

MEMORANDUM

TO: File No. S7-39-10
FROM: Richard Grant
RE: Meeting with Representatives of the National Rural Utilities Cooperative
Finance Corporation (“CFC”)
DATE: January 13, 2011

On January 13, 2011, representatives from the Securities and Exchange Commission (“SEC”) and the Commodity Futures Trading Commission (“CFTC”) participated in a meeting with representatives from the National Rural Utilities Cooperative Finance Corporation (“CFC”). The SEC representatives, all of whom participated telephonically, were Josh Kans, Peter Curley, and Richard Grant. The CFTC representatives, all of whom were present at the meeting, were David Aron, Thelma Diaz, Lee Ann Duffy, Mark Fajfar, Steve Kane, Carl Kennedy, and Nela Richardson. The CFC representatives, all of whom were present at the meeting, were Thomas E. Kandel (CFC), Rich Laroche (CFC), John F. Suter (CFC), Ed Barron (Russell Barron), and Elizabeth A. Khalil (Hogan Lovells).

At the meeting, the CFC representatives provided their views and observations on the proposed rules to further define the terms “swap dealer,” “security-based swap dealer,” “major swap participant,” “major security-based swap participant,” and “eligible contract participant” (File No. S7-39-10) and related issues.

[No agenda available for this meeting.]



**National Rural Utilities
Cooperative Finance Corporation**

National Rural Utilities Cooperative Finance Corporation (CFC)

Implementation of
Dodd-Frank Act
2011



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A. Introduction to CFC

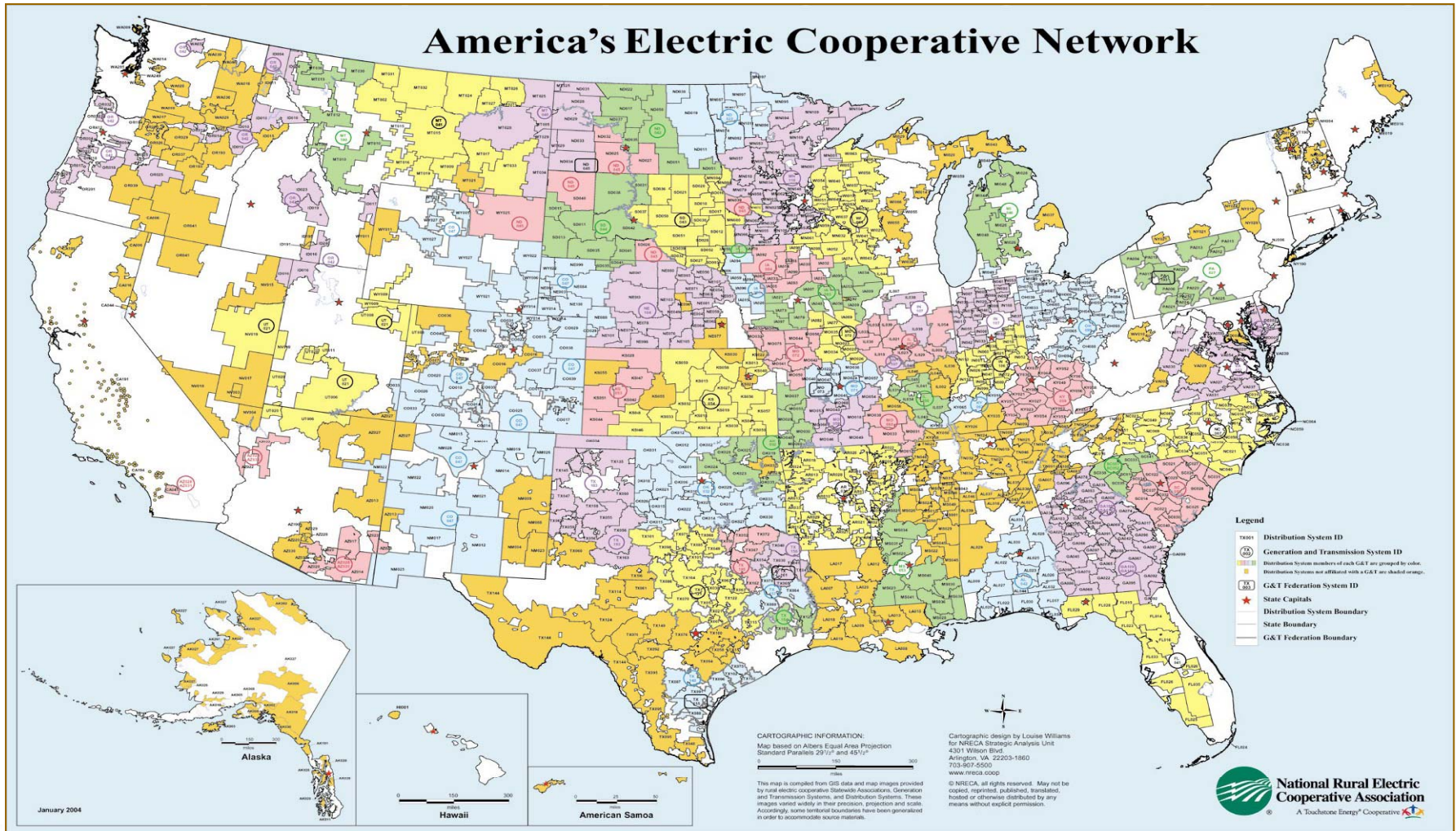


CFC is an Important Source of Capital to Utilities in Rural America

- **Member-owned cooperative association**
 - Established in 1969; owned by America's electric cooperatives
 - Private financing arm of America's rural utility systems
- **CFC's owners can qualify as commercial end users under DFA.**



