NATIONAL RURAL UTILITIES COOPERATIVE FINANCE CORP /DC/
Form 10-K
August 28, 2013

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-K

x ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the fiscal year ended May 31, 2013

OR

o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the Transition Period From To

Commission File Number 1-7102

NATIONAL RURAL UTILITIES COOPERATIVE
FINANCE CORPORATION

(Exact name of registrant as specified in its charter)

DISTRICT OF COLUMBIA
(State or other jurisdiction of incorporation or organization)

52-0891669
(I.R.S. Employer Identification Number)

20701 COOPERATIVE WAY, DULLES, VA 20166
(Address of principal executive offices)
(Registrant’s telephone number, including area code, is 703-467-1800)

Securities registered pursuant to Section 12(b) of the Act:

Title of each class	Name of each exchange on which registered	Title of each class	Name of each exchange on which registered
7.20% Collateral Trust Bonds, due 2015	NYSE	7.35% Collateral Trust Bonds, due 2026	NYSE
	NYSE		

6.55% Collateral Trust
Bonds, due 2018

Securities registered pursuant to Section 12(g) of the Act: None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes x No ¨

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Act. Yes ¨ No x

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No ¨

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§229.405 of this chapter) is not contained herein, and will not be contained, to the best of the registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. x

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer", "accelerated filer," and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer ¨ Accelerated filer ¨ Non-accelerated filer x Smaller reporting company ¨

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes ¨ No x

The Registrant does not issue capital stock because it is a tax-exempt cooperative.

TABLE OF CONTENTS

CAUTIONARY NOTE REGARDING FORWARD-LOOKING STATEMENTS

This Form 10-K contains forward-looking statements defined by the Securities Act of 1933, as amended, and the Exchange Act of 1934, as amended. Forward-looking statements, which are based on certain assumptions and describe our future plans, strategies and expectations, are generally identified by our use of words such as “intend,” “plan,” “may,” “should,” “will,” “project,” “estimate,” “anticipate,” “believe,” “expect,” “continue,” “potential,” “opportunity” and sin expressions, whether in the negative or affirmative. All statements about future expectations or projections, including statements about loan volume, the adequacy of the loan loss allowance, operating income and expenses, leverage and debt-to-equity ratios, borrower financial performance, impaired loans, and sources and uses of liquidity, are forward-looking statements. Although we believe that the expectations reflected in our forward-looking statements are based on reasonable assumptions, actual results and performance could materially differ. Factors that could cause future results to vary from current expectations include, but are not limited to, general economic conditions, legislative changes including those that could affect our tax status, governmental monetary and fiscal policies, demand for our loan products, lending competition, changes in the quality or composition of our loan portfolio, changes in our ability to access external financing, changes in the credit ratings on our debt, valuation of collateral supporting impaired loans, charges associated with our operation or disposition of foreclosed assets, regulatory and economic conditions in the rural electric industry, non-performance of counterparties to our derivative agreements and the costs and effects of legal or governmental proceedings involving CFC or its members. Some of these and other factors are discussed in our annual and quarterly reports previously filed with the U.S. Securities and Exchange Commission (“SEC”). Except as required by law, we undertake no obligation to update or publicly release any revisions to forward-looking statements to reflect events, circumstances or changes in expectations after the date on which the statement is made.

The information in this section should be read with our consolidated financial statements and related notes and the information contained elsewhere in this Form 10-K, including that set forth under Item 1A. Risk Factors and Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations.

PART I

Item 1. Business.

General

National Rural Utilities Cooperative Finance Corporation (“CFC”) is a member-owned cooperative association incorporated under the laws of the District of Columbia in April 1969. CFC’s principal purpose is to provide its members with financing to supplement the loan programs of the Rural Utilities Service (“RUS”) of the United States Department of Agriculture (“USDA”). CFC makes loans to its rural electric members so they can acquire, construct and operate electric distribution, generation, transmission and related facilities. CFC also provides its members with credit enhancements in the form of letters of credit and guarantees of debt obligations. As a cooperative, CFC is owned by and exclusively serves its membership, which consists solely of not-for-profit entities or subsidiaries or affiliates of not-for-profit entities. CFC is exempt from federal income taxes under Section 501(c)(4) of the Internal Revenue Code. As a member-owned cooperative, CFC has no publicly held equity securities outstanding. CFC funds its activities primarily through a combination of publicly and privately held debt securities and member investments. CFC’s objective is to offer its members cost-based financial products and services consistent with sound financial management and is not to maximize net income. As described under Allocation and Retirement of Patronage Capital on page 23, CFC allocates its net earnings, which consist of net income excluding the effect of certain non-cash accounting entries, annually to a cooperative educational fund, a members’ capital reserve, a general reserve, if necessary, and to members based on each member’s patronage of CFC’s loan programs during the year.

