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FEATURED PRESENTER:

Sheldon Petersen

CEO

National Rural Utilities
Cooperative Finance
Association

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QUENTIN
BURDICK Center for
COOPERATIVES

Dept. of Agribusiness & Applied
Economics
NDSU Dept. #7610
PO Box 6050
 Fargo, ND 58108-6050

Located at
NDSU's Barry Hall, Suite 400
811 2nd Ave N
 Fargo, ND 58102

www.ag.ndsu.edu/cooperatives



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Using the Cooperative Business Model to Connect Rural Electric Cooperatives to Wall Street

I appreciate the opportunity to talk about Cooperative Finance Corporation (CFC). We are unique because we are a cooperative, but we are also unique because of how our business structure actually operates. And quite frankly being in the world of finance I will just be kind and say it has been an interesting place to be the last two or three years.

CFC is a cooperative of made of other cooperatives. We are not a bank, a credit union or a depository institution of any fashion whatsoever. We are not a government corporation and we are not a government sponsored corporation like Fannie Mae or Freddie Mac. We are an independent, nongovernment, not-for-profit cooperative finance institution. We are owned by the electric cooperatives. We work on behalf of the electric cooperatives and they are pretty much the focus of our existence.

The story of the CFC starts with the story of the electric cooperative program in the mid-1930s. President Roosevelt initiated a depression era program to provide capital to start new farmer cooperatives in rural America. These provided electric service where it had not been provided previously. For the first 35 years they existed all the money electric cooperatives borrowed came from the federal government, specifically, the Rural Electrification Administration (REA). These funds were available at attractive terms. During the 1930s thirty-five year loans were offered at two percent interest, the government's cost of money back then. Offering thirty-five year loans to electric cooperatives was unique and not something the banking industry was used to dealing with.

This lending program worked pretty well until the mid-1960s. At that point electric co-ops experienced a growth spurt. The towns and cities electrical co-ops served started to expand. That meant a greater need for money to build poles, wires, and generating plants. At the same time Congress continued to appropriate money for the REA loan program but didn't feel it could make

more money available than before as they were trying to maintain balanced budgets.

So, after 35 years of the REA program being the primary source of money it became apparent that something needed to be done to provide supplemental dollars. In the mid-1960s our trade administration, the National Rural Electric Cooperative Association (NRECA), decided we needed to look for other options. First it had to get more money to supplement what was available. It also wanted to take some of the pressure off federal government lending programs.

The Association looked at a lot of options. It looked at the possibility of finding ways to add money to the REA by having them sell bonds, but it determined that wasn't really going to fix the money availability problem. It looked at the possibility of forming a new government sponsored enterprise that would have been called the rural electric bank, patterned after the Farm Credit System. They were saying maybe we could get the federal government to kick in some seed money to get this corporation started then over time it will function as a government agency and the borrowers would pay back the original seed money to the government. That idea was popular enough that they took two runs at it on Capitol Hill trying to convince congress that it would be a good idea to provide additional money to the electric cooperative program. Investor owned utilities didn't support those attempts, which meant the NRECA was back to the drawing board again.

The Association decided to study other ideas by forming what was called the Long-Range Study Committee. The Committee included electric cooperatives managers and electric cooperative directors from all around the country. They came together and spent a significant amount of time studying the effort, even hiring an investment banking firm to serve as a consultant. They held hearings all across the country to gain input from the members, asking about their building plans, opinions on the best way to approach additional financing, how such an organization should be structured. They approached banks, and insurance companies, and in pretty much every case they found a uniform lack of interest. They also went to the Farm Credit System.

The leaders of our industry took a step back and said, well if we are going to do something, we are going to have to do it for ourselves, leading to the cooperative business model. That resulted in recommendations to the NRECA membership in 1969 to form a not-for-profit, cooperatively operated private financial institution that would specifically serve electric cooperatives. This resulted in the April 1969 National Rural Utilities Cooperative Finance Corporation. The Corporation was formed from the resources provided by the electric cooperative program. Business began on September 15, 1970.