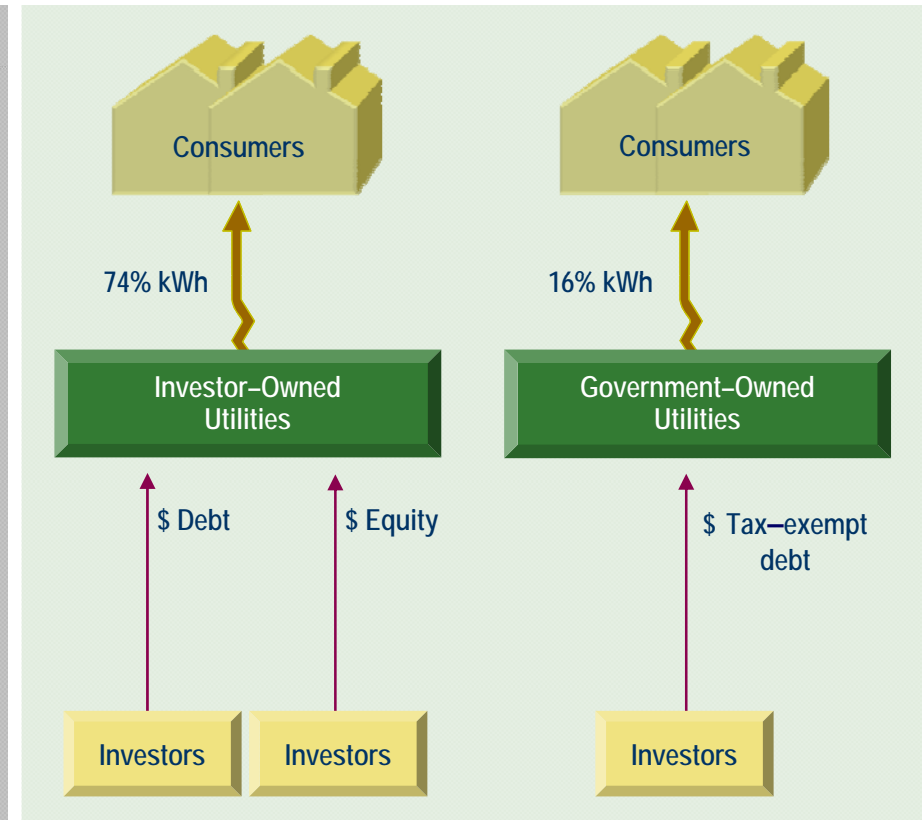
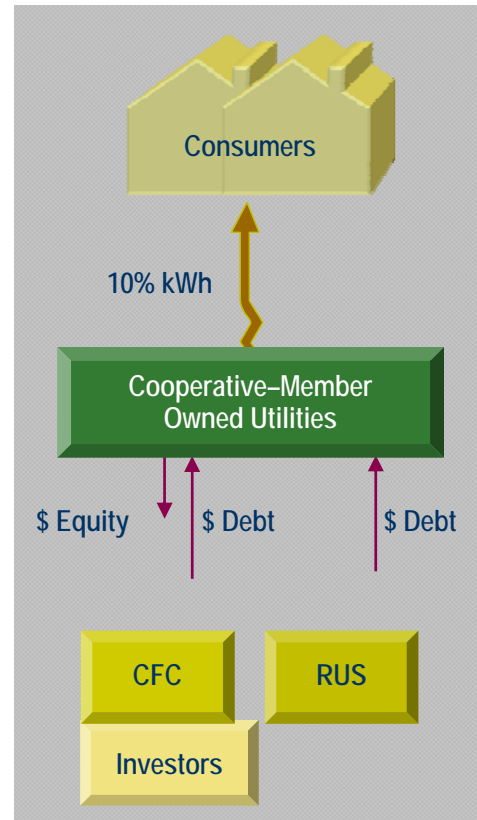
CFC's Purpose is to Provide Financing so that Electric Cooperatives can Provide Electric Power to Rural America.





