NATIONAL RURAL UTILITIES COOPERATIVE FINANCE CORP /DC/
Form 10-Q
October 14, 2009

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

FORM 10-Q

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934
For the Quarterly Period Ended August 31, 2009

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)

2201 COOPERATIVE WAY, HERNDON, VA 20171
(Address of principal executive offices)

Registrant's telephone number, including area code, is 703-709-6700.

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 ¨ No ¨

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.

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 Exchange Act). Yes ¨ No x.

The Registrant is a tax-exempt cooperative and consequently is unable to issue any equity capital stock.

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PART 1. FINANCIAL INFORMATION

Item 1. Financial Statements.

NATIONAL RURAL UTILITIES COOPERATIVE FINANCE CORPORATION

CONSOLIDATED BALANCE SHEETS
(UNAUDITED)
(in thousands)

A S S E T S

	August 31, 2009	May 31, 2009
Cash and cash equivalents	$ 526,526	$ 504,999
Restricted cash	3,273	8,207
Investments in preferred stock	72,000	47,000
Loans to members	20,131,092	20,192,309
Less: Allowance for loan losses	(606,839)	(622,960)
Loans to members, net	19,524,253	19,569,349
Accrued interest and other receivables	236,051	260,428
Fixed assets, net	44,818	43,162
Debt service reserve funds	46,662	46,662
Bond issuance costs, net	48,880	50,414
Foreclosed assets, net	47,558	48,721
Derivative assets	364,200	381,356
Other assets	22,351	22,407
	$ 20,936,572	$20,982,705

See accompanying notes.

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NATIONAL RURAL UTILITIES COOPERATIVE FINANCE CORPORATION

CONSOLIDATED BALANCE SHEETS
(UNAUDITED)
(in thousands)

L I A B I L I T I E S A N D E Q U I T Y

	August 31, 2009	May 31, 2009
Short-term debt	$ 4,457,701	$ 4,867,864
Accrued interest payable	313,087	249,601
Long-term debt	12,939,760	12,720,055
Patronage capital retirement payable	41,400	-
Deferred income	20,779	18,962
Guarantee liability	26,536	29,672
Other liabilities	47,560	32,955
Derivative liabilities	486,847	493,002
Subordinated deferrable debt	311,440	311,440
Members' subordinated certificates:		
Membership subordinated certificates	642,925	642,960
Loan and guarantee subordinated certificates	817,939	818,999
Member capital securities	337,045	278,095
Total members' subordinated certificates	1,797,909	1,740,054
Commitments and contingencies		
National Rural equity:		
Retained equity	475,259	500,823
Accumulated other comprehensive income	7,959	8,115
Total National Rural equity	483,218	508,938
Noncontrolling interest	10,335	10,162
Total equity	493,553	519,100
	$ 20,936,572	$ 20,982,705

See accompanying notes.

NATIONAL RURAL UTILITIES COOPERATIVE FINANCE CORPORATION

CONSOLIDATED STATEMENTS OF OPERATIONS
(UNAUDITED)
(in thousands)

For the Three Months Ended August 31, 2009 and 2008

	Three months ended August 31, 2009	2008
Interest income	$ 269,457	$ 263,117
Interest expense	(242,629)	(220,149)
Net interest income	26,828	42,968
Recovery of (provision for) loan losses	16,171	(10,681)
Net interest income after recovery of (provision for) loan losses	42,999	32,287
Non-interest income:		
Fee and other income	3,734	3,582
Derivative cash settlements	(3,494)	431
Results of operations from foreclosed assets	587	1,246
Total non-interest income	827	5,259
Non-interest (expense)/income:		
Salaries and employee benefits	(9,918)	(9,851)
Other general and administrative expenses	(7,108)	(4,742)
Recovery of guarantee liability	2,395	705
Derivative forward value	(10,834)	(11,028)
Market adjustment of foreclosed assets	(1,750)	-
Other	(146)	(160)
Total non-interest expense	(27,361)	(25,076)
Income prior to income taxes	16,465	12,470
Income tax (expense) benefit	(32)	760

Net income	16,433	13,230
Less: Net (income) loss attributable to the noncontrolling interest	(191)	1,241
Net income attributable to National Rural	$ 16,242	$ 14,471

See accompanying notes.

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NATIONAL RURAL UTILITIES COOPERATIVE FINANCE CORPORATION

CONSOLIDATED STATEMENTS OF CHANGES IN EQUITY
(UNAUDITED)
(in thousands)

For the Three Months Ended August 31, 2009 and 2008

	Total	Noncontrolling Interest	National Rural Total Equity	Accumulated Other Comprehensive Income (Loss)	National Rural Retained Equity	Unallocated Net Income	Members' Capital Reserve	Patronage Capital Allocated	Membership Fees and Education Fund
Three months ended August 31, 2009:									
Balance as of May 31, 2009	$519,100	$10,162	$ 508,938	$ 8,115	$500,823	$ (109,691)	$187,098	$ 420,834	$2,582
Patronage capital retirement	(41,400)	-	(41,400)	-	(41,400)	-	-	(41,400)	-
Net income	16,433	191	16,242	-	16,242	16,242	-	-	-
Other comprehensive loss	(162)	(6)	(156)	(156)	-	-	-	-	-
Other	(418)	(12)	(406)	-	(406)	-	-	-	(406)
Balance as of August 31, 2009	$493,553	$10,335	$ 483,218	$ 7,959	$475,259	$ (93,449)	$187,098	$ 379,434	$2,176
Three months ended August 31, 2008:									
Balance as of May 31, 2008	$680,212	$14,247	$ 665,965	$ 8,827	$657,138	$ 44,003	$187,409	$423,249	$2,477
Patronage capital retirement	(85,238)	-	(85,238)	-	(85,238)	-	-	(85,238)	-
Net income	13,230	(1,241)	14,471	-	14,471	14,471	-	-	-
Other comprehensive loss	(199)	(5)	(194)	(194)	-	-	-	-	-
Other	(355)	-	(355)	-	(355)	-	-	-	(355)
Balance as of August 31, 2008	$607,650	$13,001	$594,649	$ 8,633	$586,016	$58,474	$187,409	$338,011	$2,122

See accompanying notes.

NATIONAL RURAL UTILITIES COOPERATIVE FINANCE CORPORATION

CONSOLIDATED STATEMENTS OF CASH FLOWS
(UNAUDITED)
(in thousands)

For the Three Months Ended August 31, 2009 and 2008

	2009	2008
CASH FLOWS PROVIDED BY OPERATING ACTIVITIES:		
Net income	$ 16,433	$ 13,230
Add (deduct):		
Amortization of deferred income	(1,463)	(1,633)
Amortization of bond issuance costs and deferred charges	5,419	2,384
Depreciation	596	610
Recovery of (provision for) loan losses	(16,171)	10,681
Recovery of guarantee liability	(2,395)	(705)
Results of operations from foreclosed assets	(587)	(1,246)
Market adjustment on foreclosed assets	1,750	-
Derivative forward value	10,834	11,028
Restricted interest earned on restricted cash	-	(64)
Changes in operating assets and liabilities:		
Accrued interest and other receivables	20,380	(23,540)
Accrued interest payable	63,486	64,901
Other	14,065	10,019
Net cash provided by operating activities	112,347	85,665
CASH FLOWS PROVIDED BY (USED IN) INVESTING ACTIVITIES:		
Advances made on loans	(1,666,956)	(2,596,707)
Principal collected on loans	1,699,490	2,256,780
Net investment in fixed assets	(2,252)	(1,000)
Net proceeds from sale of loans	28,626	-
Investments in preferred stock	(25,000)	-
Change in restricted cash	4,935	5,912
Net cash provided by (used in) investing activities	38,843	(335,015)
CASH FLOWS (USED IN) PROVIDED BY FINANCING ACTIVITIES:		
Proceeds from issuances of short-term debt, net	687,624	723,544
Proceeds from issuance of long-term debt, net	789,482	1,450,611

Payments for retirement of long-term debt	(1,669,172)	(595,093)
Proceeds from issuance of members' subordinated certificates	72,795	29,642
Payments for retirement of members' subordinated certificates	(10,392)	(7,768)
Net cash (used in) provided by financing activities	(129,663)	1,600,936
NET INCREASE IN CASH AND CASH EQUIVALENTS	21,527	1,351,586
BEGINNING CASH AND CASH EQUIVALENTS	504,999	177,809
ENDING CASH AND CASH EQUIVALENTS	$ 526,526	$ 1,529,395

See accompanying notes.

NATIONAL RURAL UTILITIES COOPERATIVE FINANCE CORPORATION

CONSOLIDATED STATEMENTS OF CASH FLOWS
(UNAUDITED)
(in thousands)

For the Three Months Ended August 31, 2009 and 2008

	2009	2008
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:		
Cash paid for interest	$ 173,725	$ 153,025
Non-cash financing and investing activities:		
Subordinated certificates applied against loan balances	$ -	$ 675
Patronage capital retirement payable	41,400	85,223
Patronage capital applied against loan balances	-	15
Net decrease in debt service reserve funds/debt service reserve certificates	(1,113)	(7,218)

See accompanying notes.