For financial statement purposes, CFC's results of operations and financial condition are consolidated with and include Rural Telephone Finance Cooperative ("RTFC") and National Cooperative Services Corporation ("NCSC"). Unless stated otherwise, references to "we," "our" or "us" relate to the consolidation of CFC, RTFC, NCSC and certain entities created and controlled by CFC to hold foreclosed assets and to accommodate loan securitization transactions. The revenue, net profit or loss and total assets of CFC are presented as a reportable segment in Note 15, Segment Information, to the consolidated financial statements.

Our annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and amendments to those reports are available, free of charge, at www.nrucfc.coop as soon as reasonably practicable after they are electronically filed with or furnished to the SEC. These reports are also available free of charge on the SEC website at www.sec.gov. Information posted on our website is not incorporated by reference into this Form 10-K.

RTFC is a cooperative association originally incorporated in South Dakota in 1987 and reincorporated as a member-owned cooperative association in the District of Columbia in 2005. RTFC's principal purpose is to provide and arrange financing for its rural telecommunications members and their affiliates. RTFC's membership consists of a combination of not-for-profit entities and for-profit entities. CFC is the sole lender to and manages the business operations of RTFC through a long-term management agreement. Under a guarantee agreement, RTFC pays CFC a fee and, in exchange, CFC reimburses RTFC for loan losses. RTFC is headquartered with CFC in Dulles, Virginia. RTFC is a taxable cooperative that pays income tax based on its net income, excluding patronage-sourced net earnings allocated to its patrons, as permitted under Subchapter T of the Internal Revenue Code.

NCSC was incorporated in 1981 in the District of Columbia as a member-owned cooperative association. The principal purpose of NCSC is to provide financing to members of CFC, entities eligible to be members of CFC and the for-profit and non-profit entities that are owned, operated or controlled by, or provide benefit to Class A, B and C members of CFC. At May 31, 2013, NCSC's membership consisted of distribution systems that were members of CFC or were eligible for such membership. CFC is the primary source of funding to and manages the business operations of NCSC through a management agreement that is automatically renewable on an annual basis unless terminated by either party. Under a guarantee agreement, NCSC pays CFC a fee and, in exchange, CFC reimburses NCSC for loan losses. NCSC is headquartered with CFC in Dulles, Virginia. NCSC is a taxable cooperative. Thus, NCSC pays income tax on the full amount of its net income.

Our Business Development

Our business strategy and policies are set by our board of directors and, may be amended or revised from time to time by the board of directors. We are a not-for-profit tax-exempt cooperative finance organization, whose primary focus is to provide our members with the credit products they need to fund their operations. As such, our business development strategies primarily focus on lending to electric systems and our ability to secure access to capital at rates that allow us to offer competitively priced credit products to our members. In recent years, we have continued to undertake the following initiatives related to our primary focus: (i) concentrate on electric lending, (ii) diversify funding sources and decrease cost of funding, (iii) enhance market risk management and (iv) increase member investments and equity retention.

Focus on Electric Lending

In recent years, we renewed our focus on lending to our electric systems while strategically decreasing our telecommunications exposure through RTFC. A majority of NCSC's lending activities are to electric utility organizations and when NCSC is combined with CFC, electric utility organizations represent approximately 98 percent of the outstanding loan portfolio at May 31, 2013. Our electric cooperative borrowers have demonstrated stable operating performance and strong financial ratios, even during the 2007 economic downturn, because the majority of electric cooperatives' customers are residential, for whom electricity is an essential service. Our electric cooperative members experience limited competition as they generally operate in exclusive territories, the majority of which are not rate regulated. Additionally, they have access to low-cost capital from the federal government in addition to our lending resources. In our 44-year history, we have experienced $19 million in net write-offs for distribution borrowers and $68 million in net write-offs for power supply borrowers. Loans outstanding to electric utility organizations increased approximately 14 percent over the last five years. On the other hand, the telecommunications service providers, to which RTFC provides loans, have experienced fast-paced technological change, increasing competition and uncertainty with respect to their regulatory environment. For these reasons, RTFC became more selective as to the companies it finances and strategically exited lending relationships with or reduced its exposure to its larger borrowers. The telecommunications loan portfolio decreased by 71 percent over the last five years.

