NATIONAL RURAL UTILITIES COOPERATIVE FINANCE CORP /DC/
Form 10-K
August 17, 2009

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

FORM 10-K

x ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF

THE SECURITIES EXCHANGE ACT OF 1934
For the fiscal year ended May 31, 2009

OR
¨ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from to

Commission File Number 1-7102

NATIONAL RURAL UTILITIES COOPERATIVE
FINANCE CORPORATION

(Exact name of registrant as specified in its charter)

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

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

2201 COOPERATIVE WAY, HERNDON, VA 20171
(Address of principal executive offices)
(Registrant's telephone number, including area code, is 703-709-6700)

Securities registered pursuant to Section 12(b) of the Act:

Title of each class	Name of each exchange on which registered	Title of each class	Name of each exchange on which registered
5.70% Collateral Trust Bonds, due 2010	NYSE	6.75% Subordinated Notes, due 2043	NYSE
	NYSE		NYSE

7.20% Collateral Trust Bonds, due 2015		6.10% Subordinated Notes, due 2044	
6.55% Collateral Trust Bonds, due 2018	NYSE	5.95% Subordinated Notes, due 2045	NYSE
7.35% Collateral Trust Bonds, due 2026	NYSE		

Securities registered pursuant to Section 12(g) of the Act: None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes x No ¨

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Act. Yes ¨ No x

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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§229.405 of this chapter) is not contained herein, and will not be contained, to the best of the registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. x

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. (Check one):

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 Act). Yes ¨ No x

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

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CAUTIONARY NOTE REGARDING FORWARD-LOOKING STATEMENTS

This Form 10-K contains forward-looking statements defined by 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 about future expectations or projections, 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 materially differ. 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, changes in our ability to access external financing 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 information in this section should be read with our consolidated financial statements and related notes and the information contained elsewhere in this Form 10-K, including that set forth under Item 1A, Risk Factors.

PART I

Item 1. Business.

General

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. Our principal purpose is to provide our members with financing to supplement the loan programs of the Rural Utilities Service ("RUS") of the United States Department of Agriculture. We make loans to our rural utility system members ("utility members") so they can acquire, construct and operate electric distribution, generation, transmission and related facilities. We also provide our members with credit enhancements in the form of letters of credit and guarantees of debt obligations. We are exempt from federal income taxes under Section 501(c)(4) of the Internal Revenue Code. National Rural's objective is not to maximize net income, but to offer our members low cost financial products and services consistent with sound financial management.

Our annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to those reports, are available, free of charge, at www.nrucfc.coop (select "Investors," then "Financial Reports") as soon as reasonably practicable after they are electronically filed with or furnished to the SEC. They are also available free of charge on the SEC's website at www.sec.gov. Information posted on our website is not incorporated by reference into this Form 10-K.

For financial statement purposes, National Rural's results of operations and financial condition are consolidated with and include Rural Telephone Finance Cooperative ("RTFC") and National Cooperative Services Corporation ("NCSC"). Unless stated otherwise, references to "we," "our," or "us" relate to the consolidation of National Rural, RTFC, NCSC and certain entities created and controlled by National Rural to hold foreclosed assets and accommodate loan securitization transactions. The operations for National Rural, RTFC and NCSC are reported as separate segments. See Note 17 to the consolidated financial statements for further information on our segment reporting.

RTFC is a private cooperative association originally incorporated in South Dakota in 1987 and reincorporated in the District of Columbia in 2005. RTFC's principal purpose is to provide and arrange financing for its rural telecommunications members and their affiliates. National Rural is the sole lender to and manages the lending activities and business affairs of RTFC through a long-term management agreement. Under a guarantee agreement, RTFC pays National Rural a fee and in exchange National Rural reimburses RTFC for loan losses. 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.

