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

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

FORM 10-Q

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

OR

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

Commission File Number 1-7102

NATIONAL RURAL UTILITIES COOPERATIVE
FINANCE CORPORATION

(Exact name of registrant as specified in its charter)

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

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

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

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

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

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

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

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

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

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

1

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.

2

NATIONAL RURAL UTILITIES COOPERATIVE FINANCE CORPORATION

CONSOLIDATED BALANCE SHEETS
(UNAUDITED)
(in thousands)

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

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

See accompanying notes.

NATIONAL RURAL UTILITIES COOPERATIVE FINANCE CORPORATION

CONSOLIDATED STATEMENTS OF OPERATIONS
(UNAUDITED)
(in thousands)

For the Three Months Ended August 31, 2009 and 2008

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

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

See accompanying notes.

4

NATIONAL RURAL UTILITIES COOPERATIVE FINANCE CORPORATION

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

For the Three Months Ended August 31, 2009 and 2008

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

See accompanying notes.

NATIONAL RURAL UTILITIES COOPERATIVE FINANCE CORPORATION

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

For the Three Months Ended August 31, 2009 and 2008

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

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

See accompanying notes.

NATIONAL RURAL UTILITIES COOPERATIVE FINANCE CORPORATION

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

For the Three Months Ended August 31, 2009 and 2008

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

See accompanying notes.

NATIONAL RURAL UTILITIES COOPERATIVE FINANCE CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)

(1) General Information and Accounting Policies

(a) General Information

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

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

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

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

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

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

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

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

(b) Principles of Consolidation

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

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

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

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

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

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

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

(c) Interest Income

The following table presents the components of interest income:

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

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

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

(d) Interest Expense

The following table presents the components of interest expense:

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

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

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

(e) Comprehensive Income

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

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

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

(f) Use of Estimates

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

(g) Subsequent Events

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

(h) Reclassifications

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

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

(i) New Accounting Pronouncements

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

(2) Loans and Commitments

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

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

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

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

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

Non-Performing and Restructured Loans

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

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

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

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

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

Loan Loss Allowance

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

Activity in the loan loss allowance account is summarized below:

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

Loan Security

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

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

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

Pledging of Loans and Loans on Deposit

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

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

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

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

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

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

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

(3) Foreclosed Assets

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

The activity for foreclosed assets is summarized below:

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

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

(4) Short-Term Debt and Credit Arrangements

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

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

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

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

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

14

Revolving Credit Agreements

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

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

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

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

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

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

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

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

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

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

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

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

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

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

(5) Long-Term Debt

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

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

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

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

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

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

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

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

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

(6) Subordinated Deferrable Debt

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

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

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

(7) Derivative Financial Instruments

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

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

Interest Rate Swaps

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

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

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

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

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

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

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

Rating Triggers

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

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

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

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

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

(8) Members' Subordinated Certificates

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

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

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

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

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

Member Capital Securities

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

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

(9) Equity

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

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

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

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

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

Equity includes the following components:

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

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

(10) Guarantees

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

The following table summarizes total guarantees by type and segment:

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

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

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

20

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

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

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

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

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

Activity in the guarantee liability account is summarized below:

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

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

(11) Fair Value Measurement

Fair Value

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

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

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

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

Assets and Liabilities Measured at Fair Value on a Recurring Basis

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

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

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

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

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

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

Assets and Liabilities Measured at Fair Value on a Nonrecurring Basis

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

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

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

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

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

22

(12) Fair Value of Financial Instruments

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

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

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

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

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

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

Debt Service Reserve Funds

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

Short-Term Debt

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

Long-Term Debt

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

Subordinated Deferrable Debt

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

Members' Subordinated Certificates

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

Derivative Instruments

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

Commitments

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

Guarantees

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

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

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

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

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

24

(13) Restructured/Non-performing Loans and Contingencies

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

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

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

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

(dollar amounts in thousands)	For the three months ended August 31, 2009	2008
Non-performing loans	$ 7,409	$ 7,434
Restructured loans	6,040	6,704
Total	$ 13,449	$ 14,138

(b) We classified $1,049 million and $1,056 million of loans as impaired at August 31, 2009 and May 31, 2009, respectively. We reserved $403 million and $414 million of the loan loss allowance for such impaired loans at August 31, 2009 and May 31, 2009, 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. We accrued a total of $1 million of interest income on impaired loans for the three months ended August 31, 2009 and 2008. The average recorded investment in impaired loans for the three months ended August 31, 2009 and 2008 was $1,034 million and $1,061 million, respectively.

We update 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 our 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, 2009 and May 31, 2009, National Rural had a total of $484 million and $491 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, 2009 and May 31, 2009. Total loans to CoServ at August 31, 2009 and May 31, 2009 represented 2.4 percent of our 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. Under this facility, advances are limited to $46 million per year. As of the date of this filing, there is $184 million available under this loan facility. 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. 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 the lesser of their outstanding balance or $405 million plus an interest payment true up on or after December 13, 2008. To date, National Rural has not received 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 before 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 our analysis, we believe that we are adequately reserved for our exposure to CoServ at August 31, 2009.

(d) Innovative Communication Corporation ("ICC") is a diversified telecommunications company headquartered in St. Croix, United States Virgin Islands ("USVI"). In the USVI, through subsidiaries including 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 provided telecommunications, cable television, and Internet access services in the eastern and southern Caribbean and mainland France.

At August 31, 2009 and May 31, 2009, RTFC had $524 million 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 former chairman, Jeffrey Prosser ("Prosser").

In February 2006, involuntary bankruptcy petitions were filed against Prosser, Emcom and ICC-LLC; and in April 2006, RTFC reached a settlement with ICC, Vitelco, ICC-LLC, Emcom, their directors and Prosser, individually. Under the settlement, RTFC obtained entry of judgments in the District Court of the Virgin Islands against ICC for approximately $525 million and Prosser for approximately $100 million. RTFC also obtained dismissals with prejudice and releases 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-related litigation in RTFC's favor. Regardless, Prosser and related parties continue to assert claims against National Rural and certain of its officers and directors and other parties in various proceedings and forums. National Rural therefore anticipates that it will continue to be engaged in defense of those assertions on many fronts, as well as pursuing claims of its own.

ICC-LLC, Emcom and Prosser each have bankruptcy proceedings pending in the United States District Court for the Virgin Islands, Bankruptcy Division (the "Bankruptcy Court"). A Chapter 11 trustee has been appointed for the ICC-LLC and Emcom estates; and a Chapter 7 trustee was appointed in Prosser's individual case. 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 of RTFC's claims and the claims of other parties-in-interest. Certain assets have been sold, including certain foreign companies, aircraft, and real estate.

On February 1, 2008, the Court approved a motion of the Chapter 11 trustee of ICC to sell substantially all of ICC's assets, divided into three groups: Group 1 consisting of ICC assets and stock in ICC subsidiaries operating in the U.S. Virgin Islands, the British Virgin Islands and St. Martin (the "Group 1 Assets"); Group 2 consisting of ICC assets and stock in ICC subsidiaries operating in France and certain of its Caribbean territories and the Netherland Antilles (the

"Group 2 Assets"); and Group 3 consisting of the newspaper and media operations of ICC (the "Group 3 Assets"). The Group 2 Assets and Group 3 Assets were sold in December 2008 and May 2008, respectively, and in each case, the distribution of proceeds was approved by the Court and resulted in a net recovery to us.

On March 13, 2009, RTFC and the Trustee entered into a Purchase Agreement as part of a $250 million credit bid for the ICC Group 1 Assets. The Purchase Agreement is conditional upon the approval of the bankruptcy court and applicable regulators. On April 6, 2009, the Bankruptcy Judge approved, on an interim basis, the sale of the ICC Group 1 Assets to RTFC. RTFC has begun the process of obtaining the applicable regulatory approvals.

In April 2009, RTFC acquired $85 million of Vitelco preferred stock and $12.5 million of accrued and unpaid dividends relating to such shares for a total purchase price of $30 million. We believe that the acquisition of the preferred shareholders interests at a discount has improved our estimated recovery from the collateral.

Based on our analysis, we believe that we are adequately reserved for our exposure to ICC at August 31, 2009.

(e) At August 31, 2009 and May 31, 2009, National Rural had a total of $42 million in restructured loans outstanding to Pioneer Electric Cooperative, Inc. ("Pioneer"), an electric distribution cooperative located in Greenville, Alabama. Pioneer was current with respect to all debt service payments at August 31, 2009 and all loans to Pioneer remain on accrual status. National Rural is the principal creditor to Pioneer.

Based on our analysis, we believe that we are adequately reserved for our exposure to Pioneer at August 31, 2009.

(14) Segment Information

Our 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, 2009 and 2008 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, 2009, and consolidated balance sheets at August 31, 2009.

(dollar amounts in thousands)	National Rural	RTFC	NCSC	Consolidated
Statement of Operations:				
Interest income	$ 244,393	$ 18,454	$ 6,610	$ 269,457
Interest expense	(221,954)	(17,302)	(3,373)	(242,629)
Net interest income	22,439	1,152	3,237	26,828
Recovery of loan losses	16,142	-	29	16,171
Net interest income after recovery of loan losses	38,581	1,152	3,266	42,999
Non-interest income:				
Fee and other income	3,357	40	337	3,734
Derivative cash settlements	(1,338)	-	(2,156)	(3,494)
Results of operations from foreclosed assets	587	-	-	587
Total non-interest income	2,606	40	(1,819)	827
Non-interest (expense) income:				
General and administrative expenses	(14,339)	(1,514)	(1,173)	(17,026)
Recovery of guarantee liability	2,395	-	-	2,395
Derivative forward value	(11,155)	-	321	(10,834)

Market adjustment of foreclosed assets	(1,750)	-	-	(1,750)
Other expenses	(96)	-	(50)	(146)
Total non-interest expense	(24,945)	(1,514)	(902)	(27,361)
Income (loss) prior to income taxes	16,242	(322)	545	16,465
Income tax benefit (expense)	-	1	(33)	(32)
Net income (loss)	$ 16,242	$ (321)	$ 512	$ 16,433
Reconciliation of net income:				
Net income per segment reporting				$ 16,433
Less: Net income attributable to the noncontrolling interest				(191)
Net income attributable to National Rural				$ 16,242
Assets:				
Total loans outstanding	$ 17,986,700	$ 1,735,709	$ 404,076	$ 20,126,485
Deferred origination fees	4,607	-	-	4,607
Less: Allowance for loan losses	(606,762)	-	(77)	(606,839)
Loans to members, net	17,384,545	1,735,709	403,999	19,524,253
Other assets	1,216,419	179,487	16,413	1,412,319
Total assets	$ 18,600,964	$ 1,915,196	$ 420,412	$ 20,936,572