How did the Corporation get capitalized? As a cooperative you couldn't have people investing in common stock. Given the tax code we intended to operate under we knew we couldn't even have preferred stock as an organization. The approach they ultimately took, which I find quite interesting, was that they would convince Wall Street that, while they couldn't invest equity in this new organization, if they bought bonds in the new organization those bonds would be so long dated and deeply supported that they might be willing to look at them as equity. In 1969, the Association formed the founding body of our organization and sent out an invitation to subscribe. It was sent to every electric cooperative in the country asking them to invest an amount of money for fifty years at three percent interest and have almost no expectation of getting it back if things didn't work out. Overwhelmingly the electric cooperatives across the program agreed to do this. About 15 years later

we went back to our members and said we would like the original subordinated debt used as our starting equity to be changed from a fifty-year maturity to one hundred years at five percent interest. Every electric cooperative agreed to do that. Our organization was started through the creativity of the electric cooperative group and the willingness to invest in a unique kind of security to get it started, without government support. Today, I'm not sure it would be possible to go to Wall Street and convince them subordinated debt is the same thing as equity, but we continue to have the rating agencies look at that part of our balance sheet as equity even though technically it is subordinated debt. Today that is worth about \$650 million.

The original formation of cooperative also included establishment of a board of directors. We have 23 members on our board. They include 10 electric cooperative general managers from areas around the country, 10 electric cooperative directors' board members from areas around the country, as well as the president and the vice president of the Electric Rural Cooperative Association. We also have a financial expert as one additional director since we are a Sarbanes-Oxley jurisdictional organization. Our board members have intense industry knowledge of the area we are working in. They may serve three-year terms but no more than two three-year terms because the incorporators felt it was really important to get input from all areas from our cooperative community as we guide the corporation going forward.

The federal government was very cooperative getting our program started to bring in additional money to supplement what was available from the REA. They agreed to treat these investments made by the electric cooperatives as an incentive investment, which meant co-ops could borrow money against it. They also agreed to share the mortgage that they held, the mortgage security, the collateral on every electric cooperative with CFC to the extent we each had a certain amount of money in the operation of co-ops. That was extremely important. The government had never done that kind of thing before. Without that collateral, without that shared arrangement each time we made a loan we would never be able to go to Wall Street and actually sell bonds to leverage the corporation.

Originally our lending was done just from that seed capital that was invested in our organization. We made short-term loans in December of 1970. Our first long-term loan was made in February, 1971. Immediately, however, we really had a spotlight shown on the organization when President Nixon, quite to the surprise of all of us, issued an executive order to terminate the Rural Electric Administration lending program. This meant that CFC was there, at least on an interim basis, to provide capital to keep the cooperatives up and running. The lending program through REA was eventually restored and business started going again as usual.

The original business model remains largely unchanged and is pretty simple. The cooperatives invested in our subordinated capital, which becomes our equity. We then can go to the Wall Street capital market and sell commercial paper. We can sell medium term notes, we can sell bonds, and take that debt money, add it to pool of money we have and lend it out to electric cooperatives. In many cases these loans are for 35 years. Today, we sell not only to Wall Street capital markets but we are also active issuers in the European capital market. We have even sold bonds in Australia from time to time.

I have to tell you that originally convincing Wall Street our investment plan was going to work was a challenge for the people who started the organization. First of all, we are a group of farmer cooperatives who hadn't really done much financing on Wall Street before. To be perfectly honest with

you, electric cooperatives were still relatively young in their formation. They probably didn't have the best balance sheet to look at and also we would have to acknowledge we didn't have a great deal of financial sophistication because, again, the money came from the federal government. Over time, by working with the selected investment bankers on Wall Street, rating agencies, and convincing them electric service providers are usually a monopoly and an essential service, and reminding them electric cooperatives are diversified over 47 states, we persuaded them we could be a good investment for them to make.