Electric Cooperatives: A Small But Important Segment of the Industry

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





Rural Electric Cooperatives – Principles & Values

1. **Voluntary and open membership** – Are open to all persons able to use their services and willing to accept the responsibilities of membership.
2. **Democratic member control** – Cooperatives are democratic organizations controlled by their members, who participate in setting their policies and making decisions.
3. **Member economic participation** – Members contribute equitably to, and democratically control, the capital of their cooperative. At least part of that capital is usually the common property of the cooperative.
4. **Autonomy and independence** – Cooperatives are autonomous corporations controlled by their members. If they enter into agreements with other organizations, including governments, or raise capital from external sources, they do so on terms that ensure democratic control by members and maintain their cooperative autonomy.
5. **Consumer education to members** – Cooperatives provide education, training and information for their members so they can contribute effectively to the development of their cooperatives.
6. **Cooperation among cooperatives** – Serve their members most effectively and strengthen the cooperative movement by working together through local, national, regional and international structures.
7. **Concern for community** – While focusing on member needs cooperatives work for the sustainable development of their communities through policies accepted by members.

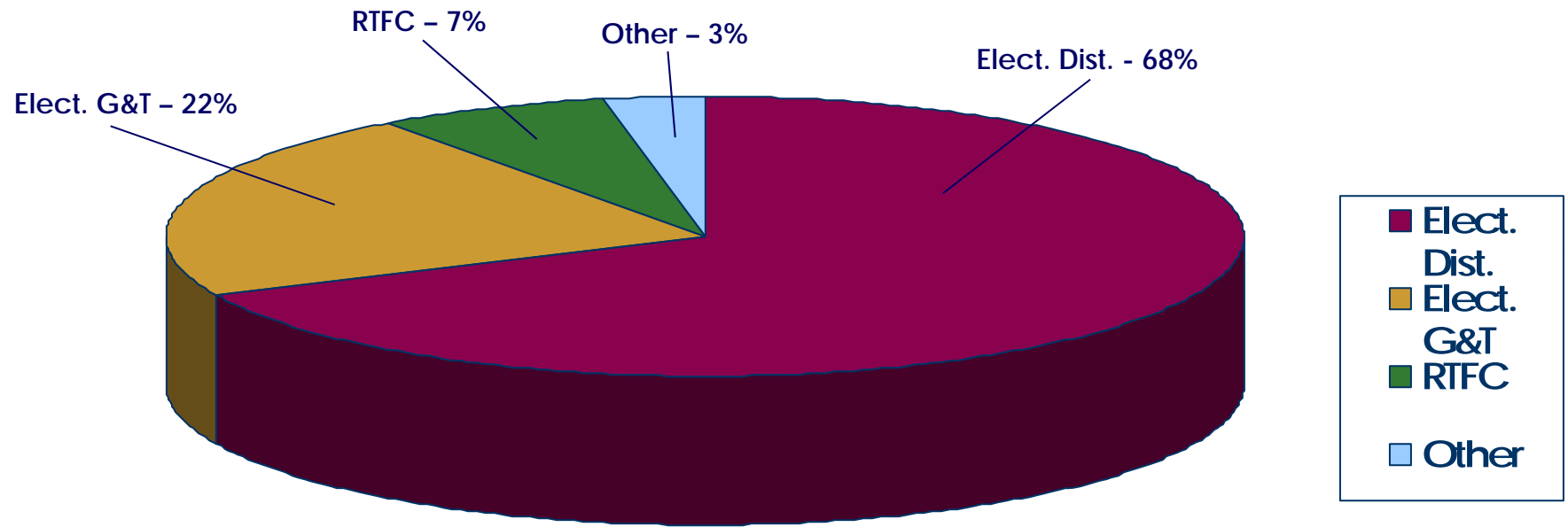


As a Cooperative CFC is Owned by and Exclusively Serves its Members

Members	System Functions
Distribution Cooperatives	Most electric cooperatives are distribution utilities purchasing wholesale power from others to distribute it, over their own distribution lines, to the ultimate customer.
Power Supply (Generation & Transmission) Cooperatives	Generation and transmission cooperatives carry high voltage electricity from generation facilities over long distances. G&Ts provide both generation and transmission functions.
Statewide and Associate Members	Most states have statewide associations supported by local cooperatives in that state. Provides a variety of services and legislative representation for members.
Rural Telephone Finance Cooperative (RTFC)	Affiliated business line for lending to rural telephone companies and their affiliates.
National Cooperative Services Corporation (NCSC)	Affiliated business line for providing financing to the for-profit or non-profit entities that are owned, operated or controlled by or provide substantial benefit to, members of CFC.



Loan and Guarantee Portfolio Overview



As of August 31, 2010



CFC's Public Purpose

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



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

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



CFC Is Committed to Strong Corporate Governance

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



CFC's Metrics and Capital Structure Differ from For-Profit Banks and Savings and Loan Institutions.

- Because of its nonprofit cooperative and tax exempt status, CFC is unable to issue equity securities.
- Instead of Equity Securities, CFC issues long-dated subordinated debt (Capital Term Certificates) to its members. These securities and retained earnings provide "equity like" comfort to investors in CFC securities.
- CFC's Capital Structure and use of "Adjusted Equity" and other metrics has been well accepted for 40 years by rating agencies and creditors who have recognized the prudent and conservative nature of our financial structure.
- CFC requests that the CFTC not rely solely on GAAP or for-profit banking standards to determine whether an entity is "highly leveraged".