NATIONAL RURAL UTILITIES COOPERATIVE FINANCE CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)

(1) General Information and Accounting Policies

(a) General Information

National Rural Utilities Cooperative Finance Corporation (referred to as "National Rural," "we," "our," or "us") is a private, cooperative association incorporated under the laws of the District of Columbia in April 1969. The principal purpose of National Rural is to provide its members with a source of financing to supplement the loan programs of the Rural Utilities Service ("RUS") of the United States Department of Agriculture. National Rural makes loans to its rural utility system members ("utility members") to enable them to acquire, construct and operate electric distribution, generation, transmission and related facilities. National Rural also provides its members with credit enhancements in the form of letters of credit and guarantees of debt obligations. National Rural is exempt from payment of federal income taxes under the provisions of Section 501(c)(4) of the Internal Revenue Code. National Rural's objective is not to maximize its net income, but to offer its members low cost financial products and services consistent with sound financial management.

Rural Telephone Finance Cooperative ("RTFC") was incorporated as a private cooperative association in the state of South Dakota in September 1987. In February 2005, RTFC reincorporated as a cooperative association in the District of Columbia. RTFC's principal purpose is to provide and arrange financing for its rural telecommunications members and their affiliates. RTFC's objective is not to maximize its net income, but to offer its members low cost financial products and services consistent with sound financial management. RTFC's results of operations and financial condition are consolidated with National Rural in the accompanying financial statements. RTFC is headquartered with National Rural in Herndon, Virginia. RTFC is a taxable cooperative that pays income tax based on its net income, excluding net income allocated to its members, as allowed by law under Subchapter T of the Internal Revenue Code.

National Cooperative Services Corporation ("NCSC") was incorporated in 1981 in the District of Columbia as a private cooperative association. NCSC's principal purpose is to provide financing to the for-profit or non-profit entities that are owned, operated or controlled by or provide substantial benefit to, members of National Rural. NCSC is a member-owned finance cooperative, therefore its objective is not to maximize its net income, but to offer its members low cost financial products and services consistent with sound financial management. NCSC's membership consists of National Rural and distribution systems that are members of National Rural or are eligible for such membership. NCSC's results of operations and financial condition are consolidated with those of National Rural in the accompanying financial statements. NCSC is headquartered with National Rural in Herndon, Virginia. NCSC is a taxable corporation.

Our consolidated membership totaling 1,522 members at August 31, 2009 is made up of:

- 829 distribution systems and 68 generation and transmission ("power supply") systems, totaling 897 utility members, the majority of which are consumer-owned electric cooperatives;
- 498 telecommunications members;
- 66 service members; and
- 61 associates.

Our members are located in 49 states, the District of Columbia and two U.S. territories. Memberships between National Rural, RTFC and NCSC have been eliminated in consolidation. All references to members within this document include members and associates.

In the opinion of management, the accompanying consolidated financial statements contain all adjustments (which consist only of normal recurring accruals) necessary for a fair statement of our results for the interim periods presented.

These interim unaudited consolidated financial statements should be read in conjunction with the audited consolidated financial statements and notes thereto included in our Annual Report on Form 10-K for the fiscal year ended May 31, 2009.

(b) Principles of Consolidation

The accompanying financial statements include the consolidated accounts of National Rural, RTFC and NCSC and certain entities created and controlled by National Rural to hold foreclosed assets and accommodate loan securitization transactions, after elimination of intercompany accounts and transactions. We are required to consolidate the financial results of RTFC and NCSC because we are the primary beneficiary of variable interests in RTFC and NCSC due to our exposure to absorbing the majority of expected losses.

National Rural is the sole lender to and manages the lending activities and business affairs of RTFC through a management agreement in effect until December 1, 2016. Under a guarantee agreement, RTFC pays National Rural a fee to reimburse RTFC for its loan losses. All loans that require RTFC board approval also require approval by National Rural for funding under RTFC's credit facilities with National Rural. National Rural is not a member of RTFC and does not elect directors to the RTFC board. RTFC has a non-voting associate relationship with National Rural.

National Rural is the primary source of funding to and manages the lending and financial affairs of NCSC through a management agreement which is automatically renewable on an annual basis unless terminated by either party. NCSC funds its programs either through loans from National Rural or commercial paper and long-term notes issued by NCSC and guaranteed by National Rural. In connection with these guarantees, NCSC must pay a guarantee fee and purchase from National Rural interest-bearing subordinated term certificates in proportion to the related guarantee. Under a guarantee agreement, NCSC pays National Rural a fee to reimburse NCSC for its loan losses, excluding losses in the consumer loan program. All loans that require NCSC board approval also require National Rural approval. National Rural controls the nomination process for one out of 11 NCSC directors. NCSC members elect directors based on one vote for each member. NCSC is a service organization member of National Rural.

RTFC and NCSC creditors have no recourse against National Rural in the event of a default by RTFC and NCSC, unless there is a guarantee agreement under which National Rural has guaranteed NCSC or RTFC debt obligations to a third party. At August 31, 2009, National Rural had guaranteed $292 million of NCSC debt, derivative instruments and guarantees with third parties. The maturities for NCSC obligations guaranteed by National Rural run through 2031. At August 31, 2009, National Rural's maximum potential exposure totaled $308 million for guarantees of NCSC debt, derivatives and guarantees with third parties. Guarantees related to NCSC debt and derivative instruments are not included in Note 11, Guarantees at August 31, 2009 as the debt and derivatives are reported on the consolidated balance sheet. At August 31, 2009, National Rural had $0.5 million of guarantees of RTFC debt to third party creditors. All National Rural loans to RTFC and NCSC are secured by all assets and revenues of RTFC and NCSC. At August 31, 2009, RTFC had total assets of $1,915 million including loans outstanding to members of $1,736 million and NCSC had total assets of $420 million including loans outstanding of $404 million. At August 31, 2009, National Rural had committed to lend RTFC up to $4 billion of which $1,725 million was outstanding. At June 1, 2009, National Rural increased the commitment to NCSC from $1 billion to $1.5 billion. At August 31, 2009, National Rural had committed to provide up to $1.5 billion of credit to NCSC of which $459 million was outstanding, representing $167 million of outstanding loans and $292 million of credit enhancements.

National Rural has established limited liability corporations and partnerships to hold foreclosed assets and facilitate loan securitization transactions. National Rural owns and controls all of these entities and therefore consolidates their financial results. National Rural presents the companies formed to hold foreclosed assets in one line on the consolidated balance sheets and the consolidated statements of operations. A full consolidation is presented for the entity formed for loan securitization transactions.

Unless stated otherwise, references to “we,” “our,” or “us” represent the consolidation of National Rural, RTFC, NCSC and certain entities created and controlled by National Rural to hold foreclosed assets and to accommodate loan securitization transactions.

Based on the accounting guidance governing consolidations, affiliate equity controlled by RTFC and NCSC is classified as noncontrolling interest on the consolidated balance sheet and the subsidiary earnings controlled by RTFC and NCSC is net income attributable to the noncontrolling interest on the consolidated statement of operations.

(c) Interest Income

The following table presents the components of interest income:

	For the three months ended August 31,	
(dollar amounts in thousands)	2009	2008
Interest on long-term fixed-rate loans (1)	$ 223,526	$ 224,402
Interest on long-term variable-rate loans (1)	26,565	15,180
Interest on short-term loans (1)	16,035	19,504
Interest on investments (2)	1,657	2,181
Fee income	1,674	1,850
Total interest income	$ 269,457	$ 263,117

(1) Represents interest income on loans to members.
(2) Represents interest income on the investment of cash and trading securities.

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Deferred income on the consolidated balance sheets is comprised primarily of deferred conversion fees totaling $15 million and $16 million at August 31, 2009 and May 31, 2009, respectively.

(d) Interest Expense

The following table presents the components of interest expense:

	For the three months ended August 31,	
(dollar amounts in thousands)	2009	2008
Interest expense (1):		
Commercial paper and bid notes	$ 3,222	$ 16,438
Medium-term notes	84,595	80,458
Collateral trust bonds	78,593	62,920
Subordinated deferrable debt	4,916	4,916
Subordinated certificates	19,020	12,417
Long-term private debt	45,986	39,439
Debt issuance costs (2)	2,980	2,135
Fee expense (3)	3,317	1,426
Total interest expense	$ 242,629	$ 220,149

(1) Represents interest expense and the amortization of discounts on debt.
(2) Includes amortization of all deferred charges related to the issuance of debt, principally underwriter's fees, legal fees, printing costs and comfort letter fees. Amortization is calculated on the effective interest method. Also includes issuance costs related to dealer commercial paper which are recognized as incurred.
(3) Includes various fees related to funding activities, including fees paid to banks participating in our revolving credit agreements. Fees are recognized as incurred or amortized on a straight-line basis over the life of the respective agreement.