The first bond rating that we actually got from Standard & Poor's and from Moody's was a single A bond rating. In retrospect, that is nothing short of remarkable. The first bond sale was in 1972. It was for 7.4 percent and they felt very lucky to get those funds. Since that time we have continued to be very active in the capital market, taking the money we can sell in terms of debt on the capital markets and blending it with the equity the cooperatives have invested, and lending it out. To the extent we have more interest income coming back than we do interest expense going out the door we make a margin. We take that margin and allocate it to our members on a patronage refund basis. We pay a lot of it in cash, but we also retain some of it as capital. Hence, in addition to the initial investments we now have retained earnings along with capital as well.

I would like to point out some milestones. In the early 1980s many of you will remember that interest rates were 15, 17, 19, and 21 percent. At that time, there were some special tax provisions that Congress had made available that allowed electric cooperatives in particular to do things like lease power plants. This meant cooperatives could build a plant, sell it to another entity, and then lease it back. In doing so they would have an interest cost that was vastly different than what the interest rates were at the time because of using someone else tax benefits. It was a result of that opportunity that our organization formed another affiliate cooperative organization called National Cooperative Services Corporation. It was started for the purpose of lending money into these leveraged lease transactions, if they were to benefit an electric cooperative. That company continues to exist today. Those kinds of tax benefits don't exist any longer but there are some unique things the organization does from time to time.

Also about that time we started to really take seriously the need to work with cooperatives in developing financial plans. When we go to Wall Street and sell bonds, one of the first things they ask us is, "How are your electric cooperatives doing financially?" We started working with them specifically on developing patronage retirement programs so they can convey the benefits back to the members. That has been enormously successful. Today, electric cooperatives are recognized on Wall Street as very strong utility operations having a good connection to their membership.

In 1986, several cooperatives in Texas got together and decided they felt it was time they graduated from the federal lending program. They worked with their congressmen to develop an opportunity for electric cooperatives actually pay off their government loans early at a discount. In 1986, we had 29 electric cooperatives and 21 telephone cooperatives become 100 percent CFC borrowers.

In 1987, we were approached by the National Telephone Cooperative Association and asked if we could provide financial services for telephone cooperatives in the same fashion we did for electric cooperatives. As a result of that request, the Rural Telephone Finance Cooperative was formed as another affiliate corporation.

In about 2004 or 2005, we took a new twist with the business model. We decided there was a need to diversify our funding sources beyond just what was available from selling bonds, notes and commercial paper. We started working with a government sponsored enterprise (GSE) called Farmer Mac. Farmer Mac is a very little known GSE. It got its start in the mid-1980s buying agricultural real estate loans on the secondary market. Farmer Mac continues to operate today through the help of the National Rural Electric Cooperative Association. A couple years ago we were actually able to convince Congress that Farmer Mac's authorities should be expanded to allow them to buy real estate loans for electric cooperatives, allowing us to have yet another funding source where we can originate loans for electric cooperatives, sell them on the secondary market, service them and be the face of the electric cooperative program.

That brings me to the financial market collapse. First of all, from the perspective of CFC the most significant thing that happened there was the collapse of Lemman Brothers. A predecessor firm of Lemman Brothers was actually the consulting firm that helped our organization get started. Because of that relationship, for the first 38 years of our operation, Lemman Brothers was our lead investment banking firm. We were actually one of their largest clients; in fact we were their largest issuer of commercial paper for years. When Lemman Brothers collapsed, it was devastating to us because we lost a lot of friends we had worked with. Some who were working for the organization weren't expecting the collapse. The Thursday before Lemman Brothers actually collapsed, I was starting to get very uneasy because we had a lot of our working relationship with them. I called a fairly high level individual at the firm and I said, "Listen I need to know what is going on. We have too much connected with you folks." His response to me was, "Sheldon, we have 40 billion dollars of cash in the bank, what could possibly go wrong?" I found out the following Monday what could possibly go wrong.