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Background of NRUCFC

- **National Rural Utilities Cooperative Finance Corporation is a member-owned, non-governmental organization that provides financial products to 1,526 member systems consolidated across the United States of America.**
 - » **The Company offers full-service financing, investment, and related services to its members, and offers a wide range of flexible, low-cost financing programs and interest rate options.**
 - » **Headquartered in Herndon, Virginia, outside of Washington, D.C., the Company raises funds for loan programs with support of its owners' equity and investments through the sale of multiple financing vehicles in the private and public financial markets.**
 - » **The Company is governed by a 23-member board made up of cooperative utility directors and managers. It has approximately 231 employees, including well seasoned regional credit portfolio managers.**
- **Points to Remember:**
 - » **Primary objective is to provide its utility members/owners with an assured source of capital at the lowest reasonable loan and guarantee rates consistent with sound financial performance.**
 - » **Has no exposure to residential mortgages, mortgage-backed securities, collateralized loan or debt obligations, or structured investment vehicles. Financial derivatives only utilized for interest rate and currency hedging.**
 - » **NRUCFC is a member-owned finance company. CFC is not a bond insurance company.**
 - » **Largest non-governmental lender to rural utility industry in the U.S.A with over \$20 billion of gross loans outstanding, and its owners have invested over \$4 billion in a wide array of securities at November 30, 2008.**
 - » **NRUCFC has securities listed on NYSE and is a "Well-Known and Seasoned Issuer" in the public markets. The company is subject to the Sarbanes-Oxley law and is in compliance with all applicable requirements.**



B. How and Why CFC Uses Derivatives



How & Why CFC Uses Derivatives

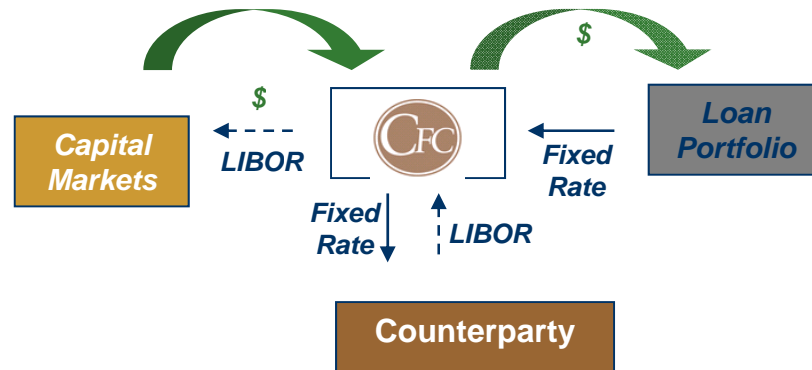
- **Derivative use is limited to plain vanilla interest rate exchange agreements. Since 1993, CFC has executed derivatives for the following reasons:**
 - To practice good risk management
 - To match-fund its fixed and variable loan pools and manage the size of its warehouse/prefund position
 - To provide flexibility in loan structuring and match cash-flows that may have deferral periods, accretions and other types of amortizations
 - To mitigate interest rate risk on forward starting loans
To create lower cost synthetic fixed/floating liabilities vs. issuance in the cash market
 - To limit exposure to exchange rate fluctuations when foreign currency denominated debt is issued. (None currently outstanding.)



CFC uses Derivatives to Hedge Market Interest Rate Risk

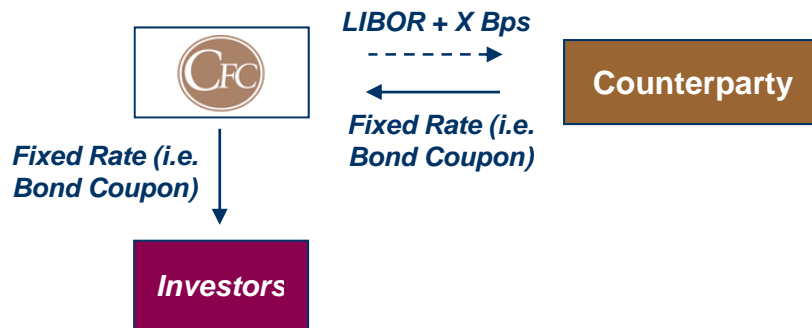
- In this example, CFC receives fixed interest from an aggregate loan portfolio but pays floating LIBOR to capital market investors. This mismatch in interest rate creates exposure, prompting CFC to swap the fixed rate from its loan portfolio to floating.

Pay-Fixed Swap



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

Pay-Floating Swap





Interest Rate Management

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



CFC Enters into Swaps with Highly Rated Counterparties

SWAP PORTFOLIO BY RATING 5.31.2010

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%



CFC Enters into a Limited Number of Swaps Each Year.