We do not include indirect costs, if any, related to funding activities in interest expense.

(e) Comprehensive Income

Comprehensive income includes our net income, as well as other comprehensive income related to derivatives. Comprehensive income is calculated as follows:

	For the three months ended August 31,	
(dollar amounts in thousands)	2009	2008
Net income	$ 16,433	$ 13,230
Other comprehensive income:		
Less: Realized gains on derivatives	(162)	(199)
Comprehensive income	16,271	13,031
Less: Comprehensive (income) loss attributable to the noncontrolling interest	(185)	1,246
Comprehensive income attributable to National Rural	$ 16,086	$ 14,277

Due to our adoption of new accounting guidance related to noncontrolling interest on June 1, 2009, our consolidated comprehensive income for the three months ended August 31, 2008 was adjusted to include comprehensive income attributable to our noncontrolling interest.

(f) Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States ("GAAP") requires management to make estimates and assumptions that affect the assets, liabilities, revenues and expenses reported in the financial statements, as well as amounts included in the notes thereto, including discussion and disclosure of contingent liabilities. While we use our best estimates and judgments based on the known facts at the date of the financial statements, actual results could differ from these estimates as future events occur.

(g) Subsequent Events

We evaluated all subsequent events that occurred after the balance sheet date and through the date our unaudited consolidated financial statements were issued on October 14, 2009.

(h) Reclassifications

Reclassifications of prior period amounts have been made to conform to the current reporting format for the following two items. Fees and other income totaling $3 million for the quarter ended August 31, 2008 have been reclassified from interest income to the fee and other income line of non-interest income on the consolidated statements of operations to conform with the August 31, 2009 presentation. Other expense totaling $0.2 million for the quarter ended August 31, 2008 has been reclassified from interest expense to the other expense line item in non-interest expense on the consolidated statements of operations to conform with the August 31, 2009 presentation.

Due to the retrospective presentation and disclosure requirements of new accounting guidance for noncontrolling interests, we reflected the changes in presentation and disclosure of noncontrolling interest in our consolidated financial statements and footnotes for all periods presented in this Form 10-Q.

(i) New Accounting Pronouncements

In August 2009, the FASB issued Accounting Standards Update ("ASU") 2009-05 to update guidance on measuring the fair value of liabilities. This ASU provides clarification that in circumstances in which a quoted price in an active market for the identical liability is not available, a reporting entity is required to measure fair value using one or more of the following techniques: 1) a valuation technique that uses a quoted price of an identical liability when traded as an asset or quoted prices for similar liabilities or similar liabilities when traded as assets and/or 2) another valuation technique including one of the following: a) a technique that is based on the amount at the measurement date that the reporting entity would pay to transfer an identical liability or b) a technique based on the amount a reporting entity would receive to enter into an identical liability. ASU 2009-05 also clarifies that both a quoted price in an active market for an identical liability at the measurement date and a quoted price for the identical liability when traded as an asset in an active market when no adjustments to the quoted price of the asset are required are Level 1 fair value measurements. The ASU is effective for financial statements issued for interim and annual periods beginning after August 28, 2009. The adoption of ASU 2009-05 is not expected to have a material impact on our consolidated financial statements.

(2) Loans and Commitments

Loans to members bear interest at rates determined from time to time by us after considering our interest expense, operating expenses, provision for loan losses and the maintenance of reasonable earnings levels. In compliance with our cooperative charter, our policy is to set interest rates at the lowest level we consider to be consistent with sound financial management.

Loans outstanding to members and unadvanced commitments by loan type and by segment are summarized as follows:

	August 31, 2009		May 31, 2009	
(dollar amounts in thousands)	Loans Outstanding	Unadvanced Commitments (1)	Loans Outstanding	Unadvanced Commitments (1)
Total by loan type (2) (3):				
Long-term fixed-rate loans (4)	$ 15,246,074	$ -	$ 14,602,365	$ -
Long-term variable-rate loans (4)	2,676,702	5,744,267	3,243,716	5,609,977
Loans guaranteed by RUS	242,966	-	243,997	-
Short-term loans	1,960,743	8,066,747	2,098,129	7,941,146
Total loans outstanding	20,126,485	13,811,014	20,188,207	13,551,123
Deferred origination fees	4,607	-	4,102	-
	(606,839)	-	(622,960)	-

Less: Allowance for loan losses								
Net loans outstanding	$	19,524,253	$	13,811,014	$	19,569,349	$	13,551,123
Total by segment (2):								
National Rural:								
Distribution	$	13,637,987	$	9,349,777	$	13,730,511	$	9,472,849
Power supply		4,256,807		3,594,673		4,268,244		3,178,471
Statewide and associate		91,906		135,363		92,578		152,701
National Rural total		17,986,700		13,079,813		18,091,333		12,804,021
RTFC		1,735,709		450,561		1,680,154		457,022
NCSC		404,076		280,640		416,720		290,080
Total loans outstanding	$	20,126,485	$	13,811,014	$	20,188,207	$	13,551,123

(1) Unadvanced loan commitments include loans for which loan contracts have been approved and executed, but funds have not been advanced. Before advancing funds, additional information may be required to assure that all conditions for the advance of funds have been fully met and there has been no material change in the member's condition as represented in the supporting documents. Since commitments may expire without being fully drawn upon and a significant amount of the commitments are for standby liquidity purposes, the total unadvanced loan commitments do not necessarily represent our future cash requirements. Collateral and security requirements for advances on commitments are identical to those required at the time of the initial loan approval.
(2) Table includes non-performing and restructured loans.
(3) Loans are classified as long-term or short-term based on their original maturity.
(4) Because the interest rate on unadvanced commitments is not set until drawn, long-term unadvanced loan commitments have been classified in this table as variable-rate unadvanced commitments. However, at the time of the advance, the borrower may select a fixed or a variable rate on the new loan.

Non-Performing and Restructured Loans

Non-performing and restructured loans outstanding and unadvanced commitments to members by loan type and by segment included in the table above are summarized as follows:

(dollar amounts in thousands)	August 31, 2009 Loans Outstanding	August 31, 2009 Unadvanced Commitments (1)	May 31, 2009 Loans Outstanding	May 31, 2009 Unadvanced Commitments (1)
Non-performing and restructured loans:				
Non-performing loans (2):				
RTFC:				
Long-term fixed-rate loans	$ 8,960	$ -	$ 8,960	$ -
Long-term variable-rate loans	457,504	-	457,504	-
Short-term loans	57,297	-	57,294	-
Total non-performing loans	$ 523,761	$ -	$ 523,758	$ -
Restructured loans (2):				
National Rural:				
Long-term fixed-rate loans (3)	$ 41,817	$ -	$ 41,907	$ -
Long-term variable-rate loans (3)	483,720	186,673	490,827	186,673
Short-term loans	-	12,500	-	12,500
National Rural total restructured loans	525,537	199,173	532,734	199,173
RTFC:				
Long-term fixed-rate loans	4,672	-	4,853	-
Total restructured loans	$ 530,209	$ 199,173	$ 537,587	$ 199,173

(1) Unadvanced loan commitments include loans for which loan contracts have been approved and executed, but funds have not been advanced. Before advancing funds, additional information may be required to assure that all conditions for the advance of funds have been fully met and there has been no material change in the member's condition as represented in the supporting documents. Since commitments may expire without being fully drawn upon and a significant amount of the commitments are for standby liquidity purposes, the total unadvanced loan commitments do not necessarily represent our future cash requirements. Collateral and security requirements for advances on commitments are identical to those required at the time of the initial loan approval.

(2) Loans are classified as long-term or short-term based on their original maturity.

(3) Because the interest rate on unadvanced commitments is not set until drawn, long-term unadvanced loan commitments have been classified in this table as variable-rate unadvanced commitments. However, at the time of the advance, the borrower may select a fixed or a variable rate on the new loan.

Loan Loss Allowance

We maintain an allowance for loan losses at a level estimated by management to provide for probable losses inherent in the loan portfolio.

Activity in the loan loss allowance account is summarized below:

	For the three months ended and as of August 31,		For the year ended and as of May 31
(dollar amounts in thousands)	2009	2008	,2009
Balance at beginning of period	$ 622,960	$ 514,906	$ 514,906
(Recovery of) provision for loan losses	(16,171)	10,681	113,699
Charge-offs	(23)	(3,078)	(5,988)
Recoveries	73	88	343
Balance at end of period	$ 606,839	$ 522,597	$ 622,960

Loan Security

We evaluate each borrower's creditworthiness on a case-by-case basis. It is generally our policy to require collateral for long-term loans. Such collateral usually consists of a first mortgage lien on the borrower's total assets, including plant and equipment, and a pledge of future revenues. The loan and security documents also contain various provisions with respect to the mortgaging of the borrower's property and debt service coverage ratios, maintenance of adequate insurance coverage as well as certain other restrictive covenants.