27

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

(dollar amounts in thousands)	National Rural	RTFC	NCSC	Consolidated
Statement of Operations:				
Interest income	$ 236,364	$ 19,377	$ 7,376	$ 263,117
Interest expense	(196,959)	(18,246)	(4,944)	(220,149)
Net interest income	39,405	1,131	2,432	42,968
Provision for loan losses	(10,681)	-	-	(10,681)
Net interest income after provision for loan losses	28,724	1,131	2,432	32,287
Non-interest income:				
Fee and other income	3,097	195	290	3,582
Derivative cash settlements	1,625	-	(1,194)	431
Results of operations from foreclosed assets	1,246	-	-	1,246
Total non-interest income	5,968	195	(904)	5,259
Non-interest (expense) income:				
General and administrative expenses	(12,141)	(1,325)	(1,127)	(14,593)
Recovery of guarantee liability	705	-	-	705
Derivative forward value	(8,738)	-	(2,290)	(11,028)
Other expenses	(47)	-	(113)	(160)
Total non-interest expense	(20,221)	(1,325)	(3,530)	(25,076)
Income (loss) prior to income taxes	14,471	1	(2,002)	12,470
Income tax benefit	-	-	760	760
Net income (loss)	$ 14,471	$ 1	$ (1,242)	$ 13,230
Reconciliation of net income:				
Net income per segment reporting				$ 13,230
Less: Net loss attributable to the noncontrolling interest				1,241
Net income attributable to National Rural				$ 14,471
Assets:				
Total loans outstanding	$ 17,242,464	$ 1,705,004	$ 415,016	$ 19,362,484
Deferred origination fees	2,867	-	-	2,867
Less: Allowance for loan losses	(522,351)	-	(246)	(522,597)
Loans to members, net	16,722,980	1,705,004	414,770	18,842,754
Other assets	2,036,560	189,604	46,313	2,272,477
Total assets	$ 18,759,540	$ 1,894,608	$ 461,083	$ 21,115,231

(15) Subsequent Events

In September 2009, we issued $250 million of 2.625 percent collateral trust bonds due 2012 and $250 million of 3.875 percent collateral trust bonds due 2015.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations.

Unless stated otherwise, references to “we,” “our,” or “us” relate to the consolidation of National Rural Utilities Cooperative Finance Corporation ("National Rural"), Rural Telephone Finance Cooperative ("RTFC"), National Cooperative Services Corporation ("NCSC") and certain entities created and controlled by National Rural to hold foreclosed assets and accommodate loan securitization transactions. The following discussion and analysis is designed to provide a better understanding of our consolidated financial condition and results of operations and as such should be read in conjunction with the consolidated financial statements, including the notes thereto. We refer to our financial measures that are not in accordance with generally accepted accounting principles ("GAAP") as "adjusted" throughout this document. See Non-GAAP Financial Measures for further explanation of why the non-GAAP measures are useful and for a reconciliation to GAAP amounts.

This Form 10-Q contains forward-looking statements within the meaning of the Securities Act of 1933, as amended, and the Exchange Act of 1934, as amended. Forward-looking statements, which are based on certain assumptions and describe our future plans, strategies and expectations, are generally identified by our use of words such as "intend," "plan," "may," "should," "will," "project," "estimate," "anticipate," "believe," "expect," "continue," "potential," "opportunity," and similar expressions, whether in the negative or affirmative. All statements that address expectations or projections about the future, including statements about loan growth, the adequacy of the loan loss allowance, net income growth, leverage and debt to equity ratios, and borrower financial performance are forward-looking statements. Although we believe that the expectations reflected in our forward-looking statements are based on reasonable assumptions, actual results and performance could differ materially from those set forth in the forward-looking statements. Factors that could cause future results to vary from current expectations include, but are not limited to, general economic conditions, legislative changes, governmental monetary and fiscal policies, changes in tax policies, changes in interest rates, demand for our loan products, changes in the quality or composition of our loan and investment portfolios, changes in accounting principles, policies or guidelines, and other economic and governmental factors affecting our operations. Some of these and other factors are discussed in our annual and quarterly reports previously filed with the Securities and Exchange Commission ("SEC"). Except as required by law, we undertake no obligation to update or publicly release any revisions to forward-looking statements to reflect events, circumstances or changes in expectations after the date on which the statement is made.

The following discussion and analysis is designed to provide a better understanding of our consolidated financial condition and results of operations and as such should be read in conjunction with the consolidated financial statements, including the notes thereto and the information contained elsewhere in this Form 10-Q, in addition to Part I, Item 1A. Risk Factors in our Form 10-K for the year ended May 31, 2009.

Business Overview

National Rural was formed in 1969 by rural electric cooperatives to provide a source of financing to supplement the loan programs of the Rural Utilities Service ("RUS"). National Rural is organized as a cooperative and is a tax-exempt entity under Section 501(c)(4) of the Internal Revenue Code.

RTFC is a private cooperative association created to provide and/or arrange financing for its rural telecommunications members and their affiliates. 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. NCSC also is a private 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 is a taxable corporation.

Our primary objective as a cooperative is to provide financial products to our rural electric and telecommunications members at a low cost while maintaining sound financial results required for investment grade credit ratings on our debt instruments. Our goal is not to maximize profit on loans to members, but to balance charging our members low rates on loans and maintaining the financial performance required to access the capital markets on behalf of our members. Therefore, the rates we charge our borrowers reflect our funding costs plus a spread to cover our operating expenses and a provision for loan losses and to provide earnings sufficient to preserve interest coverage to meet our financial objectives.

We obtain funding from the capital markets, private placements of debt and our members. We enter the capital markets, based on the combined strength of our members, to borrow the funds to fulfill our members' financing requirements. We regularly obtain funding in the capital markets by issuing:

- fixed-rate or variable-rate secured collateral trust bonds;
- fixed-rate or variable-rate unsecured medium-term notes including retail notes;
- commercial paper;
- bank bid note agreements; and
- fixed-rate subordinated deferrable debt.

We issue fixed-rate and variable-rate debt to private funding sources. We also obtain debt financing from our members and other qualified investors through the direct sale of our commercial paper, daily liquidity fund and unsecured medium-term notes.

As a condition of membership, rural electric cooperatives have generally been required to purchase membership subordinated certificates from us. Members are sometimes required to make an additional investment in us by purchasing loan or guarantee subordinated certificates as a condition for obtaining long-term loans or guarantees. Requirements for the purchase of such equity certificates depend upon several factors, including but not limited to the borrower's debt to equity ratio with us, the relative size of the credit facility, and the relative risk of the transaction. The membership subordinated certificates and the loan and guarantee subordinated certificates are unsecured and subordinate to our senior debt. During the 2009 fiscal year, we began offering member capital securities to our voting members. These securities represent members' voluntary investments in us. Effective June 1, 2009, member capital securities may be purchased by members in an amount we determine to meet their capital contribution requirements as a condition of obtaining additional credit facilities from us.

National Rural is required by District of Columbia cooperative law to have a mechanism to allocate our net income to our members. We allocate our net income, excluding the non-cash effects of the accounting for derivative financial instruments and foreign currency translation, annually to a cooperative educational fund, a members' capital reserve and to members based on each member's patronage of our loan programs during the year. RTFC annually allocates its net income to a cooperative educational fund and to its members based on each member's patronage of its loan programs during the year. NCSC does not allocate its net income to its members, but does allocate a portion of its margins to a cooperative educational fund.

Our performance is closely tied to the performance of our member rural electric and telecommunications systems due to the near 100 percent concentration of our loan and guarantee portfolio in those industries.

Financial Overview

In this section, we analyze our results of operations, financial condition, liquidity and market risk. We also analyze trends and significant transactions completed in the periods covered by this Form 10-Q.

Results of Operations

We use a times interest earned ratio ("TIER") instead of the dollar amount of net interest income or net income as our primary performance indicator, since net income can fluctuate as total loans outstanding and/or interest rates change. TIER is a measure of our ability to cover the interest expense on our debt obligations. TIER is calculated by dividing the sum of interest expense and the net income prior to the cumulative effect of change in accounting principle by the interest expense. Adjusted net income is calculated by excluding the effect of derivatives. Due to the adoption of new accounting guidance regarding noncontrolling interests on June 1, 2009, minority interest net income is included in total net income in the consolidated income statement. As a result, it is not necessary to adjust net income to include minority interest net income as it was in prior periods. As required, we have reflected changes in presentation and disclosure of noncontrolling interest in our consolidated financial statements for all periods presented in this Form 10-Q, including the adjusted net income and adjusted TIER calculations for the three months ended August 31, 2008. Adjusted TIER is calculated by using adjusted net income and including all derivative cash settlements in interest expense. See Non-GAAP Financial Measures for more information on the adjustments we make to our financial results for our own analysis and covenant compliance.

For the three months ended August 31, 2009, we reported net income of $16 million, which resulted in a TIER calculation of 1.07 compared to net income of $13 million and TIER of 1.06 for the prior-year period. For the three months ended August 31, 2009, we reported an adjusted net income of $27 million with an adjusted TIER of 1.11, compared with an adjusted net income of $24 million and adjusted TIER of 1.11 for the prior-year period. The $3 million increase in net income for the three months ended August 31, 2009 compared with the prior-year period was primarily due to the $27 million increase in the recovery for loan losses which was partly offset by the $16 million decrease in net interest income and the $4 million decrease in derivative cash settlements.

Interest income of $269 million for the three months ended August 31, 2009 increased 2 percent compared with the prior-year period. During the three months ended August 31, 2009, there was an increase of $1 billion or 5 percent to the average balance of loans outstanding which was largely offset by a 14 basis point decline in the weighted-average yield earned on the loan portfolio as compared with the prior-year period. The decline in the yield earned on the loan portfolio was the result of the lower interest rates earned on variable-rate loans.