NCSC was incorporated in 1981 in the District of Columbia as a private cooperative association. The principal purpose of NCSC is to provide financing to the for-profit and non-profit entities that are owned, operated or controlled by, or provide substantial benefit to, members of National Rural. NCSC's membership consists of National Rural and distribution systems that are members of National Rural or are eligible for such membership. National Rural is the primary source of funding to and manages the lending activities and business affairs of NCSC through a management agreement which is automatically

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renewable on an annual basis unless terminated by either party. Under a guarantee agreement, NCSC pays National Rural a fee and in exchange National Rural reimburses NCSC for loan losses. NCSC is headquartered with National Rural in Herndon, Virginia. NCSC is a taxable corporation.

Members

Our consolidated membership totaling 1,522 members at May 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.

Each member (other than associates) is entitled to one vote. 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.

We currently have four classes of electric members:

- Class A - cooperative or not-for-profit distribution systems that receive or are eligible to receive loans or other assistance from RUS;
- Class B - cooperative or not-for-profit power supply systems;
- Class C - statewide and regional associations wholly-owned or controlled by Class A or Class B members; and
- Class D - national associations of cooperatives.

In addition to members, associates are not-for-profit entities organized on a cooperative basis which are owned, controlled or operated by Class A, B or C members and which provide non-electric services primarily for the benefit of consumers. Associates are not entitled to vote at any meeting of the members and are not eligible to be represented on our board of directors. All references to members within this document include members and associates.

Membership in RTFC is limited to commercial (for-profit) or cooperative (not-for-profit) telecommunications systems that receive or are eligible to receive loans or other assistance from RUS, and that are engaged (or plan to be engaged) in providing telecommunications services to their users.

Membership in NCSC is limited to National Rural and organizations that are Class A members of National Rural or are eligible to be Class A members of National Rural.

In many cases, the residential and commercial customers of our electric members are also the customers of RTFC's telecommunications members, as the service territories of the electric and telecommunications members overlap in many of the rural areas of the United States.

The table below shows the total number of National Rural, RTFC and NCSC members by state or U.S. territory, the percentage of total loans, and the percentage of total loans and guarantees outstanding at May 31, 2009.

State/Territory	Number of Members	Loan %	Loan and Guarantee %	State/Territory	Number of Members	Loan %	Loan and Guarantee %
Alabama	30	2.13%	2.93%	Missouri	64	3.94%	4.03%
Alaska	30	1.69	1.61	Montana	39	0.64	0.66
American Samoa	1	-	-	Nebraska	40	0.07	0.06
Arizona	26	1.22	1.29	Nevada	7	0.85	0.97
Arkansas	30	3.05	2.90	New Hampshire	4	0.66	0.73
California	10	0.18	0.20	New Jersey	1	0.09	0.09
Colorado	39	4.68	4.65	New Mexico	25	0.16	0.16
Connecticut	1	0.99	0.93	New York	20	0.07	0.07
Delaware	1	0.18	0.17	North Carolina	40	2.32	2.67
District of Columbia	4	0.05	0.12	North Dakota	32	0.34	0.35
Florida	19	3.23	3.05	Ohio	42	2.20	2.10
Georgia	67	7.85	7.49	Oklahoma	49	2.48	2.33
Guam	1	-	-	Oregon	39	1.50	1.55
Hawaii	1	0.03	0.04	Pennsylvania	23	1.86	1.84
Idaho	17	0.78	0.75	South Carolina	38	2.30	2.16
Illinois	52	3.28	3.47	South Dakota	46	0.71	0.66
Indiana	53	4.16	3.91	Tennessee	29	0.38	0.38
Iowa	118	2.45	2.33	Texas	107	16.51	16.53
Kansas	49	3.97	3.93	Utah	11	2.78	2.65
Kentucky	33	2.34	2.63	Vermont	7	0.39	0.37
Louisiana	17	1.92	1.81	Virgin Islands	-	2.59	2.44
Maine	5	0.02	0.02	Virginia	27	1.00	0.95
Maryland	2	1.07	1.25	Washington	19	0.80	0.84
Massachusetts	1	-	-	West Virginia	4	0.01	0.01
Michigan	27	1.38	1.33	Wisconsin	60	2.08	1.95
Minnesota	73	3.93	3.70	Wyoming	15	0.60	0.59
Mississippi	27	2.09	2.35	Total	1,522	100.00%	100.00%

Distribution Systems

Distribution systems are utilities engaged in retail sales of electricity to consumers in their defined service areas on an exclusive basis. Most distribution systems have all-requirements power purchase contracts with their power supply systems, which are owned and controlled by the member distribution systems. Wholesale power for resale also comes from other sources, including power supply contracts with government agencies, investor-owned utilities and other entities, and in rare cases, the distribution systems own generating facilities.