Diversify Funding Sources and Decrease Cost of Funding

Diversifying our funding sources to expand beyond capital markets offerings of collateral trust bonds and medium-term notes and the sale of commercial paper has been a primary initiative in recent years. To help meet our capital needs, we expanded our funding programs to include the Guaranteed Underwriter Program of the USDA, as well as note purchase agreements and whole-loan sale programs primarily with the Federal Agricultural Mortgage Corporation. At May 31, 2013, we have bond purchase agreements with the Federal Financing Bank totaling $4,423 million with a guarantee of repayment by USDA as part of the funding mechanism for the Rural Economic Development Loan and Grant program. At May 31, 2013, we had debt outstanding totaling $3,674 million under this program, with a remaining commitment of $749 million available. The guarantee fees paid to the government by CFC in connection with these borrowings are used to fund economic development programs administered by the USDA in the rural areas served by electric cooperatives and rural telephone organizations. At May 31, 2013, we have a note purchase agreement with the Federal Agricultural Mortgage Corporation totaling $3,900 million. Under the agreement we may borrow, repay and re-borrow funds up to $3,900 million at any time or from time to time through January 11, 2016 as market conditions permit. We may select a fixed rate or a variable rate at the time of each advance. Additionally, we developed a program to sell member systems' distribution and power supply loans to the Federal Agricultural Mortgage Corporation to help manage single-obligor exposures within our loan portfolio, to create an additional form of liquidity and to manage the level of our debt-to-equity ratio. In addition to the program we have with the Federal Agricultural Mortgage Corporation, we established a similar program with KeyBank National Association ("KeyBank") during fiscal year 2012. In the fourth quarter of fiscal year 2012, we sold a power supply loan with an outstanding principal balance of $25 million to KeyBank, representing our first sale under the agreement with this purchaser. During the first quarter of fiscal year 2013 we sold another $25 million loan to KeyBank. At May 31, 2013, we were servicing $1,094 million of loans sold to our loan sales program partners.

In recent years, we have also sought to decrease costs related to our funding where possible. Credit spreads and rates continued to decrease during fiscal 2013 which provided us with the opportunity to refinance maturing debt with lower cost debt and exercise early redemptions of our collateral trust bonds and subordinated deferrable debt to replace such debt with lower cost debt. Specifically, we completed a debt exchange transaction in which we exchanged $340 million of our 8 percent medium-term notes, Series C, due 2032 for $379 million of 4.023 percent collateral trust bonds due 2032 and $134 million of cash. On March 1, 2013, we redeemed early $300 million of our $900 million, 5.50 percent, collateral trust bonds with an original maturity of July 1, 2013. On April 25, 2013, we issued $400 million of 4.75 percent subordinated debt due 2043. On May 24, 2013, we redeemed early all of our $88 million of Series NRC 6.10 percent subordinated debt due 2044 and all of our $98 million of Series NRU 5.95 percent subordinated debt due 2045 at par. In recent years, we maintained a high utilization of our commercial paper and other short-term funding to take advantage of the low interest rate environment. At May 31, 2013 and 2012, commercial paper, select notes, daily liquidity fund and bank bid notes outstanding represented 20 percent and 17 percent, respectively, of total debt outstanding. See Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations—Liquidity and Capital Resources for additional information regarding our funding sources.

Enhance Market Risk Management
In fiscal year 2013, we continued the practice of having monthly Asset Liability Committee meetings to enhance the overall corporate monitoring of our funding activities. Our Asset Liability Committee was established in fiscal year 2009 and monitors our management of risks related to interest rates, counterparty credit and liquidity to ensure consistent access to funding that is in alignment with our strategic goals. The committee's mandate is to review CFC's liquidity, as well as the relationship of interest rates and tenor of our assets to our liabilities and, as a result, our spread between interest income and interest expense. Functional responsibilities of this committee include reviewing funding options, investment opportunities and trends in funding alternatives and risk exposure. Performance results and budget deviations also are reviewed. If necessary, the organization's asset-liability strategy is reviewed for modification to react to the current market environment. At least monthly, the Asset Liability Committee reviews a complete interest rate risk analysis, reviews proposed modifications, if any, to our interest rate risk management strategy and considers adopting strategy changes. See Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations—Market Risk for additional information regarding our market risk management.