Our interest expense increased by $22 million or 10 percent for the three months ended August 31, 2009 as compared with the prior-year period primarily due to the additional interest incurred due to prefunding of debt maturities, including $1,250 million in late August 2009. The prefunding of debt and the 5 percent increase in average loans outstanding resulted in an

8 percent increase in average debt outstanding for the three months ended August 31, 2009 compared with the prior year period. The increase in debt volume came primarily from notes issued to Federal Agricultural Mortgage Corporation ("Farmer Mac"), retail notes and member capital securities. Additionally, a 7 basis point increase in the weighted average cost of debt resulted from a shift from commercial paper funding to higher-cost term debt and member capital securities, as well as higher interest rates on our collateral trust bonds issued in October 2008. These factors were partly offset by lower interest rates on our variable-rate debt and commercial paper funding.

Our adjusted interest expense, which includes derivative cash settlements in interest expense, increased by $26 million for the three months ended August 31, 2009 compared to the prior-year period. In addition to the factors above, the increase in the adjusted interest expense was largely due to the $4 million decrease in cash settlements for the quarter ended August 31, 2009 from the prior-year period resulting from lower short-term interest rates on the receive leg of pay fixed-receive variable swaps during the quarter ended August 31, 2009 compared with the prior-year period.

During the quarter ended August 31, 2009, there was a loan loss recovery of $16 million compared to a provision of $11 million in the prior-year period. The recovery of loan losses during the three months ended August 31, 2009 was primarily due to payments received on impaired loans and the net decrease in our variable interest rates from May 31, 2009 to August 31, 2009. The remaining decrease in the loan loss allowance for the three months ended August 31, 2009 was primarily due to decreases in the outstanding balance and the weighted average maturity of loans in the general portfolio.

The loan loss provision is affected by changes in the calculated impairment on our impaired loans due to changes in interest rates. The impairment amount for certain loans is calculated by discounting future expected cash flows using the original contract interest rate on the loan, a portion of which is based on our variable interest rates. Changes to our variable interest rates are based on the underlying cost of funding, competition and other factors. Based on the current balance of impaired loans at August 31, 2009, an increase or decrease of 25 basis points to our short-term and long-term variable interest rates results in an increase or decrease of approximately $9 million, respectively, to the calculated impairment on loans irrespective of a change in the credit fundamentals of the impaired borrower.

Financial Condition

At August 31, 2009, total loans outstanding remained relatively flat as compared with May 31, 2009 due to a $105 million decrease in electric loans and a $13 million decrease in NCSC loans mostly offset by a $56 million increase in RTFC loans. See further discussion of our loan portfolio in Financial Condition, Loan and Guarantee Portfolio Assessment. We expect loan growth to remain relatively stable during fiscal year 2010.

New loan advances have continued to substantially offset loan amortization and maturities despite the slowdown in the economy. The current economic conditions reduced the competition for power supply loans from investment and commercial banks. In addition, there is currently a need for utilities to improve their infrastructure, including base load generation, transmission and distribution plants, a significant portion of which is typically financed with borrowed capital.

The current difficult economic conditions have not resulted in a rise in delinquencies or defaults in our members' receivables. Calendar year 2008 data from member systems shows no increase in late payments or write-offs for the year ended December 31, 2008 compared to the prior calendar year. The majority of the cooperatives' customers are residential, and electricity is considered an essential service, so we continue to believe the impact of the recession on collections will likely be moderate.

Total debt outstanding decreased by $133 million at August 31, 2009 as compared with May 31, 2009 due to the following debt maturities or paydowns:

- Approximately $1,669 million of medium-term notes matured; and

- $200 million term loan was paid off early.

These decreases were mostly offset by the following increases to debt outstanding:

- $918 million to commercial paper and the daily liquidity fund;
- $625 million in fixed-rate notes to Farmer Mac with maturities through August 2014;
- $165 million of various member and dealer medium-term notes including retail notes; and
- $59 million of member capital securities.

In September 2009, we issued $250 million of 2.625 percent collateral trust bonds due 2012 and $250 million of 3.875 percent collateral trust bonds due 2015.

Total equity decreased $26 million from May 31, 2009 to August 31, 2009 primarily due to the board authorized patronage capital retirement totaling $41 million partly offset by net income of $16 million for the three months ended August 31, 2009. The patronage capital retirement was returned to members in cash at the end of September 2009. Total equity fluctuates based on the changes in earnings which are significantly affected by changes in the fair value of our derivative instruments. The fair values of these derivative instruments are sensitive to changes in interest rates. As a result, it is difficult to predict the future changes in equity due to the uncertainty of the movement in future interest rates. In our internal analysis and for covenant compliance under our credit agreements, we adjust equity to exclude the non-cash effects of the accounting for derivative financial instruments and foreign currency translation.

Liquidity

Our primary sources of liquidity include:

- scheduled member loan principal prepayments and repayments and the interest on those loans;
- member investments (member commercial paper, the daily liquidity fund, member medium-term notes and member capital securities);
- revolving bank line facilities;
- capital market debt issuances (dealer commercial paper, collateral trust bonds, medium-term notes and retail notes); and
- private debt issuances (Farmer Mac and Rural Economic Development Loan and Grant (“REDLG”)).

Our primary uses of liquidity include:

- principal repayments and interest on debt;
- loan advances; and
- patronage capital retirements.

We face liquidity risk in refinancing maturing obligations. At August 31, 2009, we had $2,976 million of commercial paper, daily liquidity fund, and bank bid notes scheduled to mature during the next 12 months. Based on past history, we expect to continue to maintain member investments in commercial paper and the daily liquidity fund at approximately the current level of $1,383 million at August 31, 2009. Dealer commercial paper and bank bid notes of $1,567 million and non-member commercial paper of $26 million at August 31, 2009 were reduced by the $500 million issuance of collateral trust bonds in September 2009. We currently believe that we have the market access to maintain dealer commercial paper and bank bid notes at approximately $1 billion to $1.5 billion.

At August 31, 2009, we had $3 billion in available lines of credit with financial institutions. These revolving credit agreements provide backup liquidity for 100% of our dealer and member commercial paper. We expect to be in compliance with the covenants under our revolving credit agreements, therefore we can maintain a commercial paper balance up to $3 billion in order to meet maturing debt obligations. Additionally, we could draw on these facilities to repay any amount of dealer or member commercial paper that cannot be rolled over in the event of market disruptions.

We also have access to the Commercial Paper Funding Facility (“CPFF”) created by the Federal Reserve Board to provide liquidity to highly-rated U.S. issuers of commercial paper through February 2010, where we have the capacity to issue a maximum of $3 billion of commercial paper. At this time, there is no intention to make use of the more expensive funding through the CPFF since there is sufficient demand in the dealer and member commercial paper markets.

At August 31, 2009, we had long-term debt maturing in the next 12 months totaling $1,482 million. This amount includes $268 million of medium-term notes sold through dealers (including retail notes), $412 million of medium-term notes sold to members, $610 million of collateral trust bonds, $188 million of secured notes payable and $4 million of unsecured notes payable. Based on past history, we expect to maintain the level of member and dealer investments in medium-term notes within a range of the current outstanding balance. We have experienced a significant increase in demand for our retail notes since January 2009 and expect that we should be able to maintain our total retail note balance at least at the current level. The total balance of retail notes outstanding has increased $804 million over the past 12 months to $1,055 million at August 31, 2009. We expect to refinance the remaining $802 million of long-term debt maturing in the next 12 months through capital market and private placement issuances, our member capital securities program and our cash on hand at August 31, 2009.

We believe that our $500 million issuance of collateral trust bonds in September 2009 demonstrates that our access to the capital markets remains strong. Secured notes payable scheduled to mature in the next twelve months were issued under revolving credit facilities with Farmer Mac that allow us to borrow, repay and re-borrow funds as market conditions permit. We had $575 million available under revolving note purchase agreements with Farmer Mac at August 31, 2009, subject to market conditions. Our members also continue to support the member capital securities program with the sale of $337 million securities as of August 31, 2009. In addition, we had $527 million of cash on hand to meet our maturing obligations at August 31, 2009.

We face liquidity risk in the funding of our loan portfolio based on member demand for new loans, although we expect loans outstanding to remain relatively stable during fiscal year 2010. We also face liquidity risk in our ability to renew our revolving credit agreements at current commitment levels. Our $1.0 billion 364-day revolving credit agreement matures in March 2010. If we are not able to renew this agreement at the current commitment level, it would reduce the amount of commercial paper funding we could obtain in the future.

At August 31, 2009, we believe that our sources of liquidity are adequate to cover our expected uses of liquidity.

Results of Operations

Three months ended August 31, 2009 versus August 31, 2008 results
The following table presents the results of operations for the three months ended August 31, 2009 and 2008.

(dollar amounts in thousands)	August 31, 2009	August 31, 2008	Increase (Decrease)
Interest income	$ 269,457	$ 263,117	$ 6,340
Interest expense	(242,629)	(220,149)	(22,480)
Net interest income	26,828	42,968	(16,140)
Recovery of (provision for) loan losses	16,171	(10,681)	26,852
Net interest income after recovery of (provision for) loan losses	42,999	32,287	10,712
Non-interest income:			
Fee and other income	3,734	3,582	152
Derivative cash settlements	(3,494)	431	(3,925)
Results of operations of foreclosed assets	587	1,246	(659)
Total non-interest income	827	5,259	(4,432)
Non-interest (expense) income:			
Salaries and employee benefits	(9,918)	(9,851)	(67)
Other general and administrative expenses	(7,108)	(4,742)	(2,366)
Recovery of guarantee liability	2,395	705	1,690
Market adjustment on foreclosed assets	(1,750)	-	(1,750)
Derivative forward value	(10,834)	(11,028)	194
Other	(146)	(160)	14
Total non-interest expense	(27,361)	(25,076)	(2,285)
Income prior to income taxes	16,465	12,470	3,995
Income tax (expense) benefit	(32)	760	(792)
Net income	16,433	13,230	3,203
Less: Net income attributable to noncontrolling interest	(191)	1,241	(1,432)
Net income attributable to National Rural	$ 16,242	$ 14,471	$ 1,771
TIER	1.07	1.06	
Adjusted TIER (1)	1.11	1.11	

(1) Adjusted to exclude the effect of the derivative forward value from net income and to include all derivative cash settlements in the interest expense. See Non-GAAP Financial Measures for further explanation and a reconciliation of these adjustments.

The following tables provide a breakout of the average yield on loans, the average cost on debt and the change to interest income, interest expense and net interest income due to changes in average loan and debt volume versus changes to interest rates summarized by loan and debt type. The following tables also include a breakout of the change to derivative cash settlements due to changes in the average notional amount of our derivative portfolio versus changes to the net difference between the average rate paid and the average rate received. Management calculates an adjusted interest expense, which includes all derivative cash settlements in interest expense. See Non-GAAP Financial Measures for further explanation of the adjustment we make in our financial analysis to include all derivative cash settlements in interest expense.

