NATIONAL RURAL UTILITIES COOPERATIVE FINANCE CORP /DC/
Form 10-Q
October 14, 2008

FORM 10-Q

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

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934
For the Quarterly Period Ended August 31, 2008

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 is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See 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 cooperative and consequently, does not issue any equity capital stock.

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, 2008	May 31, 2008
Cash and cash equivalents	$ 1,529,395	$ 177,809
Restricted cash	8,548	14,460
Loans to members	19,365,351	19,029,040
Less: Allowance for loan losses	(522,597)	(514,906)
Loans to members, net	18,842,754	18,514,134
Accrued interest and other receivables	281,180	258,315
Fixed assets, net	21,435	21,045
Debt service reserve funds	47,775	54,993
Bond issuance costs, net	44,956	39,618
Foreclosed assets, net	60,207	58,961
Derivative assets	255,283	220,514
Other assets	23,698	19,532
	$21,115,231	$19,379,381

See accompanying notes.

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, 2008	May 31, 2008
Short-term debt	$ 8,098,624	$ 6,327,453
Accrued interest payable	309,200	244,299
Long-term debt	9,987,480	10,173,587
Patronage capital retirement payable	85,223	-
Deferred income	20,540	21,971
Guarantee liability	14,120	15,034
Other liabilities	42,753	27,216
Derivative liabilities	217,391	171,390
Subordinated deferrable debt	311,440	311,440
Members' subordinated certificates:		
Membership subordinated certificates	649,465	649,465
Loan and guarantee subordinated certificates	771,345	757,314
Total members' subordinated certificates	1,420,810	1,406,779
Commitments and contingencies		
Minority interest	13,001	14,247
Equity:		
Retained equity	586,016	657,138
Accumulated other comprehensive income	8,633	8,827
Total equity	594,649	665,965
	$21,115,231	$19,379,381

See accompanying notes.

NATIONAL RURAL UTILITIES COOPERATIVE FINANCE CORPORATION

CONSOLIDATED STATEMENTS OF OPERATIONS
(UNAUDITED)
(in thousands)

For the Three Months Ended August 31, 2008 and 2007

	Three months ended August 31, 2008	2007
Interest income	$ 266,518	$ 267,954
Interest expense	(220,309)	(247,325)
Net interest income	46,209	20,629
Provision for loan losses	(10,681)	-
Net interest income after provision for loan losses	35,528	20,629
Non-interest income:		
Rental and other income	181	351
Derivative cash settlements	431	8,329
Results of operations from foreclosed assets	1,246	1,960
Total non-interest income	1,858	10,640
Non-interest (expense)/income:		
Salaries and employee benefits	(9,851)	(8,823)
Other general and administrative expenses	(4,742)	(4,487)
Recovery of guarantee liability	705	2,100
Derivative forward value	(11,028)	(33,600)
Loss on sale of loans	-	(518)
Total non-interest expense	(24,916)	(45,328)
Income (loss) prior to income taxes and minority interest	12,470	(14,059)
Income tax benefit	760	1,099
	13,230	(12,960)

Income (loss) prior to minority interest		
Minority interest, net of income taxes	1,241	1,578
Net income (loss)	$ 14,471	$ (11,382)

See accompanying notes.

NATIONAL RURAL UTILITIES COOPERATIVE FINANCE CORPORATION

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

For the Three Months Ended August 31, 2008 and 2007

	Total	Accumulated Other Comprehensive Income (Loss)	Subtotal Retained Equity	Membership Fees	Unallocated Net Income	Education Fund	Members' Capital Reserve	Patrona Capit Alloca Genera Reserv Fund Othe
Three months ended August 31, 2008:								
Balance as of May 31, 2008	$ 665,965	$ 8,827	$ 657,138	$ 993	$ 44,003	$ 1,484	$ [illegible]	[illegible]
Patronage capital retirement	(85,238)	-	(85,238)	-	-	-		(85,238) -
Income prior to income taxes and minority interest	12,470	-	12,470	-	12,470	-		---
Other comprehensive loss	(194)	(194)	-	-	-	-		---
Income tax expense	760	-	760	-	760	-		---
Minority interest	1,241	-	1,241	-	1,241	-		---
Other	(355)	-	(355)	-	-	(355)		---
Balance as of August 31, 2008	$ 594,649	$ 8,633	$ 586,016	$ 993	$ 58,474	$ 1,129	$ 187,409	[illegible] $
Three months ended August 31, 2007:								
Balance as of May 31, 2007	$ 710,041	$ 12,204	$ 697,837	$ 997	$ 131,528	$ 1,406	$ [illegible]	[illegible]
Patronage capital retirement	(85,494)	-	(85,494)	-	-	-		(85,494) -
Loss prior to income taxes	(14,059)	-	(14,059)	-	(14,059)	-		---

and minority interest							
Other comprehensive loss	(75)	(75)	-	-	-	-	---
Income tax benefit	1,099	-	1,099	-	1,099	-	---
Minority interest	1,578	-	1,578	-	1,578	-	---
Other	(328)	-	(328)	(2)	-	(326)	[illegible]
Balance as of August 31, 2007	$ 612,762	$ 12,129	$ 600,633	$ 995	$ 120,146	$ 1,080	[illegible]

See accompanying notes.

5

NATIONAL RURAL UTILITIES COOPERATIVE FINANCE CORPORATION

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

For the Three Months Ended August 31, 2008 and 2007

	2008	2007
CASH FLOWS PROVIDED BY OPERATING ACTIVITIES:		
Net income (loss)	$ 14,471	$ (11,382)
Add (deduct):		
Amortization of deferred income	(1,633)	(1,940)
Amortization of bond issuance costs and deferred charges	2,384	8,358
Depreciation	610	544
Provision for loan losses	10,681	-
Recovery of guarantee liability	(705)	(2,100)
Results of operations from foreclosed assets	(1,246)	(1,960)
Derivative forward value	11,028	33,600
Loss on sale of loans	-	518
Restricted interest earned on restricted cash	(64)	-
Changes in operating assets and liabilities:		
Accrued interest and other receivables	(23,540)	(13,217)
Accrued interest payable	64,901	49,340
Other	8,778	(2,019)
Net cash provided by operating activities	85,665	59,742
CASH FLOWS (USED IN) PROVIDED BY INVESTING ACTIVITIES:		
Advances made on loans	(2,596,707)	(1,831,171)
Principal collected on loans	2,256,780	1,859,582
Net investment in fixed assets	(1,000)	(190)
Net proceeds from sale of loans	-	39,273
Change in restricted cash	5,912	-
Net cash (used in) provided by investing activities	(335,015)	67,494
CASH FLOWS PROVIDED BY (USED IN) FINANCING ACTIVITIES:		

Proceeds from issuances (repayments) of short-term debt, net	723,544	(531,012)
Proceeds from issuance of long-term debt, net	1,450,611	600,546
Payments for retirement of long-term debt	(595,093)	(107,865)
Payments for retirement of subordinated deferrable debt	-	(175,000)
Proceeds from issuance of members' subordinated certificates	29,642	8,308
Payments for retirement of members' subordinated certificates	(7,768)	(7,689)
Net cash provided by (used in) financing activities	1,600,936	(212,712)
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	1,351,586	(85,476)
BEGINNING CASH AND CASH EQUIVALENTS	177,809	304,107
ENDING CASH AND CASH EQUIVALENTS	$ 1,529,395	$ 218,631

See accompanying notes.