But you know, we entered a period here between the takeover of Bear Sterns, between the government takeover of Fannie Mae and Freddie, the collapse of Lemman Brothers, and the bailout of AIG when banks would literally not even lend to each other. It was hysteria to say the least. Fortunately it did not last that long. But I am pleased to tell you that at no time during that point did we ever actually lose access to the capital markets. We were always able to stay connected to the people we relied on for years as providers of credit. The groups buying our bonds are insurance companies, pension funds, the major bond funds in the world, money market funds, state funded pensions and so on. In fact, I would guess that many of you in this room, through one of these institutional investors, are actually investors in CFC and don't even know it.

One interesting aspect of what was going on is related to the uniqueness of a cooperatively operated, independently financed company. In the financial market collapse so many independent finance companies started to lose their footing and in some cases collapse. When I talk about independent, I'm talking about finance companies that aren't owned by a major company. Several of these actually converted into bank holding companies. By doing so they actually qualified for many of the government programs, like TARP for instance, to have a ready access to capital.

The reason why I focus on the financial market collapse just for a moment is to tell you that for us it was dramatic to have to work in that environment. I'm pleased to say we never lost access to the capital. There were parts of it I would like to forget. For instance, throughout the course of the collapse, electric cooperatives continued to draw down money on their loans that were available to them. In October of 2008, right smack in the middle of the collapse, we needed to add about a billion

dollars to our balance sheet. We went to the market and sold a ten year bond issue for ten and five-eighths percent. Today we could do that same bond issue probably in the neighborhood of four and a half percent. We are stuck with that ten and five eighths percent now for eight more years. It wasn't what we wanted to do, but we needed to do it. And it wasn't necessarily in the best interest of CFC as a company, but it was in the best interest to the electric cooperatives that were expecting the money. And so we take that in stride. Interestingly enough, in October of 2008, we were actually the only finance company that could actually access the bond market at that time.

The other element I wanted to point out to you is how I felt the financial market collapse actually drew us closer to our membership. We are not a bank, not a credit union, not a depository institution, not a government sponsored enterprise. We don't fit anybody's model. And so when the markets were in turmoil, and Frank Paulson and Ben Bernanke were getting together with the leaders in Congress, and they were developing things like TARP, the Troubled Asset Relief Program, nowhere in there did it say what could be done for independent cooperative financial institutions.

Actually, of the 31 programs developed by the FDIC, the Treasury Department, the Federal Reserve, and to some degree Congress, one of those was actually something we could use. It was called the Commercial Paper Funding Facility and was made available to high rated issuers of commercial paper. We actually chose to try that for one maturity period. It turned out to be so expensive we chose to just pay it off and not carry forward with it. My point is that as a cooperative finance institution, the programs available to support financial institutions didn't really apply to us.

When Leman Brothers actually collapsed, one thing it did was highlight the degree of leverage existing within the financial services industry. For instance, Leman Brothers was leveraged at a ratio of 30:1, another way of saying they had about three percent equity. Well it doesn't take much for a multi-billion dollar corporation to experience a few losses on mortgage-backed securities or collateralized debt obligations to wipe out three percent equity. Investors learned the need to have a solid equity cushion supporting the financial institutions they work with. We have operated over the years at roughly 7:1, a much more conservative leverage ratio, about a 13 percent equity level.

Since everybody in the market was getting TARP and other support to bolster their financial position, we were going to need to do something as well. Not because we necessarily needed it but because the investors expected it. So in the middle of the financial market collapse we went back to the member electric cooperatives and asked them to consider an additional investment in certificates very similar to the certificates used to form the company. The response that we received was overwhelming. In fact we blew by all the targets that we had and we actually had an additional 400 million dollars invested by the electric cooperatives. Again, this showed we didn't need to rely on the government but on our members that have a vested interest in our organization.