The following tables summarize our secured and unsecured loans outstanding by loan type and by segment:

(dollar amounts in thousands)	August 31, 2009				May 31, 2009			
Total by loan type:	Secured	%	Unsecured	%	Secured	%	Unsecured	%
Long-term fixed-rate loans	$ 14,634,667	96%	$ 611,407	4 %	$14,044,469	96%	$ 557,896	4%
Long-term variable-rate loans	2,298,042	86	378,660	14	2,835,451	87	408,265	13
Loans guaranteed by RUS	242,966	100	-	-	243,997	100	-	-
Short-term loans	235,169	12	1,725,574	88	233,179	11	1,864,950	89
Total loans	$17,410,844	87	$ 2,715,641	13	$17,357,096	86	$ 2,831,111	14
Total by segment:								
National Rural	$15,564,515	87%	$ 2,422,185	13%	$15,562,761	86%	$ 2,528,572	14%
RTFC	1,502,647	87	233,062	13	1,443,395	86	236,759	14
NCSC	343,682	85	60,394	15	350,940	84	65,780	16
Total loans	$17,410,844	87	$ 2,715,641	13	$17,357,096	86	$ 2,831,111	14

Pledging of Loans and Loans on Deposit

The following table summarizes our collateral pledged to secure our collateral trust bonds and notes payable to the Federal Agricultural Mortgage Corporation ("Farmer Mac") (see Note 5, Long-Term Debt) and the amount of the corresponding debt outstanding:

(dollar amounts in thousands)	August 31, 2009	May 31, 2009
Collateral trust bonds:		
2007 indenture		
Distribution system mortgage notes	$ 4,136,428	$ 4,176,760
Collateral trust bonds outstanding	3,000,000	3,000,000
1994 indenture		
Distribution system mortgage notes	$ 2,261,597	$ 2,308,713
RUS guaranteed loans qualifying as permitted investments	210,306	211,337
Total pledged collateral	$ 2,471,903	$ 2,520,050
Collateral trust bonds outstanding	2,190,000	2,190,000
1972 indenture		
Cash	$ 2,032	$ 2,032
Collateral trust bonds outstanding	1,736	1,736
Farmer Mac:		
Utility system notes	$ 2,231,050	$ 1,488,929
Farmer Mac notes payable	1,825,000	1,200,000

The following table shows the collateral on deposit for the notes payable to the Federal Financing Bank ("FFB") of the United States Treasury as part of the Rural Economic Development Loan and Grant ("REDLG") program (see Note 5, Long-Term Debt) and the amount of the corresponding debt outstanding:

(dollar amounts in thousands)	August 31, 2009	May 31, 2009
Utility system mortgage notes on deposit	$ 3,783,697	$ 3,770,983
REDLG notes payable	3,000,000	3,000,000

The $3 billion of notes payable to the FFB at August 31, 2009 and May 31, 2009 contain a rating trigger related to our senior secured credit ratings from Standard & Poor's Corporation, Moody's Investors Service and Fitch Ratings. A rating trigger event exists if our senior secured debt does not have at least two of the following ratings: (i) A- or higher from Standard & Poor's Corporation, (ii) A3 or higher from Moody's Investors Service, (iii) A- or higher from Fitch Ratings and (iv) an equivalent rating from a successor rating agency to any of the above rating agencies. If our senior secured credit ratings fall below the levels listed above, the mortgage notes on deposit at that time, which totaled $3,784 million at August 31, 2009, would be pledged as collateral rather than held on deposit. At August 31, 2009 and May 31, 2009, National Rural's senior secured debt ratings were above the rating trigger threshold.

A total of $2 billion of notes payable to the FFB at August 31, 2009 and May 31, 2009 have a second trigger requiring that a director on the National Rural board satisfies the requirements of a financial expert as defined by Section 407 of the Sarbanes-Oxley Act of 2002. A financial expert triggering event will occur if the financial expert position remains vacant for more than

90 consecutive days. If we do not satisfy the financial expert requirement, the mortgage notes on deposit at that time, which totaled $2,499 million at August 31, 2009, would be pledged as collateral rather than held on deposit. The financial expert position on National Rural's board of directors has been filled since March 2007.

(3) Foreclosed Assets

Assets received in satisfaction of loan receivables are recorded at cost and are evaluated periodically for impairment. These assets are classified on the consolidated balance sheets as foreclosed assets, net. These assets do not meet the criteria to be classified as held for sale at August 31, 2009 and May 31, 2009.

The activity for foreclosed assets is summarized below:

(dollar amounts in thousands)	Three months ended August 31, 2009	2008	Year ended May 31, 2009
Beginning balance	$ 48,721	$ 58,961	$ 58,961
Results of operations	587	1,246	3,774
Net cash provided by foreclosed assets	-	-	(6,000)
Market adjustment	(1,750)	-	(8,014)
Ending balance	$ 47,558	$ 60,207	$ 48,721

The balance of foreclosed assets included land development loans and limited partnership interests in certain real estate developments for all periods presented. The reduction to the fair value of the collateral supporting these land development loans during the quarter ended August 31, 2009 was primarily due to lower gas prices which decreased the fair value of the underlying collateral. During the year ended May 31, 2009, current economic conditions put a strain on cash flows for one of the land developers and their ability to make loan payments as scheduled. At January 1, 2009, this borrower's loan was put on non-accrual status. During the year ended May 31, 2009, the other land development loan was restructured to lower the interest rate due to concerns about the borrower's ability to meet all future payments based on the original loan terms. As a result, we classified both land development loans as impaired at August 31, 2009 and May 31, 2009. Subsequent to August 31, 2009, the restructured land development loan was also put on non-accrual status.

(4) Short-Term Debt and Credit Arrangements

The following is a summary of short-term debt outstanding:

(dollar amounts in thousands)	August 31, 2009	May 31, 2009
Short-term debt:		
Commercial paper sold through dealers, net of discounts	$ 1,341,777	$ 594,533
Commercial paper sold directly to members, at par	1,052,494	934,897
Commercial paper sold directly to non-members, at par	26,375	12,502
Total commercial paper	2,420,646	1,541,932
Daily liquidity fund sold directly to members	330,251	291,341
Term loan	-	200,000
Bank bid notes	225,000	255,000

Subtotal short-term debt	2,975,897	2,288,273
Long-term debt maturing within one year:		
Medium-term notes sold through dealers	267,736	1,674,760
Medium-term notes sold to members	411,624	502,396
Secured collateral trust bonds	609,991	209,985
Secured notes payable	187,800	187,800
Unsecured notes payable	4,653	4,650
Total long-term debt maturing within one year	1,481,804	2,579,591
Total short-term debt	$ 4,457,701	$ 4,867,864

We issue commercial paper for periods of one to 270 days. We also enter into short-term bank bid note agreements, which are unsecured obligations that do not require backup bank lines for liquidity purposes. We do not pay a commitment fee for bank bid notes. The commitments are generally subject to termination at the discretion of the individual banks.

In June 2009, we paid off the $200 million term loan borrowed under a credit agreement with a syndicate of banks in January 2009. The term loan was due to mature on January 21, 2010, but was paid off early without any termination fee.

Revolving Credit Agreements

The following is a summary of the amounts available under our revolving credit agreements:

(dollar amounts in thousands)	August 31, 2009	May 31, 2009	Termination Date	Facility fee per year (1)
Five-year agreement (2)	$ 1,125,000	$1,125,000	March 16, 2012	6 basis points
Five-year agreement (2)	1,025,000	1,025,000	March 22, 2011	6 basis points
364-day agreement	1,000,000	1,000,000	March 12, 2010	12.5 basis points
Total	$ 3,150,000	$3,150,000		

(1) Facility fee determined by National Rural's senior unsecured credit ratings based on the pricing schedules put in place at the initiation of the related agreement.

(2) Amounts include Lehman Brothers Bank, FSB's portion of the credit facility totaling $134 million allocated as follows: $76 million under the five-year facility maturing 2012, and $58 million under the five-year facility maturing in 2011. We do not expect Lehman Brothers Bank, FSB to fund its portion of the credit facility according to the agreements. See further discussion below.

We have the right under the 364-day revolving credit agreement, subject to certain terms and conditions, to increase the aggregate amount of the commitments by up to $250 million either by increasing the commitment of one or more existing lenders or by adding one or more new lenders, provided that no existing lender's commitment may be increased without the consent of the lender and administrative agent.

Both five-year agreements contain a provision under which if borrowings exceed 50 percent of total commitments, a utilization fee of five basis points must be paid on the outstanding balance.

At August 31, 2009 and May 31, 2009, we were in compliance with all covenants and conditions under our revolving credit agreements and there were no borrowings outstanding under these agreements.