NATIONAL RURAL UTILITIES COOPERATIVE FINANCE CORPORATION

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

For the Three Months Ended August 31, 2008 and 2007

	2008	2007
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:		
Cash paid for interest	$ 153,025	$ 189,627
Cash paid for income taxes	-	-
Non-cash financing and investing activities:		
Subordinated certificates applied against loan balances	$ 675	$ -
Patronage capital retirement payable	85,223	85,494
Patronage capital applied against loan balances	15	-
Net decrease in debt service reserve funds/debt service reserve certificates	(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 ("National Rural" or "the Company") is a private, not-for-profit 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 is a not-for-profit member-owned finance cooperative, thus 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.

Rural Telephone Finance Cooperative ("RTFC") was incorporated as a private not-for-profit cooperative association in the state of South Dakota in September 1987. In February 2005, RTFC reincorporated as a not-for-profit cooperative association in the District of Columbia. The principal purpose of RTFC is to provide and arrange financing for its rural telecommunications members and their affiliates. RTFC's results of operations and financial condition are consolidated with those of 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 non-profit cooperative association. The principal purpose of NCSC 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 also markets, through its cooperative members, a consumer loan program for home improvements and an affinity credit card program. 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.

The Company's consolidated membership was 1,525 as of August 31, 2008 including 898 utility members, the majority of which are consumer-owned electric cooperatives, 498 telecommunications members, 66 service members and 63 associates in 48 states, the District of Columbia and two U.S. territories. The utility members included 829 distribution systems and 69 generation and transmission ("power supply") systems. Memberships among 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 the Company's 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 the Company's Annual Report on Form 10-K for the fiscal year ended May 31, 2008.

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 the Company uses its 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.

The Company does not believe it is vulnerable to the risk of a near term severe impact as a result of any concentrations of its activities.

(b) Principles of Consolidation

The accompanying financial statements include the consolidated accounts of National Rural, RTFC and NCSC and certain entities controlled by National Rural and created to hold foreclosed assets and effect loan securitization transactions, after elimination of intercompany accounts and transactions. Financial Accounting Standards Board ("FASB") Interpretation No. ("FIN") 46(R), Consolidation of Variable Interest Entities, an interpretation of Accounting Research Bulletin (“ARB”) No. 51, requires National Rural to consolidate the financial results of RTFC and NCSC. National Rural is the primary beneficiary of variable interests in RTFC and NCSC due to its exposure to absorbing the majority of expected losses.

National Rural is the sole lender to and manages the lending and financial affairs of RTFC through a management agreement in effect until December 1, 2016. Under a guarantee agreement, RTFC pays National Rural a fee in exchange for a reimbursement to RTFC for its loan losses. All loans that require RTFC board approval also require National Rural approval. 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 in exchange for reimbursement to 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 1 out of 11 NCSC directors. The full membership of NCSC elects directors on the basis of 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, 2008, National Rural had guaranteed $270 million of NCSC debt and derivative instruments with third parties. The maturities for NCSC debt guaranteed by National Rural run through 2022. At August 31, 2008, National Rural's maximum potential exposure totaled $289 million related to guarantees of NCSC debt and derivatives. Guarantees related to NCSC debt and derivative instruments are not included in Note 11, Guarantees at August 31, 2008 as the debt and derivatives are reported on the consolidated balance sheet. At August 31, 2008, National Rural had no 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, 2008, RTFC had total assets of $1,895 million including loans outstanding to members of $1,705 million and NCSC had total assets of $461 million including loans outstanding of $415 million. At August 31, 2008, National Rural had committed to lend RTFC up to $4 billion of which $1.7 billion was outstanding. At August 31, 2008, National Rural had committed to provide up to $1 billion of credit to NCSC of which $454 million was outstanding, representing $184 million of outstanding loans and $270 million of credit enhancements.

National Rural has established limited liability corporations and partnerships to hold foreclosed assets and to effect loan securitization transactions. National Rural has full ownership and control of all such entities and thus 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 company formed to effect loan securitization transactions.

Unless stated otherwise, references to the Company relate to the consolidation of National Rural, RTFC, NCSC and certain entities controlled by National Rural and created to hold foreclosed assets and effect loan securitization transactions.

In accordance with ARB 51, the Company presents the amount of subsidiary equity controlled by RTFC and NCSC as minority interest on the consolidated balance sheet and the subsidiary earnings controlled by RTFC and NCSC as minority interest on the consolidated statement of operations.

(c) Allowance for Loan Losses

The Company maintains an allowance for loan losses at a level estimated by management to provide for probable losses inherent in the loan portfolio. These estimates are based upon a review of the loan portfolio, past loss experience, specific problem loans, economic conditions and other pertinent factors which, in management's judgment, deserve current recognition in estimating loan losses. On a quarterly basis, the Company prepares an analysis of the loan loss allowance and makes adjustments to the allowance as necessary. The allowance is based on estimates and, accordingly, actual loan losses may differ from the allowance amount.

Management makes recommendations of loans to be charged off to the board of directors of National Rural. In making its recommendation to charge off all or a portion of a loan balance, management considers various factors including cash flow analysis and collateral securing the borrower's loans.

Activity in the loan loss allowance account is summarized below:

(in thousands)	For the three months ended August 31, 2008	2007	Year ended May 31, 2008
Balance at beginning of period	$514,906	$561,663	$ 561,663
Provision for (recovery of) loan losses	10,681	-	(30,262)
Charge-offs	(3,078)	(16,680)	(16,911)
Recoveries	88	96	416
Balance at end of period	$522,597	$545,079	$ 514,906

(d) Interest Income

The following table presents the components of interest income:

(in thousands)	For the three months ended August 31, 2008	2007
Interest on long-term fixed rate loans (1)	$224,402	$ 214,560
Interest on long-term variable rate loans (1)	15,180	24,549
Interest on short-term loans (1)	19,504	20,348
Interest on investments (2)	2,181	2,936
Conversion fees (3)	1,703	1,774
Make-whole and prepayment fees (4)	827	1,689
Commitment and guarantee fees (5)	1,869	1,535
Other fees	852	563
Total interest income	$266,518	$ 267,954

(1) Represents interest income on loans to members.
(2) Represents interest income on the investment of cash.
(3) Conversion fees are deferred and recognized using the interest method over the remaining original loan interest rate pricing term, except for a small portion of the total fee charged to cover administrative costs related to the conversion, which is recognized immediately.
(4) Make-whole and prepayment fees are charged for the early repayment of principal in full and recognized when collected.
(5) Commitment fees for RTFC loan commitments are, in most cases, refundable on a pro rata basis according to the amount of the loan commitment that is advanced. Such refundable fees are deferred and then recognized on a pro rata basis based on the portion of the loan that is not advanced prior to the expiration of the commitment. Commitment fees on National Rural loan commitments are not refundable and are billed and recognized based on the unused portion of committed lines of credit. Guarantee fees are deferred and amortized using the straight-line method into interest income over the life of the guarantee.

