

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

- 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

- 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 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 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 .

The Registrant is a tax-exempt cooperative and consequently is unable to 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, 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

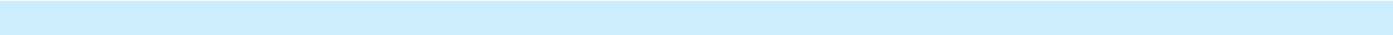
See accompanying notes.

NATIONAL RURAL UTILITIES COOPERATIVE FINANCE CORPORATION

CONSOLIDATED BALANCE SHEETS
(UNAUDITED)
(in thousands)

LIABILITIES AND EQUITY

	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.

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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.

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

	National Accumulated National					Unallocated Net Income	Members' Capital Reserve	Patronage Capital Allocated	Membership Fees and Education Fund
	Total	Noncontrolling Interest	Rural Total Equity	Other Comprehensive Income (Loss)	Rural Retained Equity				
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.