In September 2008, Lehman Brothers Holdings Inc. ("LBHI") announced that it had filed a petition under Chapter 11 of the United States Bankruptcy Code with the United States Bankruptcy Court for the Southern District of New York. As an active participant in the capital markets, we had numerous business relationships with LBHI and its subsidiaries. Among those relationships, Lehman Brothers Bank, FSB ("LBB") was a participant for up to $134 million of our revolving credit facilities at August 31, 2009. We do not believe that LBB's portion of the credit facilities will be available in the future.

For calculating the required financial covenants in our revolving credit agreements, we adjust net income, senior debt and total equity to exclude the non-cash adjustments from the accounting for derivative financial instruments and foreign currency translation. The adjusted times interest earned ratio ("TIER"), as defined by the agreements, represents the interest expense adjusted to include the derivative cash settlements plus minority interest net income, plus net income prior to the cumulative effect of change in accounting principle and dividing that total by the interest expense adjusted to include the derivative cash settlements. In addition to the non-cash adjustments discussed above, senior debt also excludes RUS guaranteed loans, subordinated deferrable debt, members' subordinated certificates and minority interest. Total equity is adjusted to include subordinated deferrable debt, members' subordinated certificates and minority interest. Due to the adoption of new accounting guidance regarding noncontrolling interests on June 1, 2009, minority interest net income is included in total net income on the consolidated statements of operations and minority interest is reported as equity on the consolidated balance sheets for all periods presented. As a result, it is not necessary to adjust net income to include minority interest net income or to adjust equity to include minority interest as it was in prior periods. Senior debt includes guarantees; however, it excludes:

- guarantees for members where the long-term unsecured debt of the member is rated at least BBB+ by Standard & Poor's Corporation or Baa1 by Moody's Investors Service; and
- the payment of principal and interest by the member on the guaranteed indebtedness if covered by insurance or reinsurance provided by an insurer having an insurance financial strength rating of AAA by Standard & Poor's Corporation or a financial strength rating of Aaa by Moody's Investors Service.

The following represents our required and actual financial ratios under the revolving credit agreements:

		Actual	
	Requirement	August 31, 2009	May 31, 2009
Minimum average adjusted TIER over the six most recent fiscal quarters	1.025	1.15	1.18
Minimum adjusted TIER at fiscal year end (1)	1.05	NA	1.10
Maximum ratio of senior debt to total equity	10.00	6.75	6.90

(1) We must meet this requirement to retire patronage capital.

The revolving credit agreements do not contain a material adverse change clause or ratings trigger that limit the banks' obligations to fund under the terms of the agreements, but we must be in compliance with the other requirements, including financial ratios, to draw down on the facilities.

(5) Long-Term Debt

The following is a summary of long-term debt outstanding:

(dollar amounts in thousands)	August 31, 2009	May 31, 2009
Unsecured long-term debt:		
Medium-term notes sold through dealers	$ 3,457,250	$ 3,469,580
Medium-term notes sold to members	227,008	220,613
Subtotal	3,684,258	3,690,193
Unamortized discount	(2,942)	(3,120)
Total unsecured medium-term notes	3,681,316	3,687,073
Unsecured notes payable	3,053,705	3,053,705
Unamortized discount	(1,642)	(1,694)
Total unsecured notes payable	3,052,063	3,052,011
Total unsecured long-term debt	6,733,379	6,739,084
Secured long-term debt:		
Collateral trust bonds	4,581,736	4,981,736
Unamortized discount	(12,555)	(12,965)
Total secured collateral trust bonds	4,569,181	4,968,771
Secured notes payable	1,637,200	1,012,200
Total secured long-term debt	6,206,381	5,980,971
Total long-term debt	$ 12,939,760	$ 12,720,055

Medium-term notes are unsecured obligations of National Rural. Collateral trust bonds are secured by the pledge of mortgage notes or eligible securities in an amount at least equal to the principal balance of the bonds outstanding. See Note 2, Loans and Commitments, for additional information on the collateral pledged to secure National Rural's collateral trust bonds.

Unsecured Notes Payable
At August 31, 2009 and May 31, 2009, we had unsecured notes payable totaling $3 billion outstanding under a bond purchase agreement with the FFB and a bond guarantee agreement with RUS as part of the funding mechanism for the REDLG program. As part of the REDLG program, we pay RUS a fee of 30 basis points per year on the total amount borrowed. At August 31, 2009, the $3 billion of unsecured notes payable issued as part of the REDLG program require us to place mortgage notes on deposit in an amount at least equal to the principal balance of the notes outstanding. See Note 2, Loans and Commitments, for additional information on the mortgage notes held on deposit and the triggering events that result in these mortgage notes becoming pledged as collateral.

Secured Notes Payable
Details about our note purchase agreements and outstanding notes payable with Farmer Mac are shown below:

(dollar amounts in thousands)		Amount Outstanding	
Note Purchase Agreement	Amount Available	August 31, 2009	May 31, 2009
December 2008 (1)	$ 500,000	$ 500,000	$ 500,000
February 2009	500,000	500,000	300,000
March 2009 (1)	400,000	400,000	400,000
May 2009	1,000,000	425,000	-

Total	$ 2,400,000	$ 1,825,000	$ 1,200,000

(1) Includes $100 million and $87.8 million of secured notes payable with Farmer Mac that were classified as short-term debt at August 31, 2009 and May 31, 2009, respectively, under the December 2008 and March 2009 note purchase agreements, respectively.

All of the agreements with Farmer Mac are revolving credit facilities that allow us to borrow, repay and re-borrow funds at any time or from time to time as market conditions permit; provided that the principal amount at any time outstanding under each of the note purchase agreements is not more than the total available under each agreement. All of the agreements require us to pledge eligible distribution system or power supply system loans as collateral in an amount at least equal to the total principal amount of notes outstanding under the agreement. See Note 2, Loans and Commitments, for additional information on the collateral pledged to secure notes payable to Farmer Mac. These agreements also require us to purchase Farmer Mac Series C cumulative, redeemable, non-voting preferred stock in an amount sufficient to maintain a balance at all times that is at least equal to 4 percent of the principal amount of the notes outstanding under the agreements.

(6) Subordinated Deferrable Debt

The following table is a summary of subordinated deferrable debt outstanding:

(dollar amounts in thousands)	August 31, 2009	May 31, 2009
6.75% due 2043 (1)	$ 125,000	$ 125,000
6.10% due 2044 (2)	88,201	88,201
5.95% due 2045 (3)	98,239	98,239
Total	$ 311,440	$ 311,440

(1) Callable by National Rural at par starting on February 15, 2008.
(2) Callable by National Rural at par starting on February 1, 2009.
(3) Callable by National Rural at par starting on February 15, 2010.

(7) Derivative Financial Instruments

We are neither a dealer nor a trader in derivative financial instruments. We utilize derivatives such as interest rate swaps and cross currency interest rate swaps to mitigate interest rate risk and foreign currency exchange risk.

Consistent with the accounting guidance for derivative financial instruments, we record derivative instruments on the consolidated balance sheet as either an asset or liability measured at fair value. Changes in the fair value of derivative instruments are recognized in the derivative forward value line item of the consolidated statement of operations unless specific hedge accounting criteria are met. Generally, our derivative instruments do not qualify for hedge accounting under the accounting guidance for derivative financial instruments. At August 31, 2009 and 2008 and May 31, 2009, we did not have any derivative instruments that were accounted for using hedge accounting.

Interest Rate Swaps
The following table shows the types and notional amounts of our interest rate swaps:

	Notional Amounts Outstanding	
(dollar amounts in thousands)	August 31, 2009	May 31, 2009
Pay fixed-receive variable	$ 6,311,873	$ 6,506,603
Pay variable-receive fixed	5,051,440	5,323,239
Total interest rate swaps	$ 11,363,313	$ 11,829,842

Income and losses recorded for our interest rate swaps are summarized below:

	For the three months ended August 31,	
(dollar amount in thousands)	2009	2008
Statement of Operations:		
Agreements that do not qualify for hedge accounting:		
Derivative cash settlements	$ (3,494)	$ 431
Derivative forward value	(10,834)	(11,028)
Total loss on derivative instruments	$ (14,328)	$ (10,597)
Comprehensive Income:		
Amortization of transition adjustment	$ (162)	$ (199)

Cash settlements includes periodic amounts that were paid and received related to our interest rate swaps, as well as amounts accrued from the prior settlement date.

A transition adjustment of $62 million was recorded as an other comprehensive loss on June 1, 2001, the date we implemented the accounting guidance for derivative financial instruments. The transition adjustment will be amortized into earnings over the remaining life of the related derivative instruments. Approximately $0.7 million of the transition adjustment is expected to be amortized to income over the next 12 months and will continue through April 2029.

We classified cash activity associated with interest rate swaps as an operating activity in the consolidated statements of cash flows.

Rating Triggers
Some of our interest rate swaps have credit risk-related contingent features referred to as rating triggers. Rating triggers are not separate financial instruments and are not required to be accounted for separately as derivatives.