Average balances and interest rates – Assets

	Average volume		Interest income		Average yield	
(dollar amounts in thousands)	August 31, 2009	August 31, 2008	August 31, 2009	August 31, 2008	August 31, 2009	August 31, 2008
Long-term fixed-rate loans (1)	$15,177,050	$ 15,211,835	$ 223,526	$ 224,402	5.84%	5.85%
Long-term variable-rate loans (1)	2,618,435	1,710,832	26,565	15,180	4.03	3.52
Short-term loans (1)	1,897,878	1,750,335	16,035	19,504	3.35	4.42
Non-performing loans	523,759	498,414	-	-	-	-
Total loans	20,217,122	19,171,416	266,126	259,086	5.22	5.36
Investments (2)	984,400	503,871	1,657	2,181	0.67	1.72
Fee income	-	-	1,674	1,850	-	-
Total	$21,201,522	$19,675,287	$ 269,457	$263,117	5.04%	5.31%

(1) Interest income on loans to members.

(2) Interest income on the investment of excess cash, preferred stock and trading securities.

Average balances and interest rates – Liabilities

	Average volume		Interest expense		Average cost	
(dollar amounts in thousands)	August 31, 2009	August 31, 2008	August 31, 2009	August 31, 2008	August 31, 2009	August 31, 2008
Commercial paper and bank bid notes (1)	$ 2,469,643	$ 2,668,090	$ (3,222)	$ (16,438)	(0.52)%	(2.44)%
Medium-term notes (1)	5,628,536	5,205,817	(84,595)	(80,458)	(5.96)	(6.13)
Collateral trust bonds (1)	5,181,804	5,607,426	(78,593)	(62,920)	(6.02)	(4.45)
Subordinated deferrable debt (1)	301,886	301,813	(4,916)	(4,916)	(6.46)	(6.46)
Subordinated certificates (1)	1,699,839	1,343,575	(19,020)	(12,417)	(4.44)	(3.67)
Long-term private debt (1)	4,467,609	3,214,630	(45,986)	(39,439)	(4.08)	(4.87)
Total debt	19,749,317	18,341,351	(236,332)	(216,588)	(4.75)	(4.68)

Debt issuance costs (2)	-	-	(2,980)	(2,135)	-	-
Fee expense (3)	-	-	(3,317)	(1,426)	-	-
Total	$19,749,317	$18,341,351	$ (242,629)	$ (220,149)	(4.87)%	(4.76) %
Derivative cash settlements (4)	$11,756,650	$13,677,707	$ (3,494)	$ 431	(0.12)%	0.01%
Adjusted interest expense (5)	19,749,317	18,341,351	(246,123)	(219,718)	(4.94)	(4.75)
Net interest income/Net yield			$ 26,828	$ 42,968	0.17%	0.55%
Adjusted net interest income/ Adjusted net yield (5)			23,334	43,399	0.10	0.56

(1) Represents interest expense and the amortization of discounts on debt.
(2) Includes amortization of all deferred charges related to debt issuances, principally underwriter's fees, legal fees, printing costs and comfort letter fees. Amortization is calculated on the effective interest method. Also includes issuance costs related to dealer commercial paper, which are recognized as incurred.
(3) Includes various fees related to funding activities, including fees paid to banks participating in our revolving credit agreements. Fees are recognized as incurred or amortized on a straight-line basis over the life of the respective agreement.
(4) For derivative cash settlements, average volume represents the average notional amount of derivative contracts outstanding and the average cost represents the net difference between the average rate paid and the average rate received for cash settlements during the period.
(5) See Non-GAAP Financial Measures for further explanation of the adjustment we make in our financial analysis to include the derivative cash settlements in interest expense.

Analysis of changes in net interest income

	August 31, 2009 vs. August 31, 2008		
	Change due to:		
(dollar amounts in thousands)	Average volume (1)	Average rate (2)	Net change
Increase (decrease) in interest income:			
Long-term fixed-rate loans	$ (513)	$ (363)	$ (876)
Long-term variable-rate loans	8,053	3,332	11,385
Short-term loans	1,644	(5,113)	(3,469)
Total interest income on loans	9,184	(2,144)	7,040
Investments	2,080	(2,604)	(524)
Fee income	-	(176)	(176)
Total interest income	$ 11,264	$ (4,924)	$ 6,340
(Increase) decrease in interest expense:			
Commercial paper and bank bid notes	$ 1,223	$ 11,993	$ 13,216
Medium-term notes	(6,533)	2,396	(4,137)
Collateral trust bonds	4,776	(20,449)	(15,673)
Subordinated deferrable debt	(1)	1	-
Subordinated certificates	(3,293)	(3,310)	(6,603)
Long-term private debt	(15,373)	8,826	(6,547)
Total interest expense on debt	(19,201)	(543)	(19,744)
Debt issuance costs	-	(845)	(845)
Fee expense	-	(1,891)	(1,891)
Total interest expense	(19,201)	(3,279)	(22,480)
Net interest income	$ (7,937)	$ (8,203)	$ (16,140)
Derivative cash settlements (3)	$ (60)	$ (3,865)	$ (3,925)
Adjusted interest expense (4)	(16,867)	(9,538)	(26,405)

(1) Calculated using the following formula: (current period average balance – prior year period average balance) x prior year period average rate.
(2) Calculated using the following formula: (current period average rate – prior year period average rate) x current period average balance.
(3) For derivative cash settlements, variance due to average volume represents the change in derivative cash settlements from the change in average notional amount of derivative contracts outstanding. Variance due to average rate represents the change in derivative cash settlements due to the net difference between the average rate paid and the average rate received for interest rate swaps during the period.

(4) See Non-GAAP Financial Measures for further explanation of the adjustment we make in our financial analysis to include the derivative cash settlements in interest expense.

Interest Income

The $6 million or 2 percent increase in interest income for the three months ended August 31, 2009 as compared with the prior-year period was due to a $1 billion or 5 percent increase in average loan volume largely offset by a 14 basis point decline in the average yield earned on the portfolio due to lower interest rates on variable-rate loans.

For the three months ended August 31, 2009, we had a reduction to interest income of $13 million due to non-accrual loans compared with a reduction of $14 million for the prior-year period. The effect on electric interest income of non-accrual loans was a reduction of $6 million for the three months ended August 31, 2009, as compared with $7 million for the prior-year period. The telecommunications interest income was reduced by $7 million for the three months ended August 31, 2009 and 2008 as a result of non-accrual loans. The effect of non-accrual loans on interest income is included in the rate variance in the table above.

Interest Expense

Our interest expense increased by $22 million or 10 percent for the three months ended August 31, 2009 as compared with the prior-year period. The increase in interest expense was primarily due to the $1,408 million, or 8 percent, increase in average debt outstanding at August 31, 2009 compared with August 31, 2008. The increase to the average balance of debt outstanding was primarily due to the prefunding of $245 million of debt that matured in July 2009 and $1,250 million of debt that matured in August 2009. As a result of the prefunding, we incurred interest expense on the additional debt during the majority of the quarter ended August 31, 2009.

The increase in interest expense was also due to a 7 basis point increase in the weighted average cost of debt due to the following factors:

- Higher interest rates on our collateral trust bonds. In October 2008, we issued $1 billion of collateral trust bonds at a rate of 10.375 percent.
- We replaced some of our commercial paper with term debt which represents a higher cost of funding. The average balance of commercial paper for the three months ended August 31, 2009 decreased 7 percent compared with the prior-year period. Since the revolving credit lines are required to maintain backup liquidity on our commercial paper, the $500 million reduction to the 364-day revolving credit agreement in March 2009 decreased the amount of commercial paper we can have outstanding.
- At August 31, 2009, we had $337 million of member capital securities outstanding, which represents a higher cost of funding at a fixed interest rate of 7.50 percent compared with commercial paper and private placements of debt. We started issuing member capital securities in November 2008 so there was no impact on interest expense during the prior-year quarter.

These factors were partly offset by the following:

- The lower interest rate environment. Lower interest rates on our variable-rate debt and commercial paper funding. Variable-rate debt represents 17 percent of total debt outstanding.
- The 39 percent increase in the average balance of long-term private placement debt during the three months ended August 31, 2009 at an average rate of 4.08 percent, a 79 basis point reduction from the period year period. The average rate on long-term private placement debt, including Farmer Mac and REDLG funding, was lower during the three months ended August 31, 2009 compared with other term debt in place during the prior-year period.
- The 17 basis point decrease in the weighted average cost of funding for medium-term notes due primarily to the $804 million increase in retail notes from August 31, 2008 to August 31, 2009 that were issued at a lower rate relative to other medium-term notes.

The adjusted interest expense, which includes all derivative cash settlements, was $246 million for the three months ended August 31, 2009 compared with $220 million for the prior-year period based on changes to interest expense noted above and derivative cash settlements described below. See Non-GAAP Financial Measures for further explanation of the adjustment we make in our financial analysis to include all derivative cash settlements in interest expense.

Net Interest Income

The $16 million decrease in net interest income for the three months ended August 31, 2009 compared with the prior-year period was due primarily to the following:

- the 8 percent increase in the average debt volume due primarily to the prefunding of maturing debt,
- the 14 basis point decline in the yield of our loan portfolio due primarily to lower interest rates earned on variable-rate loans, and
- the 7 basis point increase in the overall cost of debt as explained above.

The adjusted net interest income, which includes all derivative cash settlements, for the three months ended August 31, 2009 was $23 million, a decrease of $20 million from the prior-year period. See Non-GAAP Financial Measures for further explanation of the adjustment we make in our financial analysis to include all derivative cash settlements in determining our adjusted interest expense which, in turn, affects adjusted net interest income.

Recovery of/Provision for Loan Losses

We recorded a loan loss recovery of $16 million for the three months ended August 31, 2009 compared with an $11 million provision for the prior-year period. The recovery of loan losses during the three months ended August 31, 2009 was due to payments received on impaired loans and the net decrease in our variable interest rates from May 31, 2009 to August 31, 2009. The remaining decrease in the loan loss allowance for the three months ended August 31, 2009 was primarily due to decreases in the outstanding loan balance and the weighted average maturity of loans in the general portfolio. See further discussion in Allowance for Loan Losses in the Financial Condition section.