Deal Count	Year	Notional
42	1998	1,334,710,896
11	1999	974,350,000
32	2000	3,998,853,500
40	2001	7,617,378,573
21	2002	6,514,500,000
45	2003	4,433,402,643
14	2004	1,058,531,800
35	2005	3,247,134,500
20	2006	1,451,878,525
31	2007	2,945,218,401
25	2008	2,203,708,000
17	2009	1,558,201,100
14	2010	1,091,684,925
347		38,429,552,863



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



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

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



CFC's Credit Rating History

Senior Secured Debt		
Year	Moody's Investors Service	Standard & Poor's Corporation
1972-1973	A	A
1974	A	A+
1975-1978	A	AA
1979-1984	Aa	AA
1985-1989	Aa2	AA
1990	Aa3	A+
1991-1993	Aa3	A+
1994-2000	Aa3	AA
2001	Aa3	AA-
2002-2010	A1	A+



Liquidity Management

- At August 31, 2010, CFC had the following projected liquidity sources available:

<u>Liquidity Source</u>	<u>Amount (\$Millions)</u>
Cash and Cash Equivalents	\$451
Scheduled Loan Amortization & Prepayments ⁽¹⁾	\$1,267
Farmer Mac Revolving Funding Availability ⁽²⁾	\$913
Excess CP and Daily Liquidity Fund ("DLF") ⁽³⁾	\$459
Bank Bid Note Capacity ⁽⁴⁾	\$470
Total	\$3,560

⁽¹⁾ Scheduled loan amortization and expected prepayments over the next twelve months

⁽²⁾ The amount available was reduced to \$513 million due to the issuance of notes totaling \$400 million under these note purchase agreements in September and October 2010.

⁽³⁾ CFC limits the amount of CP and DLF to the amount of backup liquidity available under our bank lines.

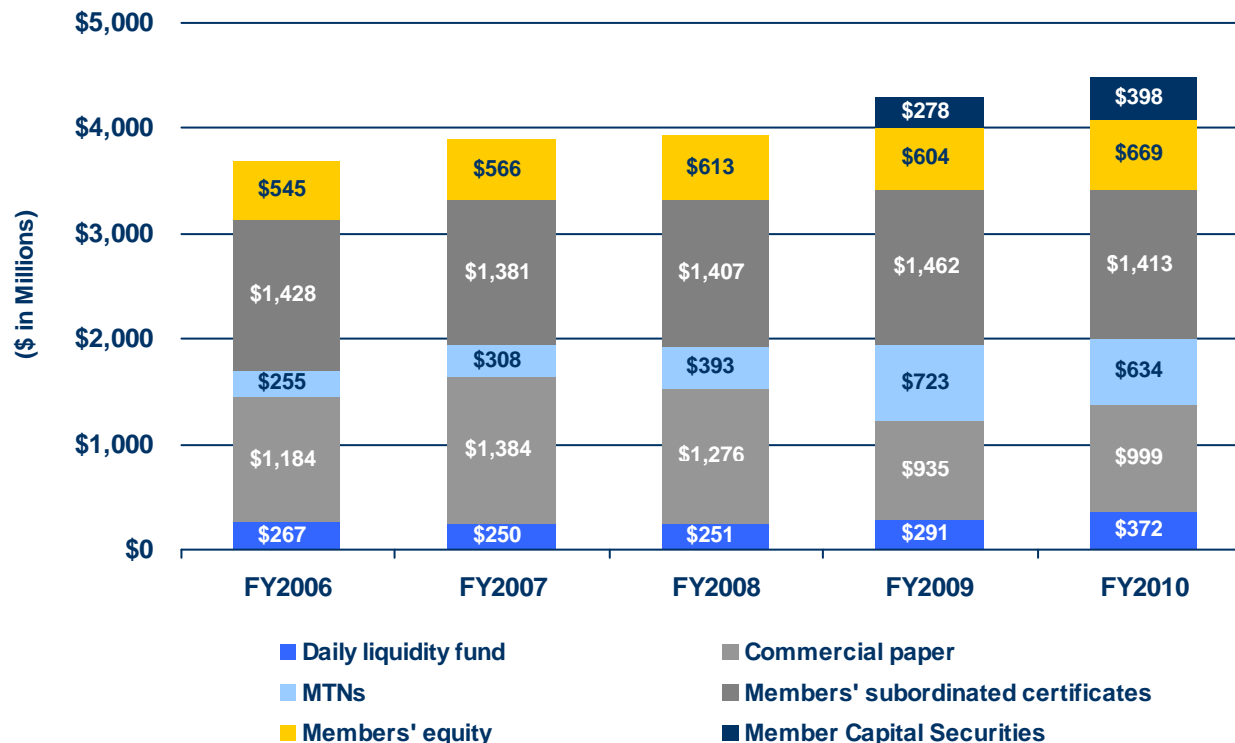
⁽⁴⁾ Unadvanced portion subject to market conditions

- Rural Economic Development Loan & Grant (REDLG) program: \$500 million available commitment in November 2010.
- CFC is a well-known seasoned issuer and believes it has adequate access to both long-term and short-term global funding options.