At August 31, 2009, the following derivative instruments had rating triggers based on our senior unsecured credit ratings from Moody's Investors Service or Standard & Poor's Corporation falling to a level specified in the agreement and grouped into the categories below. In calculating the payments and collections required upon termination, we netted the agreements for each counterparty, as allowed by the underlying master agreements.

(dollar amounts in thousands)	Notional Amount	Required Company Payment	Amount Company Would Collect	Net Total
Rating Level:				
Mutual rating trigger if ratings fall to				
Baa1/BBB+ and below (1)	$ 6,310,613	$ (152,565)	$ 11,604	$ (140,961)
Counterparty may terminate if ratings				
fall below Baa1/BBB+ (2)	1,172,368	-	160	160
Total	$ 7,482,981	$ (152,565)	$ 11,764	$ (140,801)

(1) Stated ratings are for Moody's Investors Service and Standard & Poor's Corporation, respectively. Under these rating triggers, if the credit rating for either counterparty falls to the level specified in the agreement, the other counterparty may, but is not obligated to, terminate the agreement. If either counterparty terminates the agreement, a net payment may be due from one counterparty to the other based on the fair value, excluding credit risk, of the underlying derivative instrument.
(2) Stated ratings are for Moody's Investors Service and Standard & Poor's Corporation, respectively. The rating trigger provisions on the interest rate swaps with one counterparty allow the counterparty to terminate the agreements based on our credit rating, but we do not have the right to terminate based on the counterparty's credit rating.

In addition to the rating triggers listed above, at August 31, 2009, we had a total notional amount of $645 million of derivative instruments with one counterparty that would require the pledging of collateral totaling $26 million representing the net cash settlement amount of the derivative instruments if our senior unsecured ratings from Moody's Investors Service were to fall below Baa2 or if the rating from Standard & Poor's Corporation were to fall below BBB. The aggregate fair value of all interest rate swaps with rating triggers that were in a net liability position at August 31, 2009 was $173 million.

(8) Members' Subordinated Certificates

Membership Subordinated Certificates
National Rural's members have generally been required to purchase membership subordinated certificates as a condition of membership. Such certificates are interest-bearing, unsecured, subordinated debt of National Rural. Members purchase the certificates upfront, in installments, or as a percentage of the amount they borrow from National Rural. National Rural membership certificates have an original maturity of 50 to 100 years, and bear interest at 3 to 5 percent per annum, payable semi-annually. The weighted-average maturity for all membership subordinated certificates outstanding at August 31, 2009 and May 31, 2009 was 67 years.

RTFC and NCSC members are not required to purchase membership certificates as a condition of membership.

Loan and Guarantee Subordinated Certificates
Members obtaining long-term loans, certain short-term loans, or guarantees are sometimes required to purchase additional loan or guarantee certificates, or other types of certificates, with each such loan or guarantee. Certificates

are unsecured, subordinated debt and may be interest bearing or non-interest bearing. Requirements for purchase of such equity certificates depend upon several factors, including but not limited to, borrower's debt to equity ratio with National Rural, the relative size of the facility, and the relative risk of the transaction.

National Rural associates and RTFC members are generally required to purchase loan subordinated certificates in an amount equal to 10 percent of each long-term loan advance.

Member Capital Securities

During the 2009 fiscal year, National Rural began offering member capital securities to its voting members. Member capital securities are interest-bearing unsecured obligations of National Rural and are subordinate to all of our existing and future senior indebtedness and all existing and future subordinated indebtedness of National Rural that may be held by or transferred to non-members of National Rural, but rank pari passu to our member subordinated certificates. Each member capital security matures 35 years from its date of issuance. Unless required in connection with a new loan from National Rural, these securities represent voluntary investments in National Rural by the members.

Effective June 1, 2009, member capital securities may be purchased by members in an amount determined by National Rural to meet their capital contribution requirements as a condition of obtaining additional credit facilities from National Rural.

(9) Equity

National Rural is required by the District of Columbia cooperative law to have a methodology to allocate its net earnings to its members. National Rural maintains the current year net earnings as unallocated through the end of its fiscal year. National Rural calculates net earnings by adjusting net income to exclude certain non-cash adjustments. After the end of the fiscal year, National Rural’s board of directors allocates its net earnings to members in the form of patronage capital and to board approved reserves. Currently, National Rural has two such board approved reserves, the cooperative educational fund and the members' capital reserve. National Rural allocates a small portion, less than 1 percent, of net earnings annually to the cooperative educational fund. The allocation to the cooperative educational fund must be at least 0.25 percent of net earnings as required by National Rural’s bylaws. Funds from the cooperative educational fund are disbursed annually to statewide cooperative organizations to fund the teaching of cooperative principles and for the other cooperative education programs. The board of directors determines the amount of net earnings that is allocated to the members' capital reserve, if any. The members' capital reserve represents net earnings that are held by National Rural to increase equity retention. The net earnings held in the members' capital reserve have not been allocated to members, but may be allocated to individual members in the future as patronage capital if authorized by National Rural’s board of directors. All remaining net earnings are allocated to National Rural’s members in the form of patronage capital. National Rural bases the amount of net earnings allocated to each member on the members' patronage of the National Rural lending programs during the year. There is no effect on National Rural’s total equity as a result of allocating net earnings to members in the form of patronage capital or to board approved reserves. National Rural’s board of directors has annually voted to retire a portion of the patronage capital allocated to members in prior years. National Rural’s total equity is reduced by the amount of patronage capital retired to members and by amounts disbursed from board approved reserves.

In June 2009, we revised our guidelines related to the timing and amount of patronage capital to be distributed. The purpose of the revision, which was approved by National Rural’s board of directors, was to increase our equity retention. Under the new guidelines, National Rural will retire 50 percent of prior year’s allocated net earnings and hold the remaining 50 percent for 25 years. The retirement amount and timing remains subject to annual approval by National Rural’s board of directors.

In July 2009, National Rural’s board of directors authorized the allocation of the fiscal year 2009 net earnings as follows: $1 million to the cooperative educational fund and $83 million to members in the form of patronage capital. In July 2009, National Rural’s board of directors authorized the retirement of allocated net earnings totaling $41 million, representing 50 percent of the fiscal year 2009 allocation. This amount was returned to members in cash at the end of September 2009. Future allocations and retirements of net earnings may be made annually as determined by National Rural’s board of directors with due regard for our financial condition. The board of directors for National Rural has the authority to change the current practice for allocating and retiring net earnings at any time, subject to applicable cooperative law.

Noncontrolling interest represents 100 percent of RTFC and NCSC equity as the members of RTFC and NCSC own or control 100 percent of the interest in their respective companies. On June 1, 2009, National Rural implemented new accounting guidance for noncontrolling interests in consolidated financial statements and as a result, total equity includes the noncontrolling interest at August 31, 2009 of $10 million. Additionally, noncontrolling interest totaling $10 million was reclassified from liabilities to equity at May 31, 2009 due to the retrospective presentation and disclosure requirements.

At May 31, 2009, based on the consolidation accounting guidance in effect at that time, consolidated equity was required to absorb the $6 million equity deficit of NCSC rather than being reflected in minority interest. The loss absorbed by consolidated equity was caused by the decline in the fair value of the NCSC derivatives and therefore does not represent a loss that was funded by National Rural. Under prior accounting guidance, NCSC future earnings would have been used to offset the equity deficit absorbed by consolidated equity. Based on the provisions of the new guidance, the application of the NCSC future earnings to offset the unfunded loss reported in consolidated equity at May 31, 2009 is not permitted. As a result of this new guidance, the $6 million unfunded loss absorbed at May 31, 2009 will be reported as part of consolidated retained equity for as long as NCSC is in business and the reported noncontrolling interest will be $6 million greater than the total equity reported on the separate RTFC and NCSC financial statements.

Equity includes the following components:

(dollar amounts in thousands)	August 31, 2009	May 31, 2009
Membership fees	$ 990	$ 990
Education fund	1,186	1,592
Members' capital reserve	187,098	187,098
Allocated net income	379,434	420,834
Unallocated net income (loss) (1)	21,199	(6,198)
Total members' equity	589,907	604,316
Prior years cumulative derivative forward value and foreign currency adjustments	(103,493)	44,056
Year-to-date derivative forward value loss (2)	(11,155)	(147,549)
Total National Rural retained equity	475,259	500,823
Accumulated other comprehensive income	7,959	8,115
Total National Rural equity	483,218	508,938
Noncontrolling interest	10,335	10,162
Total equity	$ 493,553	$ 519,100

(1) Excludes derivative forward value.
(2) Represents the derivative forward value loss recorded by National Rural for the year-to-date period.

(10) Guarantees

We guarantee certain contractual obligations of our members so that they may obtain various forms of financing. With the exception of letters of credit, the underlying obligations may not be accelerated due to a payment default by the member so long as we perform under our guarantee. We use the same credit policies and monitoring procedures in providing guarantees as we do for loans and commitments.