Non-interest Income

Non-interest income decreased by $4 million for the three months ended August 31, 2009 compared with the prior-year period primarily due to the decrease in cash settlements on derivative financial instruments. The $4 million decrease in cash settlements for the three months ended August 31, 2009 was due to lower short-term interest rates during the period compared with the prior-year period as we received a variable rate on the majority of our derivative contracts.

Non-interest Expense

Non-interest expense increased by $2 million for the three months ended August 31, 2009 compared with the prior-year period primarily due to the $2 million increase in other general and administrative expense and the $2 million market adjustment of foreclosed assets, partly offset by the $2 million recovery of the guarantee liability. We recorded a decrease to the fair value of foreclosed assets of $2 million for the three months ended August 31, 2009 based on declining collateral values. Foreclosed assets includes land development loans and limited partnership interests in certain real estate developments. The reduction to the fair value of the collateral supporting these land development loans during the three months ended August 31, 2009 was primarily due to lower gas prices which decreased the fair value of the underlying collateral. The recovery of the guarantee liability during the three months ended August 31, 2009 was primarily due to the $25 million decrease in guarantees outstanding and the scheduled early redemption of a tax-exempt bond guarantee.

Net Income

The change in the items described above resulted in a net income of $16 million for the three months ended August 31, 2009, compared to net income of $13 million for the prior-year period. The adjusted net income, which excludes the effect of the derivative forward value, was $27 million, compared to $24 million for the prior-year period. See Non-GAAP Financial Measures for further explanation of the adjustments we make in our financial analysis to net income.

Noncontrolling interest

Noncontrolling interest represents $0.5 million of net income for NCSC and $0.3 million of net loss for RTFC for the three months ended August 31, 2008 compared with a net loss of $1.2 million for NCSC and zero net income for RTFC during the prior-year period. The increase in NCSC net income is primarily due to fluctuations in the fair value of its derivative instruments.

Ratio of Earnings to Fixed Charges

The following table provides the calculation of the ratio of earnings to fixed charges. For the three months ended August 31, 2008, the ratio of earnings to fixed charges is the same calculation as TIER. For the three months ended August 31, 2009, the fixed charge coverage ratio includes capitalized interest in total fixed charges which is not included in our TIER calculation. See Results of Operations for a discussion of TIER and adjustments that we make to the TIER calculation.

	For the three months ended August 31,	
(dollar amounts in thousands)	2009	2008
Income prior to cumulative effect of change in accounting principle	$ 16,433	$ 13,230
Add: fixed charges	242,660	220,149
Less: interest capitalized	(31)	-
Earnings available for fixed charges	$ 259,062	$ 233,379
Total fixed charges:		
Interest on all debt (including amortization of discount and issuance costs)	$ 242,629	$ 220,149
Interest capitalized	31	-
Total fixed charges	$ 242,660	$ 220,149

Ratio of earnings to fixed charges	1.07	1.06

Financial Condition

Loan and Guarantee Portfolio Assessment

Loan Programs

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

The following table summarizes loans outstanding by type and by segment:

(dollar amounts in thousands)	August 31, 2009		May 31, 2009		Increase/ (Decrease)
Loans by type:					
Long-term loans (1):					
Long-term fixed rate loans	$15,455,260	77%	$ 14,812,550	74%	$ 642,710
Long-term variable rate loans	2,710,482	13	3,277,528	16	(567,046)
Total long-term loans	18,165,742	90	18,090,078	90	75,664
Short-term loans (2)	1,960,743	10	2,098,129	10	(137,386)
Total loans	$20,126,485	100%	$20,188,207	100%	$ (61,722)

(dollar amounts in thousands)	August 31, 2009		May 31, 2009		Increase/ (Decrease)
Loans by segment:					
National Rural:					
Distribution	$13,637,987	68%	$13,730,511	68%	$ (92,524)
Power supply	4,256,807	21	4,268,244	21	(11,437)
Statewide and associate	91,906	-	92,578	1	(672)
National Rural total	17,986,700	89	18,091,333	90	(104,633)
RTFC	1,735,709	9	1,680,154	8	55,555
NCSC	404,076	2	416,720	2	(12,644)
Total	$20,126,485	100%	$20,188,207	100%	$ (61,722)

(1) Includes loans classified as restructured and non-performing and RUS guaranteed loans.

(2) Consists of secured and unsecured short-term loans, where the interest rate could be adjusted monthly or semi-monthly.

Loans outstanding remained relatively flat at August 31, 2009 when compared to May 31, 2009.

Loans converting from a variable rate to a fixed rate for the three months ended August 31, 2009 totaled $597 million, which was partially offset by loans that converted from a fixed rate to a variable rate totaling $58 million. The significant shift in variable-rate loans converting to fixed rates was the result of the decrease of our long-term fixed rates offered during the three months ended August 31, 2009 of between 105 and 175 basis points depending on the type and maturity of the loan. For the three months ended August 31, 2008, loans converting from a variable rate to fixed rate totaled $73 million, which was partially offset by $49 million of loans that converted from a fixed rate to a variable rate.

The following table summarizes loans and guarantees outstanding by segment:

(dollar amounts in thousands)	August 31, 2009		May 31, 2009		Increase/ (Decrease)
National Rural:	Amount	% of Total	Amount	% of Total	

Distribution	$ 13,875,073	65%	$13,994,595	65%	$ (119,522)
Power supply	5,206,151	24	5,213,868	24	(7,717)
Statewide and associate	114,073	1	116,203	1	(2,130)
National Rural total	19,195,297	90	19,324,666	90	(129,369)
RTFC	1,736,209	8	1,680,654	8	55,555
NCSC	445,813	2	458,342	2	(12,529)
Total	$ 21,377,319	100%	$21,463,662	100%	$ (86,343)

The following table summarizes the loans and guarantees outstanding at RTFC by type:

	August 31, 2009		May 31, 2009		Increase/
(dollar amounts in thousands)	Amount	% of Total	Amount	% of Total	(Decrease)
Rural local exchange carriers	$ 1,533,559	88%	$1,476,402	88%	$ 57,157
Cable television providers	152,020	9	152,326	9	(306)
Fiber optic network providers	8,716	1	8,126	1	590
Competitive local exchange carriers	35,300	2	37,294	2	(1,994)
Wireless providers	4,032	-	3,924	-	108
Other	2,582	-	2,582	-	-
Total	$ 1,736,209	100%	$1,680,654	100%	$ 55,555

Our members are widely dispersed throughout the United States and its territories, including 49 states, the District of Columbia and two U.S. territories. At August 31, 2009 and May 31, 2009, loans outstanding to members in any one state or territory did not exceed 17 percent of total loans outstanding.

Credit Concentration
National Rural, RTFC and NCSC each have policies that limit the amount of credit that can be extended to individual borrowers or a controlled group of borrowers. The credit limitation policies set the limit on the total exposure and unsecured exposure to the borrower based on an assessment of the borrower's risk profile and our internal risk rating system. As a member-owned cooperative, we balance the needs of our member/owners and the risk associated with concentrations of credit exposure. The respective boards of directors must approve new credit requests from borrowers with total exposure or unsecured exposure in excess of the limits in the policies. Management may use syndicated credit arrangements to minimize credit concentrations.

Total exposure, as defined by the policies, generally includes the following:

- loans outstanding, excluding loans guaranteed by RUS;
- our guarantees of the borrower's obligations;
- unadvanced loan commitments;
- borrower guarantees to us of another borrower's debt; and
- any other indebtedness with us, unless guaranteed by the U.S. Government.

The calculation of total exposure includes facilities that might not be drawn by the borrower, such as lines of credit and loan commitments for projects that may be delayed or cancelled.

At August 31, 2009 and May 31, 2009, the total exposure outstanding to any one borrower or controlled group did not exceed 2.5 percent and 2.4 percent, respectively, of total loans and guarantees outstanding. At August 31, 2009 and May 31, 2009, the 10 largest borrowers included three distribution systems, six power supply systems and one telecommunications system. Over the past five years, our single obligor concentrations in the telecommunications portfolio have decreased resulting in outstanding loans at August 31, 2009 averaging $11 million per active, performing telecommunications borrower. The following table shows the exposure to the ten largest borrowers as a percentage of total exposure by type and by segment:

	August 31, 2009		May 31, 2009		Increase/
(dollar amounts in thousands)	Amount	% of Total	Amount	% of Total	(Decrease)
Total by type:					
Loans	$3,801,384	18%	$ 3,686,956	17%	$ 114,428
Guarantees	274,011	1	363,883	2	(89,872)
Total credit exposure to ten largest borrowers	$4,075,395	19%	$ 4,050,839	19%	$ 24,556
Total by segment:					
National Rural	$3,527,884	16%	$ 3,497,331	16%	$ 30,553
RTFC	523,761	3	523,758	3	3
NCSC	23,750	-	29,750	-	(6,000)
Total credit exposure to ten largest borrowers	$4,075,395	19%	$ 4,050,839	19%	$ 24,556

Security Provisions
Except when providing short-term loans, we typically lend to our members on a senior secured basis. Long-term loans are typically secured on parity with other secured lenders (primarily RUS), if any, by all assets and revenues of the borrower with exceptions typical in utility mortgages. Short-term loans are generally unsecured lines of credit. Guarantee reimbursement obligations are typically secured on parity with other secured creditors by all assets and revenues of the borrower or by the underlying financed asset. In addition to the collateral received, borrowers are

also required to set rates charged to customers to achieve certain financial ratios.

The following table summarizes our unsecured credit exposure as a percentage of total exposure by type and by segment:

	August 31, 2009		May 31, 2009		Increase/
(dollar amounts in thousands)	Amount	% of Total	Amount	% of Total	(Decrease)
Total by type:					
Loans	$ 2,715,641	13%	$ 2,831,111	13%	$ (115,470)
Guarantees	337,360	1	347,325	2	(9,965)
Total unsecured credit exposure	$ 3,053,001	14%	$ 3,178,436	15%	$ (125,435)
Total by segment:					
National Rural	$ 2,759,045	13%	$ 2,875,396	14%	$ (116,351)
RTFC	233,562	1	237,259	1	(3,697)
NCSC	60,394	-	65,781	-	(5,387)
Total unsecured credit exposure	$ 3,053,001	14%	$ 3,178,436	15%	$ (125,435)

Pledging of Loans and Loans on Deposit

We are required to pledge collateral equal to at least 100 percent of the outstanding balance of debt issued under the collateral trust bond indentures and the revolving debt issuance agreements with Farmer Mac. We pledge distribution mortgage loans and permitted investments under our collateral trust bond indentures. We pledge distribution and power supply mortgage loans under the debt issuance agreements with Farmer Mac, which permit up to 20 percent of loans pledged to be from power supply systems. In addition, we are required to maintain collateral on deposit equal to at least 100 percent of the outstanding balance of debt under the REDLG program. Distribution and power supply loans may be deposited for the REDLG program.