Wholesale power supply contracts ordinarily do not guarantee an uninterrupted supply nor a constant cost of power. Contracts with RUS-financed power supply systems (which generally require the distribution system to purchase all its power requirements from the power supply system) provide for rate increases to pass along increases in sellers' costs. The wholesale power contracts permit the power supply system, subject to approval by RUS and, in certain circumstances, regulatory agencies, to establish rates to its members so as to produce revenues sufficient, with revenues from all other sources, to meet the costs of operation and maintenance (including replacements, insurance, taxes and administrative and general overhead expenses) of all generating, transmission and related facilities, to pay the cost of any power and energy purchased for resale, to pay the costs of generation and transmission, to make all payments on account of all indebtedness and lease obligations of the power supply system and to provide for the establishment and maintenance of reasonable reserves. The board of directors of the power supply system typically review the rates under the wholesale power contracts at least annually.

Power contracts with investor-owned utilities and power supply systems which do not borrow from RUS generally have rates subject to regulation by the Federal Energy Regulatory Commission ("FERC"). Contracts with federal agencies generally permit rate changes by the selling agency (subject, in some cases, to federal regulatory approval).

Power Supply Systems

Power supply systems are utilities that purchase or generate electric power and provide it on a wholesale basis to distribution systems for delivery to the consumer. Of the 61 operating power supply systems that have financing commitments from us at December 31, 2008 (the most recent year for which data is available as of the date of filing this Form 10-K), 35 had generating capacity of at least 100 megawatts, 7 had less than 100 megawatts of generating capacity and 19 had no generating capacity. The systems with no generating capacity generally operated transmission lines to supply certain distribution systems or managed power supply purchase arrangements for the benefit of their distribution system members. Certain other power supply systems have been formed but do not yet own generating or transmission facilities or have financing commitments from us.

Service Organizations and Associate Systems

Service organizations include National Rural Electric Cooperative Association ("NRECA"), statewide and regional cooperative associations. NRECA represents cooperatives nationally.

Associates include organizations that are owned, controlled or operated by Class A, B or C members and that provide non-electric services primarily for the benefit of consumers.

Telecommunications Systems

Telecommunications systems include not-for-profit cooperative organizations and for-profit commercial organizations that primarily provide local exchange and access telecommunications services to rural areas.

Independent rural telecommunications companies provide service throughout many of the rural areas of the United States. These approximately 1,300 companies are called independent because they are not affiliated with Verizon, AT&T or Qwest. Included in the 1,300 total are approximately 250 not-for-profit cooperative telecommunications companies. A majority of the remainder of these independent rural telecommunications companies are family-owned or privately-held commercial companies. Less than 20 of these commercial companies are publicly traded or have issued bonds in the capital markets.

Rural telecommunications companies, including all local exchange carriers ("LECs") other than Verizon, AT&T, Qwest, Cincinnati Bell and Embarq (formerly Sprint's local exchange properties) comprise less than 15% of a local exchange telecommunications industry that provides service to over 163 million access lines. These rural companies range in size from fewer than 100 customers to more than three million. Rural telecommunications companies' annual operating revenues range from less than $100,000 to over $2 billion. In addition to basic local exchange and access telecommunications service, most independents offer other communications services including wireless telephone, cable television and internet access. Most rural telecommunications companies' networks incorporate digital switching, fiber optics, internet protocol telephony and other advanced technologies.