Deferred income on the consolidated balance sheets is comprised primarily of deferred conversion fees totaling $19 million and $20 million at August 31, 2008 and May 31, 2008, respectively.

(e) Interest Expense

The following table presents the components of interest expense:

	For the three months ended August 31,	
(in thousands)	2008	2007
Interest expense (1):		
Commercial paper and bid notes	$ 16,438	$ 38,286
Medium-term notes	80,458	83,186
Collateral trust bonds	62,920	65,350
Subordinated deferrable debt	4,916	4,915
Subordinated certificates	12,417	12,124
Long-term private debt	35,596	30,783
Debt issuance costs (2)	2,135	2,530
Commitment and guarantee fees (3)	4,767	4,070
Loss on extinguishment of debt (4)	-	5,509
Other fees	662	572
Total interest expense	$220,309	$ 247,325

(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.
(3) Includes various fees related to funding activities, including fees paid to banks participating in the Company's revolving credit agreements and fees paid under bond guarantee agreements with RUS as part of the Rural Economic Development Loan and Grant ("REDLG") program. Fees are recognized as incurred or amortized on a straight-line basis over the life of the respective agreement.
(4) Represents the loss on the early retirement of debt including the write-off of unamortized discount, premium and issuance costs.

The Company does not include indirect costs, if any, related to funding activities in interest expense.

(f) Comprehensive Income

Comprehensive income includes the Company's net income, as well as other comprehensive income related to derivatives. Comprehensive income is calculated as follows:

	For the three months ended August 31,	
(in thousands)	2008	2007
Net income (loss)	$ 14,471	$ (11,382)
Other comprehensive income:		
Reclassification adjustment for realized gains on derivatives	(194)	(75)
Comprehensive income (loss)	$ 14,277	$ (11,457)

(g) New Accounting Pronouncements

In December 2007, the FASB issued Statement of Financial Accounting Standards ("SFAS") 160, Noncontrolling Interests in Consolidated Financial Statements, an amendment of ARB 51 ("SFAS 160"), to establish accounting and reporting standards for the noncontrolling interests in a subsidiary and for the deconsolidation of a subsidiary. It also amends certain of ARB 51's consolidation procedures for consistency with the requirements of SFAS 141, Business Combinations. Noncontrolling interests shall be reclassified to equity, consolidated net income shall be adjusted to include net income attributable to noncontrolling interests and consolidated comprehensive income shall be adjusted to include comprehensive income attributable to the noncontrolling interests. This statement is effective for fiscal years beginning on or after December 15, 2008. The Company's adoption of SFAS 160 on June 1, 2009 is not expected to have a material impact on the Company's financial position or results of operations.

In March 2008, the FASB issued SFAS 161, Disclosures about Derivative Instruments and Hedging Activities ("SFAS 161"). This statement requires enhanced disclosures about an entity's derivative and hedging activities. The statement is effective for fiscal years beginning after November 15, 2008. The Company's adoption of SFAS 161 on June 1, 2009 is not expected to have an impact on the Company's financial position or results of operations.

(2) Loans and Commitments

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

	August 31, 2008		May 31, 2008	
(in thousands)	Loans Outstanding	Unadvanced Commitments (1)	Loans Outstanding	Unadvanced Commitments (1)
Total by loan type (2) (3):				
Long-term fixed rate loans	$ 15,209,819	$ -	$ 15,204,614	$ -
Long-term variable rate loans	1,931,468	5,936,480	1,882,095	5,975,541
Loans guaranteed by RUS	249,191	491	250,169	491

Short-term loans	1,972,006	7,624,220	1,690,117	7,597,712
Total loans outstanding	19,362,484	13,561,191	19,026,995	13,573,744
Deferred origination fees	2,867	-	2,045	-
Less: Allowance for loan losses	(522,597)	-	(514,906)	-
Net loans outstanding	$ 18,842,754	$ 13,561,191	$ 18,514,134	$ 13,573,744
Total by segment (2):				
National Rural:				
Distribution	$ 13,614,736	$ 9,668,309	$ 13,438,370	$ 9,579,213
Power supply	3,519,985	2,904,009	3,339,112	2,960,693
Statewide and associate	107,743	166,414	108,925	158,293
National Rural total	17,242,464	12,738,732	16,886,407	12,698,199
RTFC	1,705,004	510,806	1,726,514	562,389
NCSC	415,016	311,653	414,074	313,156
Total loans outstanding	$ 19,362,484	$ 13,561,191	$ 19,026,995	$ 13,573,744

(1) Unadvanced loan commitments include loans for which loan contracts have been approved and executed, but funds have not been advanced. Prior to advancing funds, additional information may be required to assure that all conditions for advance of funds have been fully met and that 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 future cash requirements. Collateral and security requirements for advances on commitments are identical to those on initial loan approval. 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.
(2) Non-performing and restructured loans are included in loans outstanding by loan type table.
(3) Loans are classified as long-term or short-term based on their original maturity.

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

	August 31, 2008		May 31, 2008	
(in thousands)		Unadvanced		Unadvanced
Non-performing and restructured loans (2):	Loans Outstanding	Commitments (1)	Loans Outstanding	Commitments (1)
Non-performing loans (3):				
RTFC:				
Long-term fixed rate loans	$ 212,984	$ -	$ 219,912	$ -
Long-term variable rate loans	261,114	2,160	261,109	2,160
Short-term loans	17,487	-	25,843	-
Total non-performing loans	$ 491,585	$ 2,160	$ 506,864	$ 2,160
Restructured loans (3):				
National Rural:				
Long-term fixed rate loans	$ 52,196	$ -	$ 52,309	$ -
Long-term variable rate loans	512,150	186,673	519,257	186,673
Short-term loans	-	12,500	-	12,500
National Rural total restructured loans	564,346	199,173	571,566	199,173
RTFC:				
Long-term fixed rate loans	5,376	-	5,545	-
Total restructured loans	$ 569,722	$ 199,173	$ 577,111	$ 199,173

(1) Unadvanced loan commitments include loans for which loan contracts have been approved and executed, but funds have not been advanced. Prior to advancing funds, additional information may be required to assure that all conditions for advance of funds have been fully met and that 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 future cash requirements. Collateral and security requirements for advances on commitments are identical to those on initial loan approval. 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.
(2) Non-performing and restructured loans are included in loans outstanding by loan type table.
(3) Loans are classified as long-term or short-term based on their original maturity.

Loan origination costs are deferred and amortized using the straight-line method, which approximates the interest method, over the life of the loan as a reduction to interest income.