Although not required, we typically maintain pledged collateral and collateral on deposit in excess of the required 100 percent of the outstanding balance of debt issued. However, our revolving credit agreements limit pledged collateral to 150 percent of the outstanding balance of debt issued. The excess collateral ensures that required collateral levels are maintained and, when an opportunity exists, facilitates timely execution of debt issuances by limiting or eliminating the lead time required to gather collateral. Collateral levels fluctuate because:

- distribution and power supply loans typically amortize, while the debt issued under the collateral trust bond indenture, the Farmer Mac debt issuance agreements and the REDLG program have bullet maturities;
- individual loans may become ineligible for various reasons, some of which may be temporary; and
- distribution and power supply borrowers have the ability to prepay their loans.

We may request the return of collateral pledged or held on deposit in excess of the 100 percent of the principal balance requirement or may move the collateral from one debt program to another to facilitate a new debt issuance, provided that all conditions of eligibility under the different programs are satisfied.

The following table summarizes our secured debt or debt requiring collateral on deposit, the excess collateral pledged and our unencumbered loans:

(dollar amounts in thousands)	August 31, 2009	May 31, 2009
Total loans to members	$ 20,126,485	$20,188,207
Less: Total secured debt or debt requiring collateral on deposit	(10,015,000)	(9,390,000)
Less: Excess collateral pledged or on deposit	(2,608,078)	(2,566,723)
Unencumbered loans	$ 7,503,407	$ 8,231,484
Unencumbered loans as a percentage of total loans	37 %	41 %

Non-performing Loans

A borrower is classified as non-performing when any one of the following criteria is met:

- principal or interest payments on any loan to the borrower are past due 90 days or more;
- as a result of court proceedings, repayment on the original terms is not anticipated; or
- for some other reason, management does not expect the timely repayment of principal and interest.

Once a borrower is classified as non-performing, we typically place the loan on non-accrual status and reverse all accrued and unpaid interest back to the date of the last payment. In certain circumstances, a performing restructured loan can also remain on non-accrual status (see Restructured Loans). We generally apply all cash received during the non-accrual period to the reduction of principal, thereby foregoing interest income recognition.

At August 31, 2009 and May 31, 2009, non-performing loans consist of loans to Innovative Communication Corporation (“ICC”) totaling $524 million. All loans to ICC have been on non-accrual status since February 1, 2005. ICC has not made debt service payments to us since June 2005. RTFC is the primary secured lender to ICC.

In February 2006, involuntary bankruptcy petitions were filed against ICC's indirect majority shareholder and former chairman, Jeffrey Prosser ("Prosser"), ICC's immediate parent, Emerging Communication, Inc. ("Emcom") and Emcom's parent, Innovative Communication Company LLC ("ICC-LLC"); and in April 2006, RTFC reached a settlement with ICC, Virgin Islands Telephone Corporation d/b/a Innovative Telephone ("Vitelco"), ICC-LLC, Emcom, their directors and Prosser, individually. Under the settlement, RTFC obtained entry of judgments in the District Court of the Virgin Islands against ICC for approximately $525 million and Prosser for approximately $100 million. RTFC also obtained dismissals with prejudice and releases 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-related litigation in RTFC’s favor. Regardless, Prosser and related parties continue to assert claims against National Rural and certain of its officers and directors and other parties in various proceedings and forums. National Rural therefore anticipates that it will continue to be engaged in defense of those assertions on many fronts, as well as pursuing claims of its own.

ICC-LLC, Emcom and Prosser each have bankruptcy proceedings pending in the United States District Court for the Virgin Islands, Bankruptcy Division (the “Bankruptcy Court”). A Chapter 11 trustee has been appointed for the ICC-LLC and Emcom estates; and a Chapter 7 trustee was appointed in Prosser’s individual case. 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 for disposition, including property in Prosser’s possession or control, and eventual payment in respect of RTFC’s claims and the claims of other parties-in-interest. Certain assets have been sold, including certain foreign companies, aircraft, and real estate.

On February 1, 2008, the Court approved a motion of the Chapter 11 trustee of ICC to sell substantially all of ICC’s assets, divided into three groups: Group 1 consisting of ICC assets and stock in ICC subsidiaries operating in the U.S. Virgin Islands, the British Virgin Islands and St. Martin (the “Group 1 Assets”); Group 2 consisting of ICC assets and stock in ICC subsidiaries operating in France and certain of its Caribbean territories and the Netherland Antilles (the “Group 2 Assets”); and Group 3 consisting of the newspaper and media operations of ICC (the “Group 3 Assets”). The Group 2 Assets and Group 3 Assets were sold in December 2008 and May 2008, respectively, and in each case, the distribution of proceeds was approved by the Court and resulted in a net recovery to us.

On March 13, 2009, RTFC and the Trustee entered into a Purchase Agreement as part of a $250 million credit bid for the ICC Group 1 Assets. The Purchase Agreement is conditional upon the approval of the bankruptcy court and applicable regulators. On April 6, 2009, the Bankruptcy Judge approved, on an interim basis, the sale of the ICC Group 1 Assets to RTFC. RTFC has begun the process of obtaining the applicable regulatory approvals.

In April 2009, RTFC acquired $85 million of Vitelco preferred stock and $12.5 million of accrued and unpaid dividends relating to such shares for a total purchase price of $30 million. We believe that the acquisition of the preferred shareholders interests at a discount has improved our estimated recovery from the collateral.

For a more detailed description of the contingencies related to the non-performing loans outstanding to ICC, see Note 13 Restructured /Non-performing Loans and Contingencies, to the consolidated financial statements. Based on its analysis, we believe that we have adequately reserved for our exposure to ICC at August 31, 2009.

Restructured Loans
When agreements are executed to change the original terms of a loan, generally a change to the originally scheduled cash flows, we classify the loan as restructured unless the new terms are deemed to be market terms. We make a determination about the accrual of interest income for these loans on a loan-by-loan basis. The initial decision is based on the terms of the restructure agreement and the anticipated performance of the borrower over the term of the agreement. We will periodically review the decision whether or not to accrue interest income on restructured loans based on the borrower's past performance and current financial condition.

At August 31, 2009 and May 31, 2009, restructured loans totaled $530 million and $538 million, respectively. A total of $484 million and $491 million of restructured loans were on non-accrual status at August 31, 2009 and May 31, 2009, respectively.

At August 31, 2009 and May 31, 2009, restructured loans outstanding to Denton County Electric Cooperative, d/b/a CoServ Electric ("CoServ") were $484 million and $491 million, respectively. All restructured CoServ loans have been on non-accrual status since January 1, 2001. In addition, $20 million was outstanding under the capital expenditure loan facility classified as a performing loan at both August 31, 2009 and May 31, 2009. Total loans to CoServ at August 31, 2009 and May 31, 2009 represented in each case 2.4 percent of our total loans and guarantees outstanding.

Under the terms of a bankruptcy settlement from 2002, National Rural restructured the 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. Under the facility, advances are limited to $46 million per year. As of the date of this filing, there is $184 million available under this loan facility. When CoServ requests capital expenditure loans from National Rural, these loans are made 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. 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 the lesser of their outstanding balance or $405 million plus an interest payment true up on or after December 13, 2008. To date, National Rural has not received 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 before 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 our analysis, we believe that we have adequately reserved for our exposure to CoServ at August 31, 2009.

At each of August 31, 2009 and May 31, 2009, we had a total of $42 million in restructured loans outstanding to Pioneer Electric Cooperative, Inc. ("Pioneer"). Pioneer is current with respect to all debt service payments at August 31, 2009 and all loans to Pioneer remain on accrual status. National Rural is the principal creditor to Pioneer.

Based on our analysis, we believe that we have adequately reserved for our exposure to Pioneer at August 31, 2009.

Loan Impairment
On a quarterly basis, we review all non-performing and restructured borrowers, as well as certain additional borrowers selected based on known facts and circumstances at the time of the review, to determine if the loans to the borrower are impaired and/or to update the impairment calculation. We calculate a borrower's impairment based on the expected future cash flow or the fair value of any collateral securing our loans to the borrower. In some cases, to estimate future cash flow, certain assumptions are required regarding, but not limited to, the following:

- interest rates,
- court rulings,
- changes in collateral values,
- changes in economic conditions in the area in which the cooperative operates,
- changes to the industry in which the cooperative operates, and
- likelihood of repayment amount and timing.

As events related to the borrower take place and economic conditions and our assumptions change, the impairment calculations will change. The loan loss allowance specifically reserved to cover the calculated impairments is adjusted on a quarterly basis based on the most current information available. At August 31, 2009 and May 31, 2009, impaired loans totaled $1,049 million and $1,056 million, respectively. At August 31, 2009 and May 31, 2009, we specifically reserved a total of $403 million and $414 million, respectively, to cover impaired loans.

The following table presents a summary of non-performing and restructured loans as a percentage of total loans and total loans and guarantees outstanding:

(dollar amounts in thousands)	August 31, 2009	May 31, 2009
Non-performing loans (1)	$ 523,761	$ 523,758
Percent of loans outstanding	2.60 %	2.59%
Percent of loans and guarantees outstanding	2.45	2.44
Restructured loans	$ 530,209	$ 537,587
Percent of loans outstanding	2.63%	2.66%
Percent of loans and guarantees outstanding	2.48	2.50
Total non-performing and restructured loans	$1,053,970	$ 1,061,345
Percent of loans outstanding	5.23%	5.25%
	4.93	4.94

Percent of loans and guarantees outstanding		
Total non-accrual loans	$1,007,481	$1,014,585
Percent of loans outstanding	5.00%	5.03%
Percent of loans and guarantees outstanding	4.71	4.73

(1) All loans classified as non-performing were on non-accrual status.

Allowance for Loan Losses
We maintain an allowance for loan losses at a level estimated by management to provide adequately for probable losses inherent in the loan portfolio. The allowance for loan losses is determined based upon evaluation of the loan portfolio, past loss experience, specific problem loans, economic conditions and other pertinent factors which, in management's judgment, could affect the risk of loss in the loan portfolio. We review and adjust the allowance quarterly to cover estimated probable losses in the portfolio.