The following table summarizes total guarantees by type and segment:

(dollar amounts in thousands)	August 31, 2009	May 31, 2009
Total by type:		
Long-term tax-exempt bonds (1)	$ 642,640	$ 644,540
Indemnifications of tax benefit transfers (2)	79,187	81,574
Letters of credit (3)	430,493	450,659
Other guarantees (4)	98,514	98,682
Total	$ 1,250,834	$ 1,275,455
Total by segment:		
National Rural:		
Distribution	$ 237,086	$ 264,084
Power supply	949,344	945,624
Statewide and associate	22,167	23,625
National Rural total	1,208,597	1,233,333
RTFC	500	500

NCSC	41,737	41,622
Total	$ 1,250,834	$ 1,275,455

(1) The maturities for this type of guarantee run through 2042. Amounts in the table represent the outstanding principal amount of the guaranteed bonds. At August 31, 2009, our maximum potential exposure for the $1 million of fixed-rate tax-exempt bonds is $1 million, representing principal and interest. National Rural is unable to determine the maximum amount of interest that it could be required to pay related to the remaining adjustable and floating-rate bonds. See below for further information about this type of guarantee. Many of these bonds have a call provision that in the event of a default would allow us to trigger the call provision. This would limit our exposure to future interest payments on these bonds. Our maximum potential exposure is secured by a mortgage lien on all of the system's assets and future revenues. If the debt is accelerated because of a determination that the interest thereon is not tax-exempt, the system's obligation to reimburse us for any guarantee payments will be treated as a long-term loan.
(2) The maturities for this type of guarantee run through 2015. The amounts shown represent our maximum potential exposure for guaranteed indemnity payments. A member's obligation to reimburse National Rural for any guarantee payments would be treated as a long-term loan to the extent of any cash received by the member at the outset of the transaction. This amount is secured by a mortgage lien on substantially all of the system's assets and future revenues. The remainder would be treated as a short-term loan secured by a subordinated mortgage on substantially all of the member's property. Due to changes in federal tax law, no further guarantees of this nature are anticipated.
(3) The maturities for this type of guarantee run through 2040. Additionally, letters of credit totaling $5 million at August 31, 2009 have a term of one year and automatically extend for a period of one year unless we cancel the agreement within 120 days of maturity (in which case, the beneficiary may draw on the letter of credit). The amounts shown represent National Rural’s maximum potential exposure, of which $192 million is secured at August 31, 2009. When taking into consideration reimbursement obligation agreements that we have in place with other lenders, our maximum potential exposure related to $17 million of letters of credit would be reduced to $5 million in the event of default. Security provisions include a mortgage lien on substantially all of the

system's assets, future revenues, and the system's commercial paper invested with us. In addition to the letters of credit listed in the table, under master letter of credit facilities, we may be required to issue up to an additional $434 million in letters of credit to third parties for the benefit of our members at August 31, 2009. At May 31, 2009, this amount was $440 million.
(4) The maturities for this type of guarantee run through 2015. The amounts shown represent our maximum potential exposure, which is unsecured.

At August 31, 2009 and May 31, 2009, we had a total of $337 million and $347 million of guarantees, representing 27 percent of total guarantees under which our right of recovery from our members was not secured.

Long-term Tax-Exempt Bonds
We guarantee debt issued in connection with the construction or acquisition of pollution control, solid waste disposal, industrial development and electric distribution facilities, classified as long-term tax-exempt bonds in the table above. We unconditionally guarantee to the holders or to trustees for the benefit of holders of these bonds the full principal, interest, and in most cases, premium, if any, on each bond when due. We had debt service reserve funds in the amount of $47 million at August 31, 2009 and May 31, 2009 on deposit with the bond trustee that can only be used to cover any deficiencies in the bond principal, premium or interest payments. The member systems have agreed to make up deficiencies in the debt service reserve funds for certain of these issues of bonds. In the event of default by a member system for non-payment of debt service, we are obligated to pay any required amounts under our guarantees, which will prevent the acceleration of the bond issue. The member system is required to repay, on demand, any amount advanced by us with interest, pursuant to the documents evidencing the member system's reimbursement obligation.

Of the amounts shown in the table above, $642 million and $643 million as of August 31, 2009 and May 31, 2009, respectively, are adjustable or floating/fixed-rate bonds that may be converted to a fixed rate as specified in the indenture for each bond offering. During the variable-rate period (including at the time of conversion to a fixed rate), we have, in return for a fee, unconditionally agreed to purchase bonds tendered or put for redemption if the remarketing agents have not previously sold such bonds to other investors.

Guarantee Liability
At August 31, 2009 and May 31, 2009, we recorded a guarantee liability of $27 million and $30 million, respectively, which represents the contingent and non-contingent exposures related to guarantees and liquidity obligations associated with members' debt. The contingent guarantee liability at August 31, 2009 and May 31, 2009 was $9 million and $12 million, respectively, based on management's estimate of exposure to losses within the guarantee portfolio. We use factors such as internal risk rating, remaining term of guarantee, corporate bond default probabilities and estimated recovery rates in estimating our contingent exposure. The remaining balance of the total guarantee liability of $18 million at August 31, 2009 and May 31, 2009 relates to our non-contingent obligation to stand ready to perform over the term of our guarantees and liquidity obligations that we have entered into or modified since January 1, 2003. The non-contingent obligation is estimated based on guarantee and liquidity fees collectible over the life of the guarantee. The fees are deferred and amortized using the straight-line method into interest income over the term of the guarantees.

Activity in the guarantee liability account is summarized below:

	For the three months ended August 31,		Year ended May 31,
(dollar amounts in thousands)	2009	2008	2009
Beginning balance	$ 29,672	$ 15,034	$ 15,034
Net change in non-contingent liability	(741)	(209)	13,023

Recovery of (provision for) guarantee liability	(2,395)	(705)	1,615
Ending balance	$ 26,536	$ 14,120	$ 29,672
Liability as a percentage of total guarantees	2.12%	1.37%	2.33%

(11) Fair Value Measurement

Fair Value

Fair value is defined as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. The accounting guidance for fair value, among other things, requires that we maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value.

The accounting guidance for fair value establishes the following fair value hierarchy:

- Level 1 – Quoted prices for identical instruments in active markets.
- Level 2 – Quoted prices for similar instruments in active markets; quoted prices for identical or similar instruments in markets that are not active; and model-derived valuations whose inputs are observable or whose significant value drivers are observable.
- Level 3 – Instruments whose significant value drivers are unobservable.

Our only assets and liabilities measured at fair value on a recurring or nonrecurring basis on the consolidated balance sheets at August 31, 2009 and May 31, 2009 are derivative instruments, foreclosed assets, and collateral-dependent non-performing loans. When a valuation includes inputs from multiple sources at various levels in the fair value hierarchy, we classify the valuation category at the lowest level for which the input has a significant effect on the overall valuation.

Assets and Liabilities Measured at Fair Value on a Recurring Basis

We account for derivative instruments (including certain derivative instruments embedded in other contracts) in the consolidated balance sheets as either an asset or liability measured at fair value. Because there is not an active secondary market for the types of interest rate swap derivative instruments we use, we obtain market quotes from the interest rate swap counterparties to adjust all swaps to fair value on a quarterly basis. The market quotes are based on the expected future cash flow and estimated yield curves.

We perform analysis to validate the market quotes obtained from our swap counterparties. We adjust the market values received from the counterparties using credit default swap levels for us and the counterparties. The credit default swap levels represent the credit risk premium required by a market participant based on the available information related to us and the counterparty. We only enter into exchange agreements with counterparties that participate in our revolving credit agreements. All of our exchange agreements are subject to master netting agreements.

Our valuation techniques for interest rate swap derivatives are based upon observable inputs, which reflect market data. Fair value for our interest rate swap derivative instruments are classified as a Level 2 valuation.

We record the change in the fair value of our derivatives for each reporting period in the derivative forward value line on the consolidated statements of operations as currently none of our derivatives qualify for hedge accounting.

The following table presents our assets and liabilities that are measured at fair value on a recurring basis at August 31, 2009:

(dollar amounts in thousands)	Level 1	Level 2	Level 3
Derivative assets	$ -	$ 364,200	$ -
Derivative liabilities	-	486,847	-

Assets and Liabilities Measured at Fair Value on a Nonrecurring Basis

We may be required, from time to time, to measure certain assets at fair value on a nonrecurring basis in accordance with GAAP. Any adjustments to fair value usually result from application of lower-of-cost or fair value accounting or write-downs of individual assets.

Our foreclosed assets do not meet the criteria to be classified as held for sale at August 31, 2009, and therefore are required to be carried at cost. Foreclosed assets are evaluated periodically for impairment by performing a fair value analysis based on estimated future cash flows or in some instances, an assessment of the fair value of the asset or business, which may be provided by a third party consultant. Estimates of future cash flows are subjective and are considered to be a significant input in the valuation. A review for significant changes in the key assumptions and estimates of the fair value analysis is performed on a quarterly basis.