What was particularly gratifying to me was that for probably seven or eight years before the market collapsed I would have a little jousting match with Standard and Poor's. Their lead analyst gave us a good rating, we are an A+ rated company, and gave us a stable outlook. I liked that, but we would always hear them say to me, "Listen, you guys have a good operation, got a good looking balance sheet, but you are never going to be able to grow. And the reason you aren't going to be able to grow is because you are a co-op. You don't have any way of getting additional capital money to grow with. You got to have equity to grow." And I always used to tell them, "Listen, when the time comes and we

need to get it done, trust us, we will get it done.” I would then think, “How in the world are we ever going to get this done?” Well as it turned out, when we really needed to, and we needed to rely on our members, they were there. As I look back on the financial crisis there are things I would like to forget, but that is one I never want to forget. In the mist of challenges the cooperative community comes together and remembers why we were formed in the first place: to provide service.

We are a 20 billion dollar corporation. We continue to operate as an independent finance company. We remain A+ rated. We are on the investor list of most of the major institutional investors; we have working relationships with thirty foreign and domestic money center banks. Many of the big names in New York, many of the big names overseas, even some of the regional names you are familiar with. We actually added eight new Asian banks recently to that group.

We have relationships with most of the major brokerage firms. We have relationships with secondary market loan purchasers. But to me one of the most interesting the investments in CFC is that between the equity money that was originally put in the company plus temporary and longer term investments, just as a place to park some cash, about 20 percent of the capital in our organization is provided by our members. We were a major investment tool for them. An electric co-op will invest idle capital for a while in CFC that we will use to make a loan in another electric cooperative.

I mentioned to you that in 1986 the opportunity became available for cooperatives to graduate from the government lending program if they choose. Today 235 of 865 distribution electric cooperatives have graduated and are no longer using the government program. We have 225 employees at CFC. In addition to providing loans funds, we are very focused on several other nonfinancial services as well. Which we think makes the system work better as a whole. We hold two major education conferences every year where we bring together business leaders, authors, and speakers for best practice education for cooperative managers and directors. In addition to that, we hold smaller forums around the country.

We have a group within CFC that provides regulatory support; we also do cost studies for electric cooperatives. Every year we provide them a set of financial ratios that are developed from all the financial statements at all the electric cooperatives provide to us. These are cross sectional time series ratios; there are about one hundred and fifty of them. They are called the “key ratio trend analysis.” We also do some additional benchmarking, highlighting the importance of financial performance.

These services help cooperatives manage change in the electricity market. From time to time electric cooperatives look at the possibility of merging. In other cases we have investor owned utilities around the country that felt it was no longer appropriate to provide service to a rural area and have sold actually customers in a service area to electric cooperatives in our consulting group works in that area.

We are a sponsor and contributor of content to a web portal that is operated by NRECA, our trade association, CFC Federated Rural Electric Insurance, as well as the National Rural Telephone Communications Cooperative. This portal is called cooperative.com. It’s the one stop shop where electric cooperative folks can go to have access to news, get information about the organizations as well as having bulletin board opportunities to talk amongst the cooperative community.

We also provide assistance in strategic planning and disaster recovery planning as well. In addition to that, a couple other areas we offer assistance is that we take several hundred thousand dollars of our

margins every year and we allocated them into a cooperative education fund and make those funds available to statewide organizations for the purpose of conducting education programs. Many of them are used for youth education. We think this is money very well spent.

We also have something called the cooperative system integrity fund. From time to time, we have had squabbles with neighboring utilities. Maybe a new load is coming to town and there is a debate over whose territory this happens to fall in. From time to time we have actually been challenged by industrial utilities who wanted to take over our cooperative corporations. We fight this as a cooperative community by putting resources behind a cooperative that might be challenged. The fund essentially helps with the costs associating with defending the co-op model in different times and instances.