Management makes recommendations to our board of directors regarding charge-offs of loan balances. In making its recommendation to charge-off all or a portion of a loan balance, management considers various factors including cash flows and the collateral securing the loans. Since our inception in 1969, charge-offs totaled $217 million and recoveries totaled $34 million for a net loan loss of $183 million. Management believes that the allowance for loan losses is adequate to cover estimated probable portfolio losses.

Activity in the allowance for loan losses is summarized below:

(dollar amounts in thousands)	For the three months ended and as of August 31, 2009	August 31, 2008	For the year ended and as of May 31, 2009
Beginning balance	$ 622,960	$ 514,906	$ 514,906
(Recovery of) provision for loan losses	(16,171)	10,681	113,699
Net recoveries (write-offs)	50	(2,990)	(5,645)
Ending balance	$ 606,839	$ 522,597	$ 622,960
`			
Loan loss allowance by segment:			
National Rural	$ 606,762	$ 522,351	$ 622,851
NCSC	77	246	109
Total	$ 606,839	$ 522,597	$ 622,960
As a percentage of total loans outstanding	3.02%	2.70%	3.09%
As a percentage of total non-performing loans outstanding	115.86%	106.31%	118.94%
As a percentage of total restructured loans outstanding	114.45%	91.73%	115.88%
As a percentage of total loans on non-accrual	60.23%	52.07%	61.40%

Our loan loss allowance decreased $16 million from May 31, 2009 to August 31, 2009. The reserve for impaired loans decreased by $11 million during the quarter ended August 31, 2009 due to loan repayments received on impaired loans in June 2009 and lower variable interest rates, as explained below. The remaining decrease in the loan loss allowance for the three months ended August 31, 2009 was primarily due to decreases in the balance of loans outstanding and the weighted average maturity of loans in the general portfolio. At August 31, 2009 and May 31, 2009, $526 million and $533 million, respectively, of the loans classified as impaired are current on the payments required under the restructured loan agreements. There has been no principal written off on these loans. All loans that are troubled debt restructurings are required to be classified as impaired when the interest yield on the loans after the restructure agreement is lower than the interest yield prior to the restructuring. A total of $42 million of the impaired loans at both August 31, 2009 and May 31, 2009 have been on accrual status since the time of the restructuring. A total of $484 million and $491 million of the impaired loans at August 31, 2009 and May 31, 2009, respectively, have been on non-accrual status since the date of restructuring.

We have agreed to indemnify RTFC and NCSC for loan losses, with the exception of the NCSC consumer loans that are covered by the NCSC loan loss allowance. Therefore, there is no loan loss allowance required at RTFC and $0.08 million loan loss allowance required at NCSC to cover the exposure for consumer loans of $0.5 million.

Liabilities and Equity

Outstanding Debt

The following table provides a breakout of debt outstanding:

(dollar amounts in thousands)	August 31,	May 31,	Increase/

	2009	2009	(Decrease)
Short-term debt:			
Commercial paper (1)	$ 2,750,897	$ 1,833,273	$ 917,624
Bank bid notes	225,000	255,000	(30,000)
Term loan	-	200,000	(200,000)
Long-term debt with remaining maturities less than one year	1,481,804	2,579,591	(1,097,787)
Total short-term debt	4,457,701	4,867,864	(410,163)
Long-term debt:			
Collateral trust bonds	4,569,181	4,968,771	(399,590)
Notes payable	4,689,263	4,064,211	625,052
Medium-term notes	3,681,316	3,687,073	(5,757)
Total long-term debt	12,939,760	12,720,055	219,705
Subordinated deferrable debt	311,440	311,440	-
Members' subordinated certificates:			
Membership certificates	642,925	642,960	(35)
Loan certificates	691,745	692,806	(1,061)
Guarantee certificates	126,194	126,193	1
Member capital securities	337,045	278,095	58,950
Total members' subordinated certificates	1,797,909	1,740,054	57,855
Total debt outstanding	$19,506,810	$19,639,413	$ (132,603)

	August 31, 2009	May 31, 2009
Percentage of fixed-rate debt (2)	83%	87%
Percentage of variable-rate debt (3)	17	13
Percentage of long-term debt	77	75
Percentage of short-term debt	23	25

(1) Includes $330 million and $291 million related to the daily liquidity fund at August 31, 2009 and May 31, 2009, respectively.
(2) Includes variable-rate debt that has been swapped to a fixed rate less any fixed-rate debt that has been swapped to a variable rate.
(3) The rate on commercial paper notes does not change once the note has been issued. However, the rates on new commercial paper notes change daily and commercial paper notes generally have maturities of less than 90 days. Therefore, commercial paper notes are classified as variable-rate debt. Also includes fixed-rate debt that has been swapped to a variable rate less any variable-rate debt that has been swapped to a fixed rate.

The following table provides additional information on the debt instruments we offer and related credit ratings at August 31, 2009.

Debt Instrument	Maturity Range	Rate Options	Market	Security	Credit Rating (1)
Daily liquidity fund	Demand note	Rate may change daily	Members	Unsecured	NA
Bank bid notes	Up to 3 months	Fixed rate	Bank institutions	Unsecured	NA
Commercial paper	1 to 270 days	Fixed rate	Public capital markets and members	Unsecured	P-1, A-1, F-2
Collateral trust bonds	Range from 2 years to 30 years	Fixed or variable rate	Public capital markets	Secured (2)	A1, A+, A
Medium-term notes	Range from 9 months to 30 years	Fixed or variable rate	Public capital markets and members	Unsecured	A2, A, A-
Notes payable	Range from 1 year to 30 years	Fixed or variable rate	Private placement	Varies (3)	Varies (3)
Subordinated deferrable debt (4)	Up to 39 yrs	Fixed or variable rate	Public capital markets	Unsecured (5)	A3, BBB, BBB
Subordinated certificates	Up to 100 years (6)	Varies	Members	Unsecured (7)	NA

(1) Based on ratings defined by Moody's Investors Service, Standard & Poor's Corporation and Fitch Ratings, respectively.
(2) Secured by the pledge of permitted investments and eligible mortgage notes from distribution system borrowers, in an amount at least equal to the outstanding principal amount of collateral trust bonds.
(3) At August 31, 2009, notes payable primarily represent unsecured notes payable issued under the REDLG program and secured notes payable to Farmer Mac. We must obtain credit ratings on certain senior secured debt from two rating agencies on an annual basis. The most recent credit ratings obtained on Farmer Mac notes were A+ from Standard & Poor's Corporation and A from Fitch Ratings. Unsecured guaranteed notes payable issued under the REDLG program do not have a credit rating. However, we must obtain one credit rating on an annual basis for

REDLG notes payable without regard to the bond guarantee agreement with RUS. The most recent credit rating obtained on REDLG notes payable without regard to the bond guarantee agreement with RUS was A by Standard and Poor's Corporation. We are required to maintain collateral on deposit equal to at least 100 percent of the outstanding balance of debt under the REDLG program.
(4) We have the right at any time and from time to time during the term of the subordinated deferrable debt to suspend interest payments for a period not exceeding 20 consecutive quarters. We have the right to call the subordinated deferrable debt any time after five years, at par. To date, we have not exercised our option to suspend interest payments.
(5) Subordinate and junior in right of payment to senior debt and the debt obligations we guarantee, but senior to subordinated certificates.
(6) Membership subordinated certificates generally mature 100 years from issuance. Loan and guarantee subordinated certificates have the same maturity as the related long-term loan. Some certificates may also amortize annually based on the outstanding loan balance. Member capital securities mature 35 years from issuance.
(7) Subordinate and junior in right of payment to senior and subordinated debt and debt obligations we guarantee.

Total debt outstanding decreased by $133 million at August 31, 2009 as compared with May 31, 2009 due to the following debt maturities or paydowns:

- Approximately $1,669 million of medium-term notes matured
- $200 million term loan was paid off early

These factors were mostly offset by the following increases to debt outstanding:

- $918 million to commercial paper and the daily liquidity fund,
- $625 million in fixed-rate notes to Farmer Mac with maturities through August 2014;
- $165 million of various member and dealer medium-term notes including retail notes, and
- $59 million of member capital securities

Equity

The following table provides a breakout of the equity balances:

(dollar amounts in thousands)	August 31, 2009	May 31, 2009	Increase/ (Decrease)
Membership fees	$ 990	$ 990	$ -
Education fund	1,186	1,592	(406)
Members' capital reserve	187,098	187,098	-
Allocated net income	379,434	420,834	(41,400)
Unallocated net income (loss) (1)	21,199	(6,198)	27,397
Total members' equity	589,907	604,316	(14,409)
Prior years cumulative derivative forward value and foreign currency adjustments	(103,493)	44,056	(147,549)
Year-to-date derivative forward value loss (2)	(11,155)	(147,549)	136,394
Total National Rural retained equity	475,259	500,823	(25,564)
Accumulated other comprehensive income	7,959	8,115	(156)
Total National Rural equity	483,218	508,938	(25,720)
Noncontrolling interest	10,335	10,162	173
Total equity	$ 493,553	$ 519,100	$ (25,547)

(1) Excludes derivative forward value.

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

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

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

To become a member, applicants may be required to pay a one-time fee which we treat as an equity investment. The fee varies from two hundred dollars to one thousand dollars depending on the membership class. National Rural is required by the District of Columbia cooperative law to have a methodology to allocate its net earnings to its members. National Rural maintains the current year net earnings as unallocated through the end of its fiscal year. National Rural calculates net earnings by adjusting net income to exclude certain non-cash adjustments. After the end of the fiscal year, National Rural's board of directors allocates its net earnings to its members in the form of patronage capital and to board approved reserves.

Currently, National Rural has two such board approved reserves, the cooperative educational fund and the members' capital reserve. National Rural adjusts the net earnings it allocates to its members and board approved reserves to exclude the non-cash effects of the accounting for derivative financial instruments and foreign currency translation. National Rural allocates a small portion, less than 1 percent, of net earnings annually to the cooperative educational fund. The allocation to the cooperative educational fund must be at least 0.25 percent of net earnings as required by National Rural's bylaws. Funds from the cooperative educational fund are disbursed annually to statewide cooperative organizations to fund the teaching of cooperative principles and for other cooperative education programs. The board of directors determines the amount of net earnings that is allocated to the members' capital reserve, if any. The members' capital reserve represents net earnings that are held by National Rural to increase equity retention. The net earnings held in the members' capital reserve have not been specifically allocated to members, but may be allocated to individual members in the future as patronage capital if authorized by National Rural's board of directors. All remaining net earnings are allocated to National Rural's members in the form of patronage capital. National Rural bases the amount of net earnings allocated to each member on the members' patronage of the National Rural lending programs during the year. There is no effect on National Rural's total equity as a result of allocating net earnings to members in the form of patronage capital or to board approved reserves. National Rural's board of directors has annually voted to retire a portion of the patronage capital allocated to members in prior years. National Rural's total equity is reduced by the amount of patronage capital retired to its members and by amounts disbursed from board approved reserves.