In certain instances when a loan is non-performing, we utilize the collateral fair value underlying non-performing loans, which may be provided by a third party consultant, in estimating the specific reserve to be applied. In these instances, the valuation is considered to be a nonrecurring item.

Assets measured at fair value on a nonrecurring basis at August 31, 2009 were classified as Level 3 within the fair value hierarchy. The following table provides the carrying value of the related individual assets at August 31, 2009 and the total losses for the quarter ended August 31, 2009.

(dollar amounts in thousands)	Level 3 Fair Value	Total losses for the quarter ended August 31, 2009
Foreclosed assets, net	$ 47,558	$ (1,750)
Non-performing loans, net of specific reserves	174,167	-

(12) Fair Value of Financial Instruments

The following disclosure of the estimated fair value of financial instruments is based on the applicable accounting guidance. See Note 11, Fair Value Measurement, for more details about how fair value is determined for assets and liabilities measured at fair value on a recurring or nonrecurring basis on our consolidated balance sheets. We consider relevant and observable prices in the appropriate principal market in our valuations where possible. The estimated fair value information presented is not necessarily indicative of amounts we could realize currently in a market sale since we may be unable to sell such instruments due to contractual restrictions or to the lack of an established market.

The estimated market values have not been updated since August 31, 2009; therefore, current estimates of fair value may differ significantly from the amounts presented. With the exception of redeeming subordinated deferrable debt under early redemption provisions, terminating derivative instruments under early termination provisions and allowing borrowers to prepay their loans, we have held and intend to hold all financial instruments to maturity. Below is a summary of significant methodologies used in estimating fair value amounts at August 31, 2009 and May 31, 2009.

Cash and Cash Equivalents
Includes cash and certificates of deposit with original maturities of less than 90 days. Cash and cash equivalents are valued at the carrying value which approximates fair value.

Restricted Cash
Restricted cash consists of cash and cash equivalents for which use is contractually restricted. Restricted cash is valued at the carrying value which approximates fair value.

Loans to Members
As part of receiving a loan from us, our members have additional requirements and rights that are not typical of other financial institutions, such as the right to receive a patronage capital allocation, the general requirement to purchase subordinated certificates or member capital securities to meet their capital contribution requirements as a condition of obtaining additional credit from us, the option to select fixed rates from one year to maturity with the fixed rate resetting or repricing at the end of each selected rate term, the ability to convert from a fixed rate to another fixed rate or the variable rate at any time and certain interest rate discounts that are specific to the borrower’s activity with us. These features make it difficult to find market data for similar loans. Therefore, we must use other methods to estimate the fair value. Fair values are estimated by discounting the future cash flows using the current rates at which similar loans would be made by us to new borrowers for the same remaining maturities. Because our borrowers must reprice their loans at various times throughout the life of the loan at the then current market rate, for purposes of determining fair value, we use the next repricing date as the maturity date for the remaining balance of the loan. Loans with different risk characteristics, specifically non-performing and restructured loans, are valued by using collateral valuations or by adjusting cash flows for credit risk and discounting those cash flows using the current rates at which similar loans would be made by us to borrowers for the same remaining maturities. See Note 11, Fair Value Measurement, for more details about how we calculate the fair value of certain non-performing loans. Credit risk for the remainder of the loan portfolio is estimated based on the associated reserve in our allowance for loan losses. Variable-rate loans are valued at cost, which approximates fair value since we can reset rates every 15 days.

Investments in Preferred Stock
The fair value of our investments in Series B-1 preferred stock is estimated at par based upon dealer quotes. The Series C preferred stock is estimated at par because we continue to enter into new transactions with the issuer at the same terms and the stock is callable at par. Both of these securities do not meet the definition of a marketable security.

Debt Service Reserve Funds

We consider the carrying value of debt service reserve funds to be equal to fair value. Debt service reserve funds represent cash on deposit with the bond trustee for pollution control bonds that we guarantee and therefore, carrying value is considered to be equal to fair value.

Short-Term Debt

Short-term debt consists of commercial paper, bank bid notes and other debt due within one year. The fair value of short-term debt with maturities greater than 90 days is estimated based on quoted market rates for debt with similar maturities. The fair value of short-term debt with maturities less than or equal to 90 days is carrying value, which is a reasonable estimate of fair value.

Long-Term Debt

Long-term debt consists of collateral trust bonds, medium-term notes and long-term notes payable. We issue all collateral trust bonds and some medium-term notes in underwritten public transactions. There is not active secondary trading for all underwritten collateral trust bonds and medium-term notes; therefore, dealer quotes and recent market prices are both used in estimating fair value. There is essentially no secondary market for the medium-term notes issued to our members or in transactions that are not underwritten, therefore fair value is estimated based on observable benchmark yields and spreads for similar instruments supplied by banks that underwrite our other debt transactions. The long-term notes payable are issued in private placement transactions and there is no secondary trading of such debt. Therefore, the fair value is estimated based on underwriter quotes for similar instruments, if available, or based on cash flows discounted at current rates for similar instruments supplied by underwriters or by the original issuer. Secondary trading quotes for our debt instruments used in the determination of fair value incorporate our credit risk.

Subordinated Deferrable Debt

Our subordinated deferrable debt is traded on the New York Stock Exchange, therefore daily market quotes are available. The fair value for subordinated deferrable debt is based on the closing market quotes from the last day of the reporting period.

Members' Subordinated Certificates

Members’ subordinated certificates include membership subordinated certificates issued to our members as a condition of membership, loan and guarantee subordinated certificates as a condition of obtaining loan funds or guarantees and member capital securities issued as voluntary investments by our members. All members’ subordinated certificates are non-transferable other than among members. As there is no ready market from which to obtain fair value quotes, it is impracticable to estimate fair value and members’ subordinated certificates are valued at par.

Derivative Instruments

See Note 11, Fair Value Measurement, for details about how we calculate the fair value of derivative instruments.

Commitments

The fair value of our commitments is estimated as the carrying value, or zero. Extensions of credit under these commitments, if exercised, would result in loans priced at market rates.

Guarantees

The fair value of our guarantee liability is based on the fair value of our contingent and non-contingent exposure related to our guarantees. The fair value of our contingent exposure for guarantees is based on management’s estimate of our exposure to losses within the guarantee portfolio. The fair value of our non-contingent exposure for guarantees issued is estimated based on the total unamortized balance of guarantee fees paid and guarantee fees to be paid discounted at our current short-term funding rate, which represents management's estimate of the fair value of our obligation to stand ready to perform.

Carrying and fair values of our financial instruments are presented as follows:

	August 31, 2009		May 31, 2009	
(dollar amounts in thousands)	Carrying Value	Fair Value	Carrying Value	Fair Value
Assets:				
Cash and cash equivalents	$ 526,526	$ 526,526	$ 504,999	$ 504,999
Restricted cash	3,273	3,273	8,207	8,207
	72,000	72,000	47,000	47,000

Investments in preferred stock				
Loans to members, net	19,524,253	19,669,553	19,569,349	18,766,573
Debt service reserve funds	46,662	46,662	46,662	46,662
Interest rate exchange agreements	364,200	364,200	381,356	381,356
Liabilities:				
Short-term debt	4,457,701	4,467,734	4,867,864	4,885,919
Long-term debt	12,939,760	13,988,739	12,720,055	13,160,498
Guarantee liability (1)	26,536	30,012	29,672	33,181
Interest rate exchange agreements	486,847	486,847	493,002	493,002
Subordinated deferrable debt	311,440	287,455	311,440	274,759
Members’ subordinated certificates	1,797,9099	1,797,909	1,740,054	1,740,054
Off-balance sheet instruments:				
Commitments	-	-	-	-

(1) The carrying value represents our exposure related to guarantees and therefore will not equal total guarantees shown in Note 11.

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(13) Restructured/Non-performing Loans and Contingencies

The following loans outstanding were classified as non-performing and restructured:

(dollar amounts in thousands)	August 31, 2009	May 31, 2009	August 31, 2008
Non-performing loans	$ 523,761	$ 523,758	$ 491,585
Restructured loans	530,209	537,587	569,722
Total	$ 1,053,970	$ 1,061,345	$ 1,061,307

(a) At August 31, 2009, May 31, 2009 and August 31, 2008, all loans classified as non-performing were on a non-accrual status with respect to the recognition of interest income. At August 31, 2009 and May 31, 2009, $484 million and $491 million, respectively, of restructured loans were on non-accrual status with respect to the recognition of interest income. At August 31, 2008, $512 million of restructured loans were on non-accrual status. Approximately $1 million of interest income was accrued on restructured loans during the three months ended August 31, 2009 and 2008.

Interest income was reduced as follows as a result of holding loans on non-accrual status:

	For the three months ended August 31,	
(dollar amounts in thousands)	2009	2008
Non-performing loans	$ 7,409	$