Strong Member Support

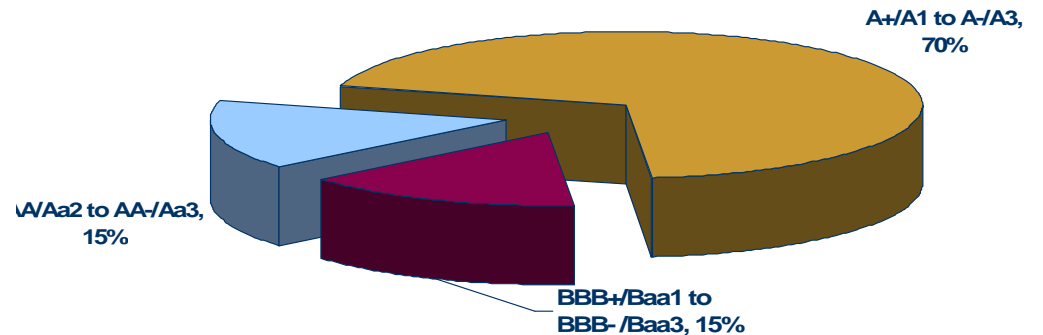
- At May 31, 2010, CFC's members provided more than \$4.4 billion in capital to CFC.
- CFC's members have consistently increased their financial commitment to CFC over the years.





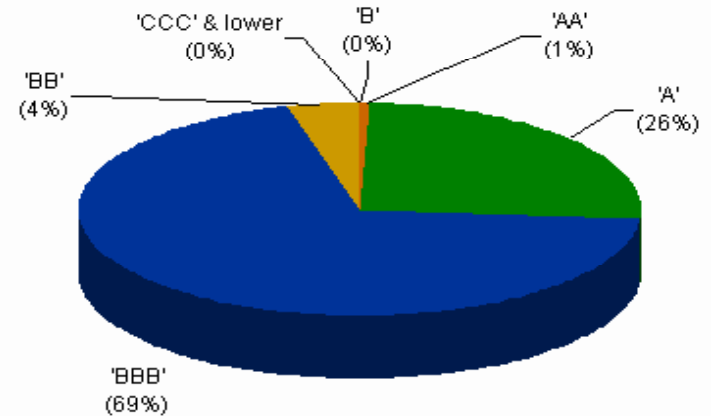
Electric Cooperatives Have Higher Credit Ratings than Investor Owned Electric Utilities

U.S. Publicly Rated Electric Cooperatives (1)



U.S. Shareholder-Owned Electric Utilities (2)

U.S. Utility Ratings Distribution
First-quarter 2010



© Standard & Poor's 2010.

Source: (1) Moody's Investor Service, Standard & Poor's & Fitch Ratings, May 2010

(2) Standard & Poor's, First Quarter 2010

Note: Only about 33 electric co-ops have a public rating.

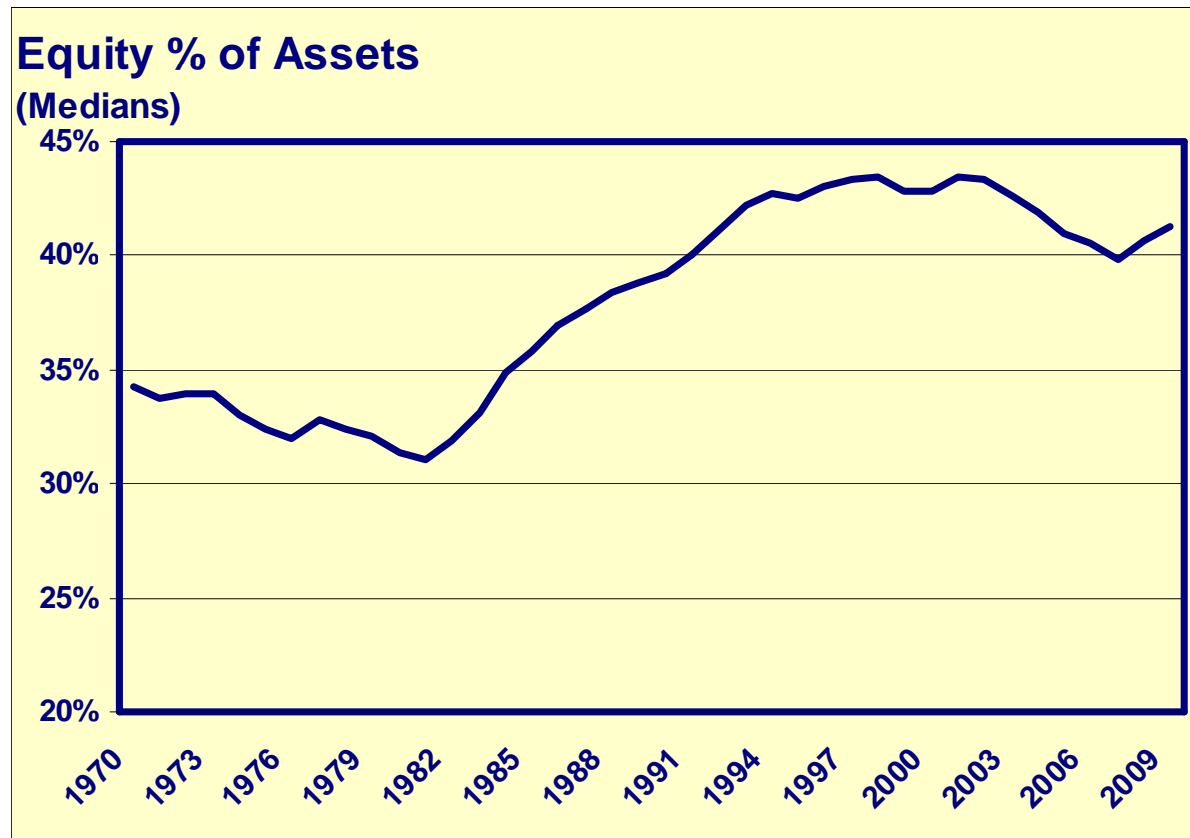


Co-op Ratepayers Have a Strong History of Reliable and Timely Payments of Electric Bills