At August 31, 2009, total equity decreased by $26 million from May 31, 2009 primarily due to the board authorized patronage capital retirement of $41 million partly offset by net income of $16 million.

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

In July 2009, National Rural's board of directors authorized the allocation of the fiscal year 2009 net earnings as follows: $1 million to the cooperative educational fund and $83 million to members in the form of patronage capital. In July 2009, National Rural's board of directors authorized the retirement of allocated net earnings totaling $41 million, representing 50 percent of the fiscal year 2009 allocation. This amount was returned to members in cash at the end of September 2009. Future allocations and retirements of net earnings 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.

Contractual Obligations

The following table summarizes our long-term contractual obligations at August 31, 2009 and the scheduled reductions by fiscal year.

(dollar amounts in millions)	2010	2011	2012	2013	2014	More than 5 years	Total
Long-term debt due in less than one year	$ 828	$ 654	$ -	$ -	$ -	$ -	$ 1,482
Long-term debt	-	1,342	1,995	382	2,202	7,019	12,940
Subordinated deferrable debt	-	-	-	-	-	311	311
Members' subordinated certificates (1)	17	15	53	23	16	1,435	1,559
Operating leases (2)	3	4	1	-	-	-	8
Contractual interest on long-term debt (3)	653	795	730	630	563	7,576	10,947
Total contractual obligations	$ 1,501	$ 2,810	$ 2,779	$ 1,035	$ 2,781	$ 16,341	$ 27,247

(1) Excludes loan subordinated certificates totaling $239 million that amortize annually based on the outstanding balance of the related loan. There are many items that affect the amortization of a loan, such as loan conversions, loan repricing at the end of an interest rate term and prepayments, therefore an amortization schedule cannot be maintained for these certificates. Over the past three years, annual amortization on these certificates has averaged $28 million. In fiscal year 2009, amortization represented 8 percent of amortizing loan subordinated certificates outstanding.

(2) Primarily represents the payment obligation related to our lease of office space for our headquarters facility through the term of the lease ending on October 17, 2011. Assuming we exercise the option to extend the lease for an additional one-year period in fiscal year 2012, the future minimum lease payments for fiscal years 2012 and 2013 would increase to $4 million and $1 million, respectively. Assuming we exercise the option to extend the lease for an additional one-year period in fiscal year 2013, the future minimum lease payments for fiscal years 2012, 2013 and 2014 would increase to $4 million, $4 million and $1 million, respectively.

(3) Represents the interest obligation on our debt based on terms and conditions at August 31, 2009.

Off-Balance Sheet Obligations

Guarantees

The following table provides a breakout of guarantees outstanding by type and by segment:

(dollar amounts in thousands)	August 31, 2009	May 31, 2009	Increase/ (Decrease)
Total by type:			
Long-term tax-exempt bonds	$ 642,640	$ 644,540	$ (1,900)
Indemnifications of tax benefit transfers	79,187	81,574	(2,387)
Letters of credit	430,493	450,659	(20,166)
Other guarantees	98,514	98,682	(168)
Total	$1,250,834	$1,275,455	$ (24,621)
Total by segment:			
National Rural	$1,208,597	$1,233,333	$ (24,736)
RTFC	500	500	-
NCSC	41,737	41,622	115
Total	$1,250,834	$1,275,455	$ (24,621)

We guarantee certain contractual obligations of our members so that they may obtain various forms of financing. With the exception of letters of credit, the underlying obligations may not be accelerated due to a payment default by the member so long as we perform under our guarantee. We use the same credit policies and monitoring procedures in providing guarantees as we do for loans and commitments. At both August 31, 2009 and May 31, 2009, 73 percent of total guarantees were secured by a mortgage lien on substantially all of the system's assets and future revenues.

The decrease in total guarantees during the three months ended August 31, 2009 is primarily due to letters of credit that expired during the period and normal amortization.

At August 31, 2009 and May 31, 2009, we had recorded a guarantee liability totaling $27 million and $30 million, respectively, which represents the contingent and non-contingent exposure related to guarantees and liquidity obligations associated with members' debt.

The following table summarizes the off-balance sheet obligations at August 31, 2009 and the related notional principal amortization and maturities by fiscal year.

		Principal Amortization and Maturities of Guaranteed Obligations					
(dollar amounts in thousands)	Outstanding Balance	2010	2011	2012	2013	2014	Remaining Years
Guarantees (1)	$1,250,834	$321,355	$216,373	$77,771	$120,445	$49,090	$465,800

(1) On a total of $642 million of tax-exempt bonds, we have unconditionally agreed to purchase bonds tendered or called for redemption at any time if the remarketing agents have not sold such bonds to other purchasers.

Contingent Off-Balance Sheet Obligations

Unadvanced Loan Commitments

At August 31, 2009, our unadvanced loan commitments totaled $13,811 million, an increase of $260 million over the $13,551 million unadvanced at May 31, 2009. These are unadvanced commitments because we approved and executed loan contracts, but the funds have not been advanced. For most long-term advances of unadvanced commitments, we confirm based on our credit underwriting policy that there have been no material adverse changes in the borrower’s financial statement condition since we approved the loan.

It would be unlikely for members to draw all of their unadvanced commitments in the near term for the following reasons:

- electric cooperatives typically execute loan contracts, but do not advance the funds at the inception of the loan, to cover multi-year work plans;
- electric cooperatives generate a significant amount of cash from the collection of invoices from their customers, so they usually do not need to draw down on loan commitments for operating cash flows; and
- unadvanced commitments generally expire within five years of the first advance on a loan.

Approximately $2 billion of long-term commitments are scheduled to expire if not advanced over the next three years.

Our line of credit loans generally contain material adverse change clauses. The majority of the short-term unadvanced commitments provide working capital liquidity to our borrowers; therefore, we do not anticipate funding most of these commitments. Approximately 58 percent and 59 percent of the unadvanced commitments at August 31, 2009 and May 31, 2009, respectively, were for short-term line of credit loans.

Unadvanced commitments are classified as contingent liabilities. Based on the conditions to advance funds described above, unadvanced loan commitments do not represent off-balance sheet liabilities and have not been included in the table summarizing off-balance sheet obligations above.

Ratio Analysis

Leverage Ratio

The leverage ratio is calculated by dividing the sum of total liabilities and guarantees outstanding by total equity. Due to the retrospective presentation and disclosure requirements of the accounting guidance for noncontrolling interests that we adopted on June 1, 2009, we have reflected the changes in presentation and disclosure of noncontrolling interest in our consolidated financial statements for all periods presented in this Form 10-Q. The leverage ratio for May 31, 2009 has been adjusted accordingly. Based on this formula, the leverage ratio at August 31, 2009 was 43.95, an increase from 41.88 at May 31, 2009. The increase in the leverage ratio is due to a decrease of $26 million in total equity offset by a decrease of $21 million in total liabilities and a decrease of $25 million in guarantees as discussed under the Liabilities and Equity section and the Off-Balance Sheet Obligations section of Financial Condition.

For covenant compliance on our revolving credit agreements and for internal management purposes, the leverage ratio calculation is adjusted to exclude derivative liabilities, debt used to fund RUS guaranteed loans, subordinated deferrable debt and subordinated certificates from liabilities, uses members' equity rather than total equity and adds subordinated deferrable debt, subordinated certificates and minority interest to calculate adjusted equity. Due to the recent adoption of new accounting guidance on noncontrolling interests, minority interest is reported as equity on the consolidated balance sheets as of August 31, 2009 and May 31, 2009. As a result, it is not necessary to adjust equity to include minority interest.

At August 31, 2009 and May 31, 2009, the adjusted leverage ratio was 6.96 and 7.11, respectively. See Non-GAAP Financial Measures for further explanation and a reconciliation of the adjustments we make in our leverage ratio calculation.

The decrease in the adjusted leverage ratio is due to an increase of $44 million in adjusted equity, a decrease in adjusted liabilities of $71 million and a decrease of $25 million to guarantees as discussed under the Liabilities and Equity section and the Off-Balance Sheet Obligations section of Financial Condition. In addition to the adjustments made to the leverage ratio in the Non-GAAP Financial Measures section, guarantees to member systems that have certain investment grade ratings from Moody's Investors Service and Standard & Poor's Corporation are excluded from the calculation of the leverage ratio under the terms of the revolving credit agreements.

Debt to Equity Ratio

The debt to equity ratio is calculated by dividing the sum of total liabilities outstanding by total equity. Due to the retrospective presentation and disclosure requirements of the accounting guidance for noncontrolling interests that we adopted on June 1, 2009, we have reflected the changes in presentation and disclosure of noncontrolling interest in our consolidated financial statements for all periods presented in this Form 10-Q. The debt to equity ratio for May 31, 2009 has been adjusted accordingly. The debt to equity ratio, based on this formula at August 31, 2009 was 41.42, an increase from 39.42 at May 31, 2009. The increase in the debt to equity ratio is due to the decrease of $26 million in total equity offset by a decrease of $21 million in total liabilities as discussed under the Liabilities and Equity section of Financial Condition.

For internal management purposes, the debt to equity ratio calculation is adjusted to exclude derivative liabilities, debt used to fund RUS guaranteed loans, subordinated deferrable debt and subordinated certificates from liabilities, uses members' equity rather than total equity and adds subordinated deferrable debt and subordinated certificates to determine adjusted equity. At August 31, 2009 and May 31, 2009, the adjusted debt to equity ratio was 6.50 and 6.63, respectively. See Non-GAAP Financial Measures for further explanation and a reconciliation of the adjustments made to the debt to equity ratio calculation. The decrease in the adjusted debt to equity ratio is due to the increase of $44 million in adjusted equity and a decrease of $71 million in adjusted liabilities.

Credit Ratings

Our long- and short-term debt and guarantees are rated by three of the major credit rating agencies registered with the SEC, Moody's Investors Service, Standard & Poor's Corporation and Fitch Ratings. The following table presents our credit ratings at August 31, 2009.

Moody's Investors