrid capital instruments are those instruments that combine certain characteristics of debt and equity, such as perpetual debt"). We note that under rules to be issued pursuant to the Dodd-Frank Act, certain hybrid securities will be phased out of inclusion as Tier 1 capital but will remain eligible for inclusion as Tier 2 capital.
[4] 12 CFR part 3 App. A.

Our subordinated debt instruments that we include in our adjusted equity calculation are held by our member-owners and share characteristics with such instruments. As described in our previous submission to the CFTC, these instruments are available to absorb losses. They also do not have redemption features that would permit a holder to withdraw funds before maturity, and have long-dated maturities. Further, CFC has the right to offset the member's investment in the member capital instruments against any amounts the member may owe CFC. This offset right has been utilized by CFC to mitigate loan losses. CFC's member capital securities also have an interest deferral right.

- **We suggest language such as the following to clarify the definition of "highly leveraged":**
  - "In the case of a nonprofit tax-exempt cooperative that is not a depository institution, 'equity' shall be calculated to include subordinated debt issued by such cooperative and held by the member-owners of such cooperative."
  - "Each entity that believes it falls into this category shall describe in writing to the CFTC and the SEC the nature of its nonprofit, tax-exempt, cooperative structure, and its associated public purpose and the amounts and characteristics of its subordinated debt."

- **Why CFC's participation in clearing is not needed for the system to work – CFC is not needed as "the engine that makes clearing run."**

We understand that there is a concern that a clearing system must have a sufficient number of participants and volume of deals in order to operate efficiently and robustly. However, CFC's volume of derivatives activity is relatively low, and thus our absence from the clearing system should not have a major impact on its ability to function. As shown in the attached chart, we had only 7 trades in 2010, and have averaged only 15 trades a year since 1998.

- Please see Attachment A for a list of swaps we have entered into since 1998 by year, number of trades, and notional amount.

- **Why CFC should not be deemed a "financial entity" and allowed to make use of the clearing exemption.**

CFC appreciates the CFTC's expressed willingness to consider the possibility that CFC should not be deemed a "financial entity," a designation that would prevent CFC from claiming an exemption from mandatory clearing. We agree that CFC is not a "financial entity" as we understand that term generally to be used. The term most aptly describes depository institutions and other for-profit entities, in contrast to an entity like CFC that was created and is controlled by nonprofit entities for which it serves as a non-governmental financing arm – essentially an extension of its nonprofit member-owners, which are not "financial entities" themselves.

It is important to keep in mind that CFC's use of derivatives is similar to that of entities that do qualify for an exemption from clearing under DFA – in fact, we are owned solely by such entities. CFC uses derivatives to hedge or mitigate only the commercial risk that arises from

its lending to its member-owners, in contrast to speculative users of derivatives, who make "bets" based on occurrences of events having no relation to the user's own business. CFC was created by rural electric cooperatives in 1969 for the purpose of providing financing to those cooperatives and is limited in its ability to operate for any other purpose. The rural electric cooperatives that own CFC also use derivatives to hedge or mitigate their own commercial risk, and do qualify for DFA's end-user clearing exemption. We believe not extending such an exemption to CFC would be an illogical result, because we exist solely to provide financing to those end users and we do not take speculative or investment positions.

The DFA definition of "financial entity" includes entities "predominantly engaged in activities that are in the business of banking, or financial in nature, as defined in section 4(k) of the Bank Holding Company Act." While such activities include lending, CFC does not engage in the business of lending in a manner akin to the way depository institutions engage in the business of lending, or in other activities in the business of banking. For instance, while banks engage in lending to the public in order to make a profit, CFC is a nonprofit cooperative that lends only to its members and exists to serve its members rather than the general public.

- **We suggest language such as the following to clarify the definition of "financial entity":**
  - " 'Financial entity' does not include: a nonprofit tax-exempt cooperative that is not a depository institution and a majority of whose members are nonprofit tax-exempt cooperatives that are not financial entities."
  - "Each entity that believes it falls into this category shall describe in writing to the CFTC and the SEC the nature of its nonprofit, tax-exempt cooperative structure, and its associated public purpose."