Loan Security

The Company evaluates each borrower's creditworthiness on a case-by-case basis. It is generally the Company's policy to require collateral for long-term loans. Such collateral usually consists of a first mortgage lien on the borrower's total system, 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 the Company's secured and unsecured loans outstanding by loan type and by segment:

(dollar amounts in thousands)	August 31, 2008				May 31, 2008			
Total by loan type:	Secured	%	Unsecured	%	Secured	%	Unsecured	%
Long-term fixed rate loans	$ 14,722,766	97%	$ 487,053	3%	$ 14,732,058	97%	$ 472,556	3%
Long-term variable rate loans	1,761,517	91	169,951	9	1,728,803	92	153,292	8
Loans guaranteed by RUS	249,191	100	-	-	250,169	100	-	-
Short-term loans	199,783	10	1,772,223	90	165,226	10	1,524,891	90
Total loans	$16,933,257	87	$ 2,429,227	13	$16,876,256	89	$ 2,150,739	11
Total by segment:								
National Rural	$15,105,074	88%	$ 2,137,390	12%	$15,021,067	89%	$ 1,865,340	11%
RTFC	1,472,667	86	232,337	14	1,497,487	87	229,027	13
NCSC	355,516	86	59,500	14	357,702	86	56,372	14
Total loans	$16,933,257	87	$ 2,429,227	13	$16,876,256	89	$ 2,150,739	11

Pledging of Loans

The following table summarizes the Company’s collateral pledged to secure its collateral trust bonds and notes payable to the Federal Agricultural Mortgage Corporation ("Farmer Mac") and the amount of the corresponding debt:

(in thousands)	August 31, 2008	May 31, 2008
2007 indenture:		
Distribution system mortgage notes	$ 2,534,075	$ 917,925
Collateral trust bonds outstanding	2,000,000	700,000
1994 indenture:		
Distribution system mortgage notes	$ 3,959,373	$3,989,443
RUS guaranteed loans qualifying as permitted investments	214,351	215,329
Total pledged collateral	$ 4,173,724	$4,204,772
Collateral trust bonds outstanding	$ 4,005,000	$4,015,000
1972 indenture:		
Cash pledged	$ 2,032	$ 2,032
Collateral trust bonds outstanding	1,927	1,927
Farmer Mac:		
Distribution system mortgage notes	$ 492,663	$1,042,564
Farmer Mac notes payable	400,000	900,000

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 REDLG program (see Note 5, Long-Term Debt) and the amount of the corresponding debt:

(in thousands)	August 31, 2008	May 31, 2008
REDLG:		
Mortgage notes on deposit	$3,225,319	$3,191,292
REDLG notes payable	2,500,000	2,500,000

The $2.5 billion of notes payable to the FFB contain a rating trigger related to the Company's senior secured credit ratings from Standard & Poor's Corporation, Moody's Investors Service and Fitch Ratings. A rating trigger event exists if the Company's 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 the Company's senior secured credit ratings fall below the levels listed above, the mortgage notes on deposit at that time, which totaled $3,225 million at August 31, 2008, would be pledged as collateral rather than held on deposit. At August 31, 2008, National Rural’s senior secured debt ratings were above the rating trigger threshold.

A total of $1.5 billion of notes payable to the FFB has a second trigger event related to the membership of a financial expert on National Rural’s board of directors. A financial expert trigger event will exist if the financial expert position (as defined by Section 407 of the Sarbanes-Oxley Act of 2002) remains vacant for more than 90 consecutive days. If the Company does not satisfy the financial expert trigger, the mortgage notes on deposit at that time, which totaled $1,881 million at August 31, 2008, 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, Net

Assets received in satisfaction of loan receivables are recorded at cost in accordance with SFAS 144, Accounting for the Impairment or Disposal of Long-Lived Assets ("SFAS 144") 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, 2008 and 2007 or May 31, 2008. At August 31, 2008 and May 31, 2008, the balance of foreclosed assets included real estate developer notes receivables and limited partnership interests in certain real estate developments.

The activity for foreclosed assets is summarized below:

	Three months ended August 31,		Year ended
(in thousands)	2008	2007	May 31, 2008
Beginning balance	$ 58,961	$ 66,329	$ 66,329
Results of operations	1,246	1,960	7,528
Net cash provided by foreclosed assets	-	-	(9,056)
Market adjustment	-	-	(5,840)
Ending balance	$ 60,207	$ 68,289	$ 58,961

(4) Short-Term Debt and Credit Arrangements

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

(in thousands)	August 31, 2008	May 31, 2008
Short-term debt:		
Commercial paper sold through dealers, net of discounts	$ 1,993,783	$ 1,511,953
Commercial paper sold directly to members, at par	1,179,170	1,153,210
Commercial paper sold directly to non-members, at par	133,938	134,351
Total commercial paper	3,306,891	2,799,514
Daily liquidity fund sold directly to members	266,917	250,750
Bank bid notes	300,000	100,000
Subtotal short-term debt	3,873,808	3,150,264
Long-term debt maturing within one year:		
Medium-term notes sold through dealers	2,040,760	558,776
Medium-term notes sold to members	364,548	288,634
Secured collateral trust bonds	1,814,998	1,824,995
Secured notes payable	-	500,000
Unsecured notes payable	4,510	4,784
Total long-term debt maturing within one year	4,224,816	3,177,189
Total short-term debt	$ 8,098,624	$ 6,327,453

National Rural issues commercial paper for periods of one to 270 days. National Rural also enters into short-term bank bid note agreements, which are unsecured obligations of National Rural and do not require backup bank lines for liquidity purposes. Bank bid notes are short-term loans for which National Rural does not pay a commitment fee. The commitments are generally subject to termination at the discretion of the individual banks.

Revolving Credit Agreements
The following is a summary of the amounts available under the Company's revolving credit agreements:

(dollar amounts in thousands)	August 31, 2008	May 31, 2008	Termination Date	Facility fee per annum (1)
Five-year agreement	$ 1,125,000	$ 1,125,000	March 16, 2012	6 basis points
Five-year agreement	1,025,000	1,025,000	March 22, 2011	6 basis points
364-day agreement (2)	1,500,000	1,500,000	March 13, 2009	5 basis points
Total	$ 3,650,000	$ 3,650,000		

(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) Any amount outstanding under the agreement may be converted to a one-year term loan at the end of the revolving credit periods. If converted to a term loan, the fee on the outstanding principal amount of the term loan is 10 basis points per annum.

Upfront fees of between three and five basis points were paid to the banks based on their commitment level to the five-year agreements in place at August 31, 2008. These fees totaled approximately $1 million and will be amortized on a straight-line basis over the life of the agreements. In addition, the Company paid $0.1 million in upfront fees to the banks for their commitment to the 364-day facility in place at August 31, 2008, which will be amortized on a straight-line basis over the life of the agreement. Each agreement contains a provision under which if borrowings exceed 50 percent of total commitments, a utilization fee must be paid on the outstanding balance. The utilization fees are five basis points for all three agreements in place at August 31, 2008.

At August 31, 2008 and May 31, 2008, the Company was in compliance with all covenants and conditions under its revolving credit agreements in place at that time and there were no borrowings outstanding under such agreements.

For the purpose of calculating the required financial covenants contained in its revolving credit agreements, the Company adjusts net income, senior debt and total equity to exclude the non-cash adjustments related to SFAS 133, Accounting for Derivative Instruments and Hedging Activities, as amended ("SFAS 133"), and SFAS 52, Foreign Currency Translation ("SFAS 52"). 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 related to SFAS 133 and SFAS 52, 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. 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 the Company's required and actual financial ratios under the revolving credit agreements at or for the three months ended August 31, 2008 and May 31, 2008:

		Actual	
	Requirement	August 31, 2008	May 31, 2008
Minimum average adjusted TIER over the six most recent fiscal quarters	1.025	1.14	1.16
Minimum adjusted TIER at fiscal year end (1)	1.05	1.15	1.15
Maximum ratio of senior debt to total equity	10.00	8.23	7.33

(1) The Company must meet this requirement in order to retire patronage capital.