Increase Member Investments and Equity Retention
In fiscal year 2009, we developed a corporate objective to increase the investments of our members and our equity retention by implementing two primary initiatives: (i) offering of member capital securities, a 35-year unsecured and subordinated voluntary debt investment, to our members beginning in November 2008 and (ii) adjusting CFC's patronage capital retirement practices in June 2009.

Member capital securities are unsecured obligations and are subordinate to all of our existing and future senior indebtedness and all of our existing and future subordinated indebtedness that may be held by or transferred to non-members, but rank on a parity to all other members' subordinated certificates. At May 31, 2013 we have $388 million of member capital securities outstanding, issued with a 35-year maturity that are callable at par by CFC starting five years from the date of issuance and anytime thereafter. The majority of member capital securities were issued with a 7.5 percent interest rate. Effective January 1, 2010, the fixed interest rate earned on newly issued member capital securities was reduced to 5 percent. Since that time, an insignificant amount of member capital securities have been issued. For computing compliance with our revolving credit agreement covenants, we are required to adjust our leverage ratio by subtracting members' subordinated certificates, including member capital securities, from total liabilities and adding this amount to total equity.

At the end of each fiscal year, the CFC Board of Directors allocates net earnings to members in the form of patronage capital and to board-approved reserves. CFC bases the amount of net earnings allocated to each member on the member’s patronage of CFC’s lending programs during the year. The CFC Board of Directors historically votes to retire a portion of the prior year’s patronage capital allocation. The current policy of the CFC Board of Directors is to retire 50 percent of the prior fiscal year’s allocated net earnings following the end of each fiscal year and to hold the remaining 50 percent for 25 years to fund operations and maintain adequate equity.

In fiscal year 2000 the board of directors established the members’ capital reserve to increase the retained earnings held by the company as operating capital. The board of directors has annually reviewed net earnings and made a determination as to the amount, if any, that they will allocate to the members’ capital reserve. The current practice is to allocate the earnings in excess of the amount required to earn a targeted adjusted TIER. For the year ended May 31, 2013, the board of directors allocated $138 million to the members’ capital reserve increasing the reserve balance to $410 million. The board of directors has the authority to allocate and retire amounts in the members’ capital reserve. The board of directors decided that $74 million of the amount allocated to the members’ capital reserve at May 31, 2013, resulting from the refinements made by the Company in the assumptions used to estimate its allowance for loan losses, is not intended to be allocated for distribution to members and instead is intended to serve as an enhancement to our capital reserves. The board of directors will continue to evaluate appropriate levels of capital for CFC.

Our Loan Programs

CFC lends to its members and associates; RTFC lends to its members, organizations affiliated with its members and its associates; NCSC lends to its members and associates. The loans to NCSC associates may require a guarantee of repayment to NCSC from the CFC member cooperative with which it is affiliated.

The loans of CFC, RTFC and NCSC generally provide that an event of default has occurred if there is any material adverse change in the business or condition, financial or otherwise, of the borrower. Our loan standards are generally comparable to those of RUS, and most members significantly exceed the financial tests set by both RUS and CFC.

CFC Loan Programs
Long-Term Loans
CFC’s long-term loans generally have the following characteristics:

- terms of up to 35 years on a senior secured basis;
- amortizing or bullet maturity loans with serial payment structures;
- the property, plant and equipment financed by and securing the long-term loan has a useful life equal to or in excess of the loan maturity;
- flexibility for the borrower to select a fixed interest rate for periods of one to 35 years or a variable rate; and
- the ability for the borrower to select various tranches with either a fixed or variable interest rate for each tranche.

Borrowers may select a fixed or a variable interest rate at the time of each advance on long-term loan facilities. When selecting a fixed rate, the borrower has the option to choose a fixed rate for a term of one year through the final maturity of the loan. When the selected fixed interest rate term expires, the borrower may select another fixed rate for a term of one year through the loan maturity or the current variable rate. Long-term fixed rates are set daily for new loan advances and loans that reprice. The fixed rate on each loan is determined on the day the loan is advanced or repriced based on the term selected. The long-term variable rate is set on the first day of each month.