We encourage the CFTC to also consider the following two additional avenues for exemption under the DFA statutory language:

- ***CFC should qualify for the end-user clearing exception as an affiliate of end users.***

  DFA provides an affiliate exception to the "financial entity" definition that could apply to CFC. Under the affiliate exception, "An affiliate of a person that qualifies for [the end-user exception] may qualify for the exception only if the affiliate, acting on behalf of the person and as an agent, uses the swap to hedge or mitigate the commercial risk of the person or other affiliate of the person that is not a financial entity."

  As noted in the proposed rule, the CFTC has leeway in how it chooses to define "affiliate." We encourage the CFTC to choose to define this term, and to write the regulation implementing this provision of DFA, in a manner so as to allow activities such as CFC's to come under the affiliate exception.

- CFC uses swaps to hedge risk that arises from lending to its members, which own CFC and control CFC on a "one member, one vote" basis, and thus could be characterized as affiliates of CFC.
- CFC's use of derivatives is done "on behalf of" its members because (1) those members own CFC and CFC exists only to serve its members; and (2) CFC's goal in using derivatives is to manage risks for all CFC members while allowing each individual member to obtain financing on terms it prefers.
- CFC's members qualify for the end-user exception.
- Since our members are in the business of producing and distributing electricity, and not managing a derivative portfolio, CFC enters into derivatives contracts itself, since it has the professional expertise, credit rating, accounting functions, and banking relationships necessary to do so.
- The majority of CFC members will not be able to execute standalone derivatives themselves, because their banking relationships are with smaller regional banks that do not offer this service. Furthermore, a member would have to have either a short-term/long-term credit rating or an established banking relationship with a large money center bank in order to execute derivatives itself. Only the larger, more sophisticated CFC member cooperatives have the latter, and thus the majority of the cooperatives are at a disadvantage. CFC fills the void for smaller cooperatives looking for the same pricing flexibility and cost advantage that larger cooperative systems enjoy.

- **We suggest language such as the following to clarify the application of the affiliate exception:**
  - "For purposes of this section, an 'affiliate' of a person includes a nonprofit, tax-exempt cooperative (i) of which the person is a member, and (ii) which is not a depository institution."
  - "Each entity that believes it falls into this category shall describe in writing to the CFTC and the SEC the nature of its nonprofit, tax-exempt cooperative structure, and its associated public purpose."
  - "For purposes of this section, 'acting on behalf of the person and as an agent' includes: (a) hedging or mitigating a risk that arises from financing provided to the person by an affiliate of that person; or (b) acting for the benefit of that person."

- ***CFC should qualify for the exception for financing of a parent company's products.*** This exception excludes from the definition of "financial entity" "an entity whose primary business is providing financing, and uses derivatives for the purpose of hedging underlying commercial risks related to interest rate and foreign currency exposures, 90 percent or more of which arise from financing that facilitates the purchase or lease of products, 90 percent or more of which are manufactured by the parent company."

- More than 90% of CFC's business consists of providing financing to its rural electric system member-owners and their related organizations.
- CFC uses derivatives to hedge interest rate risk related to its financing business.

- Collectively, CFC's member-owners are analogous to the "parent company" of CFC. While CFC is not a subsidiary of any other entity, it is a cooperative formed and sustained by the collective effort of its members to serve those members by providing them with financing.
- CFC's member-owners are in the business of generating and/or distributing electricity.
- Thus, CFC uses derivatives to hedge interest rate risks which arise from the financing of a product – electricity – which is manufactured and/or distributed by its nonprofit rural electric cooperative member-owners.

➢ **We suggest language such as the following:**

- "For purposes of this section, 'Financing that facilitates the purchase or lease of products' shall include financing that facilitates the provision of electric service."
- "For purposes of this section, 'manufacturing' includes the generation, transmission, and/or distribution of energy, such as electricity."
- "For purposes of this section, 'parent company' shall include the members of a nonprofit tax-exempt cooperative that is not a depository institution."
- "Each entity that believes it falls into this category shall describe in writing to the CFTC and the SEC the nature of its nonprofit, tax-exempt cooperative structure, and its associated public purpose."

CFC appreciates this opportunity to present this information to the CFTC. Should you have any questions or need additional information, please contact Richard E. Larochelle, Senior Vice President of Corporate Relations, at (703) 709-6794 or Rich.Larochelle@nrucfc.coop.

Attachment A

CFC's use of Derivatives, 1998 - 2010

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