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

See Note 15, Subsequent Events, for a description of subsequent events related to such agreements.

(5) Long-Term Debt

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

(in thousands)	August 31, 2008	May 31, 2008
Unsecured long-term debt:		
Medium-term notes sold through dealers	$ 2,753,630	$ 4,231,982
Medium-term notes sold to members	95,546	104,105
Subtotal	2,849,176	4,336,087
Unamortized discount	(3,633)	(5,483)
Total unsecured medium-term notes	2,845,543	4,330,604
Unsecured notes payable	2,558,362	2,558,362
Unamortized discount	(1,867)	(1,959)
Total unsecured notes payable	2,556,495	2,556,403
Total unsecured long-term debt	5,402,038	6,887,007
Secured long-term debt:		
Collateral trust bonds	4,191,927	2,891,927

Unamortized discount	(6,485)	(5,347)
Total secured collateral trust bonds	4,185,442	2,886,580
Secured notes payable	400,000	400,000
Total secured long-term debt	4,585,442	3,286,580
Total long-term debt	$ 9,987,480	$10,173,587

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, 2008 and May 31, 2008, National Rural had $2.5 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, National Rural pays to RUS a fee of 30 basis points per annum on the total amount borrowed. At August 31, 2008, the $2.5 billion of unsecured notes payable issued as part of the REDLG program require National Rural to place on deposit mortgage notes 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.

Secured Notes Payable

At August 31, 2008 and May 31, 2008, National Rural had a total of $400 million and $900 million, respectively, outstanding to Farmer Mac. Notes to Farmer Mac totaling $500 million and reported in short-term debt at May 31, 2008 matured on July 29, 2008. Notes payable sold to Farmer Mac are secured by the pledge of mortgage notes 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 collateral pledged to secure National Rural's notes payable.

(6) Subordinated Deferrable Debt

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

(in thousands)	August 31, 2008	May 31, 2008
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

The Company is neither a dealer nor a trader in derivative financial instruments. The Company utilizes derivatives such as interest rate swaps and cross currency interest rate swaps to mitigate its interest rate risk and foreign currency exchange risk.

Consistent with SFAS 133, the Company records 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, the Company's derivative instruments do not qualify for hedge accounting under SFAS 133. At August 31, 2008 and 2007 and May 31, 2008, the Company did not have any derivative instruments that were accounted for using hedge accounting.

The Company was a party to the following interest rate swaps:

	Notional Amounts Outstanding	
(in thousands)	August 31, 2008	May 31, 2008
Pay fixed and receive variable	$ 7,720,557	$ 7,659,973
Pay variable and receive fixed	5,906,440	5,256,440
Total derivative instruments	$ 13,626,997	$ 12,916,413

Derivative instruments had the following impact on the Company:

	For the three months ended August 31,	
(in thousands)	2008	2007

Statement of Operations:		
Agreements that do not qualify for hedge accounting:		
Derivative cash settlements	$ 431	$ 8,329
Derivative forward value	(11,028)	(33,600)
Total loss on derivative instruments	$ (10,597)	$ (25,271)
Comprehensive Income:		
Amortization of transition adjustment	$ (194)	$ (75)

Cash settlements includes periodic amounts that were paid and received related to the Company's derivative instruments.

A transition adjustment of $62 million was recorded as an other comprehensive loss on June 1, 2001, the date the Company implemented SFAS 133. 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 2029.

The Company has classified cash activity associated with derivatives as an operating activity in the consolidated statements of cash flows.

Rating Triggers

The Company has certain derivative contracts that contain a provision called a rating trigger. Under a rating trigger, 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 of the underlying derivative instrument. Rating triggers are not separate financial instruments and are not separate derivatives under SFAS 133. The rating triggers contained in certain of the Company's derivative instruments are based on its senior unsecured credit rating from Standard & Poor's Corporation and Moody's Investors Service.

At August 31, 2008, the Company had the following notional amount and fair values associated with derivative instruments that contain rating triggers. For the purpose of the presentation, the Company has grouped the rating triggers into two categories: (1) ratings from Moody's Investors Service falls to Baa1 or from Standard & Poor's Corporation falls to BBB+ and (2) ratings from Moody's Investors Service falls below Baa1 or from Standard & Poor's Corporation falls below BBB+. In calculating the payments and collections required upon termination, the Company netted the agreements for each counterparty, as allowed by the associated master netting agreements.

(in thousands)	Notional Amount	Required Company Payment	Amount Company Would Collect	Net Total
Rating Level:				
Fall to Baa1/BBB+	$ 1,919,918	$ (535)	$ 37,908	$ 37,373
Fall below Baa1/BBB+	7,313,977	(36,025)	29,128	(6,897)
Total	$ 9,233,895	$ (36,560)	$ 67,036	$ 30,476

In addition to the rating triggers listed above, at August 31, 2008, the Company had $717 million of notional derivative instruments, with one counterparty that would require the pledging of collateral in an amount equal to the fair value of the derivative instruments if the Company’s senior secured 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. At August 31, 2008, the fair value of the derivative instruments associated with this rating trigger was a $13 million net obligation.

(8) Members' Subordinated Certificates

Membership Subordinated Certificates

National Rural's members are required to purchase membership certificates as a condition of membership. Such certificates are interest-bearing, unsecured, subordinated debt of National Rural. Members may purchase the certificates over time as a percentage of the amount they borrow from National Rural. RTFC and NCSC members are not required to purchase membership certificates as a condition of membership. National Rural membership certificates typically have an original maturity of 100 years and pay interest at five percent semi-annually. The weighted-average maturity for all membership subordinated certificates outstanding at August 31, 2008 and May 31, 2008 was 68 years.

Loan and Guarantee Subordinated Certificates

Members obtaining long-term loans, certain short-term loans or guarantees are generally required to purchase additional loan or guarantee subordinated certificates with each such loan or guarantee based on the members' debt to equity ratio with National Rural. These certificates are unsecured, subordinated debt of the Company.

Certificates currently purchased in conjunction with long-term loans are generally non-interest bearing. National Rural's policy regarding the purchase of loan subordinated certificates requires members with a debt to equity ratio with National Rural in excess of the limit in the policy to purchase a non-amortizing/non-interest bearing subordinated certificate in the amount of two percent for distribution systems and seven percent for power supply systems. National Rural associates and RTFC members are required to purchase loan subordinated certificates in an amount equal to 10 percent of each long-term loan advance. For non-standard credit facilities, the borrower is required to purchase interest bearing certificates in amounts determined appropriate by National Rural based on the circumstances of the transaction. Loan and guarantee subordinated certificates have the same maturity as the related long-term loan. Some certificates may amortize annually based on the outstanding loan balance.

The maturity dates and the interest rates payable on guarantee subordinated certificates purchased in conjunction with National Rural's guarantee program vary in accordance with applicable National Rural policy. Members may be required to purchase non-interest bearing debt service reserve subordinated certificates in connection with National Rural's guarantee of long-term tax-exempt bonds (see Note 11, Guarantees). National Rural pledges proceeds from the sale of such certificates to the debt service reserve fund established in connection with the bond issue and any earnings from the investments of the fund inure solely to the benefit of the members for whom the bonds are issued. These certificates have varying maturities not exceeding the longest maturity of the guaranteed obligation.