Our service objectives at CFC are pretty simple: low cost of capital during all kinds of market conditions. That means we have to strike a balance. Our interest rates are at two percent for 35 years but we have to make the numbers work. Our interest rates are market interest rates. Basically what we do is set the minimum amount of margins every year that we need to make in order to keep our investors happy. We have been pretty successful in getting those numbers.

One of the other elements of our company that probably sets us apart pretty dramatically from other financial institutions is that from time to time any electric cooperative can encounter some difficulties; fuel costs get very high, or maybe they get devastated by storms or things of that nature. One of the things I'm most proud of our organization is our ability to take a very long term view in terms of helping a business cooperative work through its problems. The philosophy of a bank confronted with a possible loss is to take your hair cut early and ugly. That's not our approach. We tend to view things over the longer term and I think we have got a pretty good success record of helping cooperatives work through challenges from time to time because we can do that.

By the way, we are not a regulated entity other than by the Securities and Exchange Commission. We rely on the board of directors of the organization to be the governing body and to be the regulator. We have over the course of our history returned about one billion dollars to the electric cooperatives in terms of patronage capital. As a result they can be assured lending is ultimately done on an at-cost basis.

I will tell you that over the years we made some mistakes from time to time. We have tried to learn from those mistakes. We have a mantra at CFC right now, "Never stop asking why." We always want to make sure in the business decisions and the strategic decisions we make that we step back for just a moment and we say, "Why are we doing this?" and, "Is this consistent with our cooperative business model, the reason we were formed in the first place?" I can tell you, the big mistakes we made in the past occurred when we lost sight of that very point.

I was also asked to discuss our hiring philosophy. I'm a big believer in compensation for performance. We all know that in the financial market collapse a lot of the blame has been set on pay and bonuses of Wall Street firms, bankers and things of that nature. When we hire people to work at CFC they basically come from a few different areas. They are either utility people, commercial bankers, people who come from government sponsored enterprises like Fannie Mae and Freddie Mac, and we hire Wall Street people. As a cooperative, I'm never going to be offering the highest pay packages. However, I'm pretty excited about the fact that I think we have a top notch staff at CFC because people buy into

the mission of what we are doing. But I also learned early on that you get into business what you measure and what you incent. As a result we place a lot of time and effort on strategic positioning, business planning and measuring results. When results are satisfactory we compensate our employees accordingly. On a short term basis we tie our performance bonuses to short term type of performance issues. Keeping cost low is a very important issue for us. On a long term basis, we have a long term performance plan. And it really accomplishes two things. One it is meant to be a retention tool. One has to work at CFC over a period of time and watch performance on certain areas to actually benefit from that performance tool. There is also a long-term incentive plan based on our bond rating. Bond rating is important to our members because the better bond rating we have, the lower our cost of money when we go to Wall Street. It is important to the people who invest in us because it tells them, if we are worried about bond ratings, we are worried about protecting the investment that they made in us. This incentive has actually been cited by one of the largest bond funds in the world as to why they invest in our paper. We were actually in the middle of the financial market collapse when Reuters actually ran a news article on our performance program. We kind of got recognized using a wholly different technique that had contributed some of our long-term stability.

I will just tell you lastly that we judge our success absolutely by the final analysis of our members. That's what important. If our members are successful, we as a co-op of co-ops will be successful. If the members aren't successful, I will be pumping gas. We place a heavy reliance on feedback from our members because it is about everyone working towards a long-term approach. Serving the people that actually are at the end of the line out there paying the bills.

Thank you very much. I appreciate the opportunity to come and talk about the CFC story.

Sheldon Petersen

Petersen is currently CEO and Governor of the National Rural Utilities Cooperative Finance Association (CFC). He will examine why the cooperative business model was selected for CFC, the challenges of gaining Wall Street acceptance, how CFC successfully navigated the financial turmoil of 2008, and how cooperative principles are reflected in CFC's compensation structure. Petersen will reflect on how cooperative principles aid CFC in effectively balancing the expectation of the capital markets while meeting the financing needs of its members.