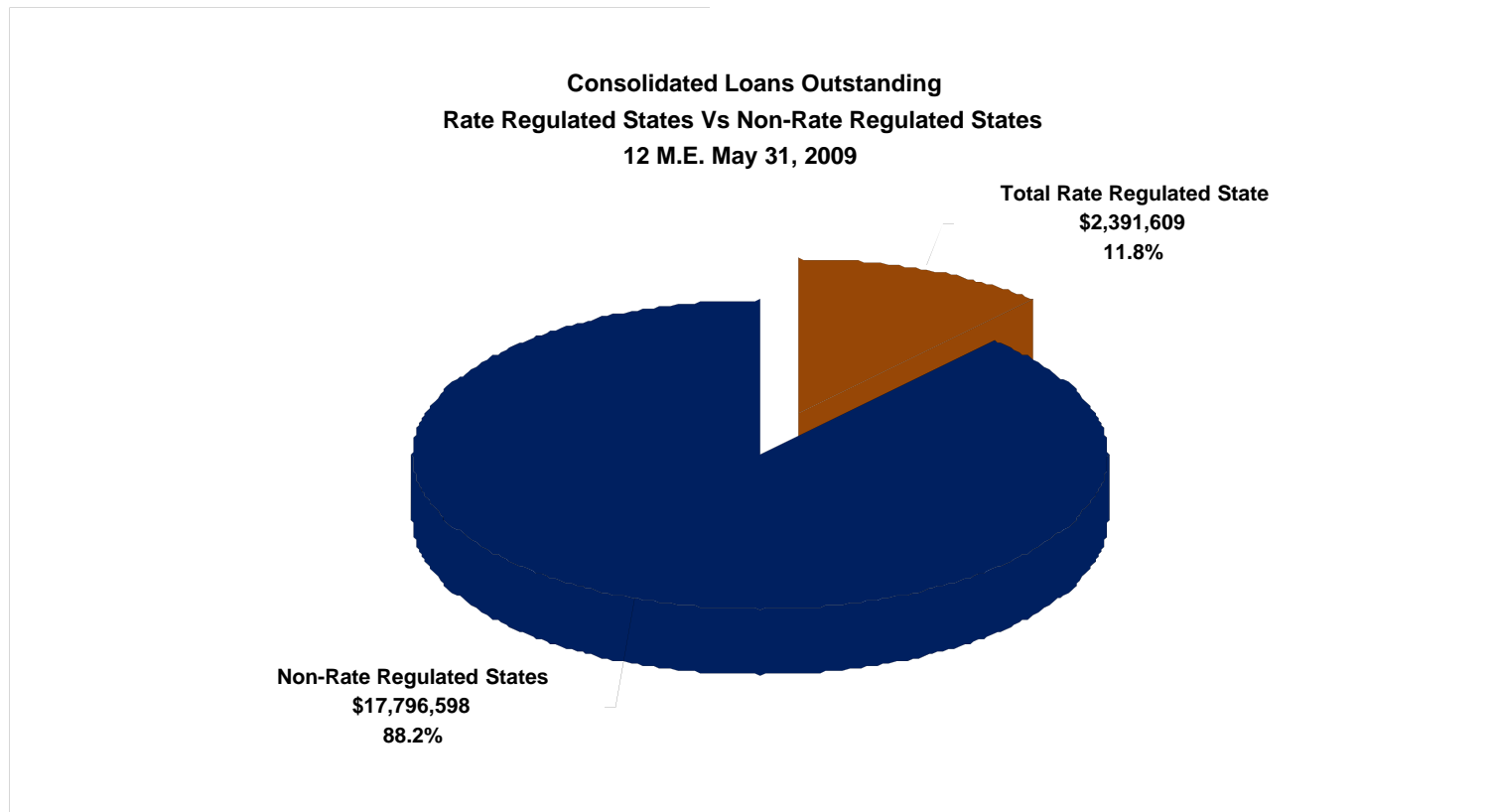


Equity of Rural Electric Distribution Systems





Electric Co-op and CFC Exposure to Adverse Regulatory Orders is Limited

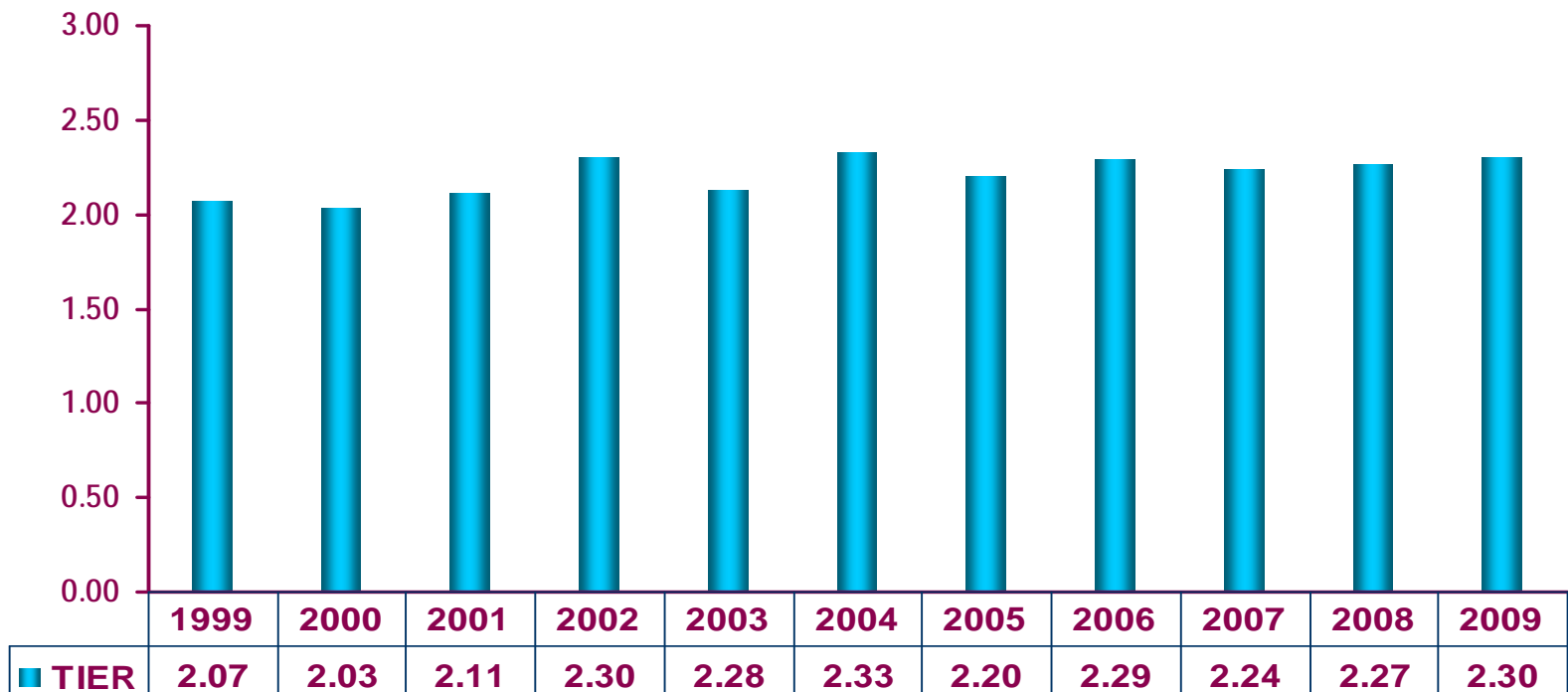


Source: CFC



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

Medians



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



Proposed Margin Requirements

- Existing Derivatives should be exempted.
- Net Out of Money position rather than Notional should be basis for any Margin Requirement.



Annual Cost to CFC if CFTC Regulations Require Collateral Pledging*

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.



CFC's Non-GAAP Measures of Adjusted Leverage and Adjusted Debt to Equity

(dollar amounts in thousands)	May 31,				
	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	<u>16,714,112</u>	<u>\$ 17,675,112</u>	<u>\$ 16,559,391</u>	<u>\$ 15,647,427</u>	<u>\$ 15,717,436</u>
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	<u>\$ 2,820,297</u>	<u>\$ 2,684,039</u>	<u>\$ 2,351,147</u>	<u>\$ 2,450,513</u>	<u>\$ 2,626,459</u>
Guarantees	<u>\$ 1,171,109</u>	<u>\$ 1,275,455</u>	<u>\$ 1,037,140</u>	<u>\$ 1,074,374</u>	<u>\$ 1,078,980</u>

(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.

Source: CFC's Form 10-K, May 31, 2010

CFC's Non-GAAP Measures of Adjusted Leverage and Adjusted Debt to Equity (cont.)

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	<u>35.33</u>	<u>41.88</u>	<u>29.01</u>	<u>25.84</u>	<u>24.13</u>
Adjusted leverage ratio	<u>6.34</u>	<u>7.06</u>	<u>7.48</u>	<u>6.82</u>	<u>6.40</u>
Debt to equity ratio	<u>33.33</u>	<u>39.42</u>	<u>27.49</u>	<u>24.37</u>	<u>22.79</u>
Adjusted debt to equity ratio	<u>5.93</u>	<u>6.59</u>	<u>7.04</u>	<u>6.39</u>	<u>5.98</u>

Source: CFC's Form 10-K, May 31, 2010