(9) Minority Interest

At August 31, 2008 and May 31, 2008, the Company reported minority interests of $13 million and $14 million, respectively, on the consolidated balance sheets. Minority 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.

(10) 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. Subsequent to 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 education fund and the members' capital reserve. National Rural allocates a small portion, less than one percent, of net earnings annually to the education fund. The allocation to the education fund must be at least 0.25 percent of net earnings as required by National Rural's bylaws. Funds from the education fund are disbursed annually to the statewide cooperative organizations to fund the teaching of cooperative principles in the service territories of the cooperatives in each state. 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 any member, 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 impact 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 July 2008, National Rural's board of directors allocated 2008 fiscal year net earnings as follows: $1 million to the education fund, $103 million to members in the form of patronage capital, and $29 million to the members' capital reserve. In July 2008, National Rural's board of directors authorized the retirement of allocated net earnings totaling $85 million, representing 70 percent of the fiscal year 2008 allocation and one-ninth of the fiscal years 1991, 1992 and 1993 allocated net earnings. This amount was paid to members in cash in October 2008. Future allocations and retirements of net earnings will be made annually as determined by National Rural's board of directors with due regard for National Rural's 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.

At August 31, 2008 and May 31, 2008, equity included the following components:

(in thousands)	August 31, 2008	May 31, 2008
Membership fees	$ 993	$ 993
Education fund	1,129	1,484
Members' capital reserve	187,409	187,409
Allocated net income	338,011	423,249
Unallocated net income (1)	23,156	(53)

Total members' equity	550,698	613,082
Prior years' cumulative derivative forward value and foreign currency adjustments	44,056	131,551
Current period derivative forward value (2)	(8,738)	(87,495)
Total retained equity	586,016	657,138
Accumulated other comprehensive income	8,633	8,827
Total equity	$594,649	$665,965

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

(11) Guarantees

The Company guarantees certain contractual obligations of its members so that they may obtain various forms of financing. With the exception of letters of credit, the underlying obligations may not be accelerated so long as the Company performs under its guarantee.

18

At August 31, 2008 and May 31, 2008, the Company recorded a guarantee liability totaling $14 million and $15 million, respectively, which represents the contingent and non-contingent exposure related to guarantees of members' debt obligations. The contingent guarantee liability at August 31, 2008 and May 31, 2008 totaled $9 million and $10 million, respectively, based on management's estimate of exposure to losses within the guarantee portfolio. The Company uses factors such as internal risk rating, remaining term of guarantee, corporate bond default probabilities and estimated recovery rates in estimating its contingent exposure. The remaining balance of the total guarantee liability of $5 million at August 31, 2008 and May 31, 2008 relates to the Company's non-contingent obligation to stand ready to perform over the term of its guarantees that it has entered into or modified since January 1, 2003 in accordance with FIN 45, Guarantor's Accounting and Disclosure Requirement for Guarantees, Including Indirect Guarantees of Indebtedness of Others (an interpretation of FASB Statements No. 5, 57, and 107 and rescission of FASB Interpretation No. 34). The non-contingent obligation is estimated based on guarantee 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)	2008	2007	2008
Beginning balance	$ 15,034	$ 18,929	$ 18,929
Net change in non-contingent liability	(209)	131	(791)
Recovery of contingent guarantee losses	(705)	(2,100)	(3,104)
Ending balance	$ 14,120	$ 16,960	$ 15,034
Liability as a percentage of total guarantees	1.37%	1.57%	1.45%

National Rural has guaranteed 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 below. National Rural has unconditionally guaranteed to the holders or to trustees for the benefit of holders of these bonds the full principal, premium, if any, and interest on each bond when due. National Rural has debt service reserve funds in the amount of $48 million and $55 million at August 31, 2008 and May 31, 2008, respectively, on deposit with the bond trustee that can only be used for covering 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, National Rural is obligated to pay any required amounts under its guarantees, which will prevent the acceleration of the bond issue. The member system is required to repay, on demand, any amount advanced by National Rural with interest, pursuant to the documents evidencing the member system's reimbursement obligation.

Of the amounts shown in the table below, $329 million and $330 million as of August 31, 2008 and May 31, 2008, 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), National Rural has unconditionally agreed to purchase bonds tendered or put for redemption if the remarketing agents have not previously sold such bonds to other purchasers. National Rural's maximum potential exposure includes guaranteed principal and interest related to the bonds. In addition to these tax-exempt bonds, National Rural was the guarantor, but not liquidity provider, for $155 million of tax-exempt bonds that were in the auction rate mode at August 31, 2008 and May 31, 2008. National Rural is unable to determine the maximum amount of interest that it could be required to pay related to the adjustable, floating and auction-rate bonds. See footnote (1) to the table below for further information about this type of guarantee.

The following table summarizes total guarantees by type and segment:

(in thousands)	August 31, 2008	May 31, 2008
Total by type:		
Long-term tax-exempt bonds (1)	$ 496,770	$ 498,495
Indemnifications of tax benefit transfers (2)	91,519	94,821
Letters of credit (3)	344,790	343,424
Other guarantees (4)	100,407	100,400
Total	$ 1,033,486	$ 1,037,140
Total by segment:		
National Rural:		
Distribution	$ 196,232	$ 184,459
Power supply	779,596	786,455
Statewide and associate	20,382	22,785
National Rural total	996,210	993,699
RTFC	260	260
NCSC	37,016	43,181
Total	$ 1,033,486	$ 1,037,140

(1) The maturities for this type of guarantee run through 2037. At August 31, 2008, National Rural's maximum potential exposure for the $13 million of fixed rate tax-exempt bonds is $20 million, representing principal and interest. Many of these bonds have a call provision that in the event of a default would allow National Rural to trigger the call provision. This would limit National Rural's exposure to future interest payments on these bonds. National Rural's maximum potential exposure is secured by a mortgage lien on all of the system's assets and future revenues. However, if the debt is accelerated because of a determination that the interest thereon is not tax-exempt, the system's obligation to reimburse National Rural 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 National Rural’s maximum potential exposure for guaranteed indemnity payments. 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 2018. Additionally, letters of credit totaling $6 million at August 31, 2008 have a term of one year and automatically extend for a period of one year unless the Company cancels the agreement within 120 days of maturity (in which case, the beneficiary may draw on the letter of credit). At August 31, 2008, the Company's maximum potential exposure is $345 million, of which $193 million is secured. When taking into consideration reimbursement obligation agreements that National Rural has in place with other lenders, National Rural’s maximum potential exposure related to $21 million of letters of credit would be reduced to $6 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 at the Company. In addition to the letters of credit listed in the table, under master letter of credit facilities, the Company may be required to issue up to an additional $422 million in letters of credit to third parties for the benefit of its members at August 31, 2008. At May 31, 2008, this amount was $415 million.
(4) The maturities for this type of guarantee run through 2025. Of National Rural’s maximum potential exposure for guaranteed principal and interest totaling $100 million at August 31, 2008, $3 million is secured by a mortgage lien on substantially all of the system's assets and future revenues and the remaining $97 million is unsecured.