To be in compliance with the covenants in the loan agreement and eligible for loan advances, distribution systems generally must maintain an average modified debt service coverage ratio, as defined in the loan agreement, of 1.35 or greater. Similarly, power supply systems generally must maintain an average modified debt service coverage ratio, as defined in the loan agreement, of 1.00 or greater. CFC may make long-term loans to distribution and power supply systems, on a case-by-case basis, that do not meet these general criteria.

Line of Credit Loans
Line of credit loans are generally unsecured. Line of credit loans are designed primarily to assist borrowers with liquidity and cash management and are generally advanced at variable interest rates. Line of credit loans are typically revolving facilities and generally require the borrower to pay off the principal balance for at least five consecutive business days at least once during each 12-month period. Line of credit loans are also made available as interim financing when a member either receives RUS approval to obtain a loan and is awaiting its initial advance of funds or submits a loan application that is pending approval from RUS (sometimes referred to as “bridge loans”). RUS loan advances, when received, must be used to repay these interim facilities.

Syndicated Line of Credit Loans
A syndicated loan is typically a large financing offered by a group of lenders that work together to provide funds for a single borrower. Syndicated loans are generally unsecured, floating-rate loans that can be provided on a revolving or term basis for tenors that range from several months to several years. Syndicated financing is arranged for borrowers on a case-by-case basis. CFC may act as lead lender, arranger and administrative agent for the syndicated facilities. CFC uses its best efforts to syndicate the loan requirements of certain borrowers. The success of such efforts depends

on the financial position and credit quality of the borrower as well as market conditions.

RTFC Loan Programs
At May 31, 2013 and 2012, 93 percent of RTFC loans were outstanding to rural local exchange carriers. Most of these rural local exchange carriers evolved from being solely voice service providers to being providers of voice, data and, in many cases, video and wireless services. Rural local exchange carriers are generally characterized by the low population density of their service territories. Services are generally delivered over networks that include digital switching, fiber optics, internet protocol telephony and other advanced technologies. There is generally a significant barrier to competitive entry.

The businesses to which the remaining RTFC loans have been made support the operations of the rural local exchange carriers and are owned, operated or controlled by rural local exchange carriers. Some of these loans are supported by payment guarantees from the sponsoring rural local exchange carriers.

Long-Term Loans
RTFC makes long-term loans to rural telecommunications companies and their affiliates for acquisition, construction or upgrade of wireline telecommunications systems, wireless telecommunications systems, fiber optic networks, cable television systems and other corporate purposes.

RTFC’s long-term loans generally have the following characteristics:

- terms not exceeding 10 years on a senior secured basis;
- the property, plant and equipment financed by and securing the long-term loan has a useful life equal to or in excess of the loan maturity;
- flexibility for the borrower to select a fixed interest rate for periods from one year to the final loan maturity or a variable interest rate; and
- the ability for the borrower to select various tranches with either a fixed or variable interest rate for each tranche.

When a selected fixed interest rate term expires, the borrower may select another fixed-rate term or a variable rate. The fixed rate on a loan is determined on the day the loan is advanced or converted to a fixed rate based on the term selected. The long-term variable rate is set on the first day of each month.

To borrow from RTFC, a wireline telecommunications system generally must be able to demonstrate the ability to achieve and maintain an annual debt service coverage ratio and an annual times interest earned ratio (“TIER”) of 1.25 and 1.50, respectively. To borrow from RTFC, a cable television system, fiber optic network or wireless telecommunications system generally must be able to demonstrate the ability to achieve and maintain an annual debt service coverage ratio of 1.25. RTFC may make long-term loans to telecommunication systems, on a case-by-case basis, that do not meet these general criteria.

Line of Credit Loans
Line of credit loans are generally unsecured. Line of credit loans are designed primarily to assist borrowers with liquidity and cash management and are generally advanced at variable interest rates. Line of credit loans are typically revolving facilities and generally require the borrower to pay off the principal balance for at least five consecutive business days at least once during each 12-month period. Line of credit loans are also made available as interim financing, or bridge loans, when a member either receives RUS approval to obtain a loan and is awaiting its initial advance of funds or submits a loan application that is pending approval from RUS. RUS loan advances, when received, must be used to repay these interim facilities.