The Company uses the same credit policies and monitoring procedures in providing guarantees as it does for loans and commitments.

At August 31, 2008 and May 31, 2008, National Rural had a total of $249 million and $236 million of guarantees, representing 24 percent and 23 percent, respectively, of total guarantees, under which its right of recovery from its members was not secured.

(12) Fair Value of Financial Instruments

Effective June 1, 2008, the Company adopted SFAS 157, Fair Value Measurement ("SFAS 157"), and SFAS 159, The Fair Value Option for Financial Assets and Financial Liabilities —Including an amendment of FASB Statement No. 115 ("SFAS 159").

SFAS 157

SFAS 157 defines fair value, sets out a framework for measuring fair value, and expands disclosure requirements about fair value measurement. SFAS 157, among other things, requires the Company to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value.

SFAS 157 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.

The Company's only assets and liabilities that are measured at fair value on a recurring or nonrecurring basis are derivative instruments, foreclosed assets and collateral dependent non-performing loans. When a valuation includes inputs from multiple sources resulting in various levels, the Company classifies 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
The Company accounts for derivatives in accordance with SFAS 133, which establishes accounting and reporting standards requiring that derivative instruments (including certain derivative instruments embedded in other contracts) be recorded 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 derivative instruments the Company uses, it obtains market quotes from the derivative counterparties to adjust all derivatives to fair value on a quarterly basis. The market quotes are based on the expected future cash flow and estimated yield curves.

The Company performs its own analysis to validate the market quotes obtained from the derivative counterparties. The Company adjusts the market values received from the derivative counterparties using credit default swap levels for the counterparties and the Company. The credit default swap levels represent the credit risk premium required by a market participant based on the available information related to the counterparty and the Company. The Company only enters into exchange agreements with highly rated counterparties that participate in the Company's revolving credit agreements. All exchange agreements contain master netting arrangements as part of their ISDA agreements.

The Company records the change in the fair value of its derivatives for each reporting period in the derivative forward value line on the consolidated statements of operations as currently all of its derivatives do not qualify for hedge accounting.

The Company's valuation techniques for derivatives are based upon observable inputs, which reflect market data. Fair value for the Company's derivative instruments falls under Level 2, as described above.

The following table presents the Company's assets and liabilities that are measured at fair value on a recurring basis at August 31, 2008:

(in thousands)	Level 1	Level 2	Level 3
Derivative assets	$ -	$ 255,283	$ -
Derivative liabilities	-	217,391	-

Assets and Liabilities Measured at Fair Value on a Nonrecurring Basis
The Company 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.

The Company's foreclosed assets do not meet the criteria to be classified as held for sale at August 31, 2008 and therefore are required to be carried at cost in accordance with SFAS 144. 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, the Company utilizes 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.

For assets measured at fair value on a nonrecurring basis that were still held in the balance sheet at quarter end, the following table provides the level of valuation assumptions used to determine each adjustment, the carrying value of the related individual assets at August 31, 2008, and the total losses for the quarter ended August 31, 2008.

(in thousands)	Level 1	Level 2	Level 3	Total losses for the quarter ended August 31, 2008
Foreclosed assets, net	$ -	$ -	$ 60,207	$ -
Non-performing loans, net of specific reserves	-	-	264,554	3,873

SFAS 159

SFAS 159 established the fair value option, which permits entities to choose to measure eligible financial instruments at fair value. The Company elected not to measure eligible financial instruments at fair value and therefore the adoption of SFAS 159 did not have an impact on the Company's financial position or results of operations.

(13) Restructured/Non-performing Loans and Contingencies

The Company had the following loans outstanding classified as non-performing and restructured:

(in thousands)	August 31, 2008	May 31, 2008	August 31, 2007
Non-performing loans	$ 491,585	$ 506,864	$ 493,951
Restructured loans	569,722	577,111	597,038
Total	$ 1,061,307	$ 1,083,975	$ 1,090,989

(a) At August 31, 2008, May 31, 2008 and August 31, 2007, all loans classified as non-performing were on a non-accrual status with respect to the recognition of interest income. At August 31, 2008 and May 31, 2008, $512 million and $519 million, respectively, of restructured loans were on non-accrual status with respect to the recognition of interest income. At August 31, 2007, $539 million of restructured loans were on non-accrual status. A total of $1 million of interest income was accrued on restructured loans during the three months ended August 31, 2008 and 2007.

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

	For the three months ended August 31,	
(in thousands)	2008	2007
Non-performing loans	$ 7,434	$ 9,214
Restructured loans	6,704	9,341
Total	$ 14,138	$ 18,555

(b) The Company classified $1,056 million and $1,078 million of loans as impaired pursuant to the provisions of SFAS 114, Accounting by Creditors for Impairment of a Loan - an Amendment of SFAS 5 and SFAS 15, as amended, at August 31, 2008 and May 31, 2008, respectively. The Company reserved $326 million and $331 million of the loan loss allowance for such impaired loans at August 31, 2008 and May 31, 2008, respectively. The amount included in the loan loss allowance for such loans was based on a comparison of the present value of the expected future cash flow associated with the loan (discounted at the original contract interest rate) and/or the estimated fair value of the collateral securing the loan to the recorded investment in the loan. Impaired loans may be on accrual or non-accrual status with respect to the recognition of interest income based on a review of the terms of the restructure agreement and borrower performance. The Company accrued a total of $1 million of interest income on impaired loans for the three months ended August 31, 2008 and 2007. The average recorded investment in impaired loans for the three months ended August 31, 2008 and 2007 was $1,061 million and $1,099 million, respectively.

The Company updates impairment calculations on a quarterly basis. Since a borrower's original contract rate may include a variable rate component, calculated impairment could vary with changes to the Company's variable rate, independent of a borrower's underlying financial performance or condition. In addition, the calculated impairment for a borrower will fluctuate based on changes to certain assumptions. Changes to assumptions include, but are not limited to the following:

- court rulings,
- changes to collateral values, and
- changes to expected future cash flows both as to timing and amount.

(c) At August 31, 2008 and May 31, 2008, National Rural had a total of $512 million and $519 million, respectively, of restructured loans outstanding to Denton County Electric Cooperative, d/b/a CoServ Electric ("CoServ"), a large electric distribution cooperative located in Denton County, Texas, that provides retail electric service to residential and business customers. All restructured loans have been on non-accrual status since January 1, 2001. In addition, a total of $20 million was outstanding under the capital expenditure loan facility which was classified as a performing loan at both August 31, 2008 and May 31, 2008. Total loans to CoServ at August 31, 2008 and May 31, 2008 represented 2.6 percent and 2.7 percent, respectively, of the Company's total loans and guarantees outstanding.

Under the terms of a bankruptcy settlement from 2002, National Rural restructured its loans to CoServ. CoServ is scheduled to make quarterly payments to National Rural through December 2037. As part of the restructuring, National Rural may be obligated to provide up to $204 million of senior secured capital expenditure loans to CoServ for electric distribution infrastructure through December 2012. When CoServ requests capital expenditure loans from National Rural, these loans are provided at the standard terms offered to all borrowers and require debt service payments in addition to the quarterly payments that CoServ is required to make to National Rural. At August 31, 2008, $20 million had been advanced to CoServ under this loan facility. To date, CoServ has made all payments required under the restructure agreement and capital expenditure loan facility. Under the terms of the restructure agreement, CoServ has the option to prepay the loan for $415 million plus an interest payment true up on or after December 13, 2007 and for $405 million plus an interest payment true up on or after December 13, 2008. National Rural has received no notice from CoServ that it intends to prepay the loan.

CoServ and National Rural have no claims related to any of the legal actions asserted prior to or during the bankruptcy proceedings. National Rural’s legal claim against CoServ is limited to CoServ's performance under the terms of the bankruptcy settlement.

Based on its analysis, the Company believes that it is adequately reserved for its exposure to CoServ at August 31, 2008.

(d) Innovative Communication Corporation ("ICC") is a diversified telecommunications company and RTFC borrower headquartered in St. Croix, United States Virgin Islands ("USVI"). In the USVI, through its subsidiary Virgin Islands Telephone Corporation d/b/a Innovative Telephone ("Vitelco"), ICC provides cellular, wireline local and long-distance telephone, cable television, and Internet access services. Through other subsidiaries, ICC provides telecommunications, cable television, and Internet access services in the eastern and southern Caribbean and mainland France.

At August 31, 2008 and May 31, 2008, RTFC had $484 million and $492 million, respectively, in loans outstanding to ICC. All loans to ICC have been on non-accrual status since February 1, 2005. ICC has not made debt service payments to RTFC since June 2005.

RTFC is the primary secured lender to ICC. RTFC's collateral for the loans included (i) a series of mortgages, security agreements, financing statements, pledges and guaranties creating liens in favor of RTFC on substantially all of the assets and voting stock of ICC, (ii) a direct pledge of 100 percent of the voting stock of ICC's USVI local exchange carrier subsidiary, Vitelco, (iii) secured guaranties, mortgages and direct and indirect stock pledges encumbering the assets and ownership interests in substantially all of ICC's other operating subsidiaries and certain of its parent entities, including ICC's immediate parent, Emerging Communication, Inc., a Delaware corporation ("Emcom") and Emcom's parent, Innovative Communication Company LLC, a Delaware limited liability company ("ICC-LLC"), and (iv) a personal guaranty of the loans from ICC's indirect majority shareholder and chairman, Jeffrey Prosser ("Prosser").

Beginning on June 1, 2004, RTFC filed a series of lawsuits against ICC, Prosser and others for failure to comply with the terms of ICC's loan agreement with RTFC dated August 27, 2001 as amended on April 4, 2003. In response to the lawsuits filed by RTFC, ICC, Vitelco and Prosser denied liability and asserted claims, by way of counterclaim and by filing its own lawsuits against RTFC, National Rural and certain of RTFC's officers, seeking various remedies, including reformation of the loan agreement, injunctive relief, and damages (together with the RTFC claims, the “Loan Litigation”).

In February 2006, involuntary bankruptcy petitions were filed against Prosser, Emcom and ICC-LLC; and on April 26, 2006, RTFC reached a settlement of the Loan Litigation with ICC, Vitelco, ICC-LLC, Emcom, their directors and Prosser, individually. Under the settlement, RTFC obtained entry of judgments in the District Court for the District of the Virgin Islands against ICC for approximately $525 million and Prosser for approximately $100 million. RTFC also obtained dismissals with prejudice of all counterclaims, affirmative defenses and other lawsuits alleging wrongful acts by RTFC, certain of its officers, and National Rural, thereby resolving all the Loan Litigation in RTFC’s favor.

Although the judgment debtors and others were given an opportunity to satisfy the judgments at a discount, on July 31, 2006, ICC-LLC, Emcom and Prosser each filed a voluntary bankruptcy petition for reorganization. The cases are pending in the United States District Court for the Virgin Island, Bankruptcy Division (the "Bankruptcy Court"). A Chapter 11 trustee, Stan Springel, was later appointed for the ICC-LLC and Emcom estates; and Prosser's individual case was converted to Chapter 7 liquidation in October 2007. Prosser's Chapter 7 trustee is in the process of marshaling Prosser's non-exempt assets for disposition and eventual payment in respect of creditor claims.

On September 21, 2007, the Bankruptcy Court entered an order placing ICC in its own bankruptcy proceeding, and on October 3, 2007 appointed Stan Springel as its trustee. The Chapter 11 trustee of ICC has assumed ownership and control of ICC, including its subsidiaries, and has begun to marshal RTFC collateral and other assets, including property in Prosser's possession or control, for disposition and eventual payment in respect of RTFC's claims and the claims of other parties-in-interest.

In most cases, the sale (as part of the Chapter 11 cases) of ICC or any of its subsidiaries engaged in a regulated telecommunications or cable television business, or of the regulated assets of ICC or its subsidiaries, will require the prior consent of the respective regulators in the United States (including the Federal Communications Commission and the U.S.

Virgin Islands Public Services Commission), the British Virgin Islands, France and its Caribbean territories, and the Netherlands Antilles. In certain limited cases, only a post-transaction notification will be required.

Based on its analysis, the Company believes that it is adequately reserved for its exposure to ICC at August 31, 2008.

(e) At August 31, 2008 and May 31, 2008, National Rural had a total of $52 million in restructured loans outstanding to Pioneer Electric Cooperative, Inc. ("Pioneer"). Pioneer was current with respect to all debt service payments at August 31, 2008. All loans to Pioneer remain on accrual status with respect to the recognition of interest income. National Rural is the principal creditor to Pioneer.

Based on its analysis, the Company believes that it is adequately reserved for its exposure to Pioneer at August 31, 2008.

(14) Segment Information

The Company's consolidated financial statements include the financial results of National Rural, RTFC and NCSC. Financial statements are produced for each of the three companies and are the primary reports that management reviews in evaluating performance. The National Rural segment includes the consolidation of entities controlled by National Rural and created to hold foreclosed assets and facilitate loan securitization transactions and intercompany transaction elimination entries. The segment presentation for the three months ended August 31, 2008 and 2007 reflect the operating results of each of the three companies as a separate segment.

National Rural is the sole lender to RTFC and the primary source of funding for NCSC. NCSC also obtains funding from third parties with a National Rural guarantee. Thus, National Rural takes all of the risk related to the funding of the loans to RTFC and NCSC, and in return, National Rural earns a net interest income on the loans to RTFC and NCSC.

Pursuant to guarantee agreements, National Rural has agreed to indemnify RTFC and NCSC for loan losses, with the exception of the NCSC consumer loan program. Thus, National Rural maintains the majority of the total consolidated loan loss allowance. A small loan loss allowance is maintained by NCSC to cover its consumer loan exposure.

The following table contains consolidated statements of operations for the three months ended August 31, 2008, and consolidated balance sheets at August 31, 2008.

(in thousands)	National Rural	RTFC	NCSC	Consolidated
Statement of Operations:				
Interest income	$ 239,420	$ 19,572	$ 7,526	$ 266,518
Interest expense	(197,006)	(18,246)	(5,057)	(220,309)
Net interest income	42,414	1,326	2,469	46,209
Provision for loan losses	(10,681)	-	-	&#16