Loan Programs

The table below shows the weighted-average loans outstanding to borrowers and the weighted-average interest rates thereon by loan type and by segment during fiscal years ended May 31:

	2009		2008	
	Weighted-average loans outstanding	Weighted-average interest rate	Weighted-average loans outstanding	Weighted-average interest rate
(dollar amounts in thousands)				
Total by loan type: (1)				
Long-term fixed-rate loans	$14,710,754	5.93%	$14,573,227	5.90%
Long-term variable-rate loans	1,654,355	5.34	1,170,017	6.94
Loans guaranteed by RUS	246,789	5.09	252,788	5.49
Short-term loans	2,034,736	4.05	1,310,313	5.89
Non-performing loans	495,014	-	504,310	0.01
Restructured loans	556,892	0.63	589,662	0.64
Total loans	$19,698,540	5.38	$18,400,317	5.63
Total by segment:				
National Rural	$17,579,888	5.43%	$16,167,441	5.67%

RTFC	1,693,123	4.50	1,791,100	4.96
NCSC	425,529	6.59	441,776	7.10
Total	$19,698,540	5. 38	$18,400,317	5.63

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

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Total loans outstanding by state or U.S. territory based on the location of the system's headquarters are summarized below at
May 31:

(dollar amounts in thousands)

State/Territory	2009	2008	2007	State/Territory	2009	2008	2007
Alabama	$ 430,065	$ 414,961	$ 347,723	Montana	$ 128,563	$ 133,655	$ 132,603
Alaska	340,861	371,768	335,352	Nebraska	13,844	18,756	16,447
American Samoa	489	769	769	Nevada	171,754	155,625	147,401
Arizona	246,171	206,558	178,659	New Hampshire	132,741	143,417	149,496
Arkansas	615,429	522,018	518,273	New Jersey	18,806	17,747	18,217
California	37,270	25,968	27,283	New Mexico	32,254	36,636	32,344
Colorado	944,938	942,179	922,558	New York	14,523	19,735	19,844
Connecticut	200,000	200,000	200,000	North Carolina	468,240	487,249	519,214
Delaware	36,253	37,950	39,582	North Dakota	68,758	69,120	77,072
District of Columbia	9,298	9,514	9,717	Ohio	444,565	455,491	390,350
Florida	651,564	677,365	617,010	Oklahoma	500,189	483,623	480,536
Georgia	1,584,178	1,567,108	1,566,308	Oregon	303,926	303,166	305,506
Hawaii	6,443	6,804	7,157	Pennsylvania	375,549	357,337	376,193
Idaho	158,013	157,703	168,253	South Carolina	464,125	484,733	476,139
Illinois	661,632	600,571	543,389	South Dakota	142,582	147,916	161,247
Indiana	839,473	530,008	481,243	Tennessee	76,553	107,575	96,073
Iowa	493,722	465,056	482,513	Texas	3,332,283	3,044,117	2,618,010
Kansas	801,389	878,630	849,864	Utah	561,050	570,971	565,768
Kentucky	472,693	363,720	355,503	Vermont	79,131	74,957	75,905
Louisiana	388,490	333,984	320,765	Virgin Islands	523,758	491,706	492,795
Maine	4,093	4,566	9,884	Virginia	201,798	235,916	184,986
Maryland	216,468	224,754	206,491	Washington	161,099	122,674	110,907
Michigan	279,490	265,116	271,541	West Virginia	2,341	6,109	5,355
Minnesota	792,863	655,576	731,883	Wisconsin	418,898	384,748	369,427
Mississippi	422,625	395,423	366,989	Wyoming	121,011	133,087	117,374
Missouri	795,956	682,860	630,289	Total	$20,188,207	$19,026,995	$18,128,207

Our loan portfolio is widely dispersed throughout the United States and its territories, including 49 states, the District of Columbia, American Samoa and the U.S. Virgin Islands. At May 31, 2009, 2008 and 2007, loans outstanding to borrowers located in any one state or territory did not exceed 17 percent, 16 percent and 15 percent, respectively, of total loans outstanding.

Interest Rates on Loans

As a cooperatively-owned finance company, we set rates that provide our members with low cost financing while maintaining investment grade credit ratings on our debt instruments. Our interest rates are set primarily based on our cost of funding, as well as applicable discounts, general and administrative expenses, the loan loss provision and a reasonable level of earnings. Various discounts reduce the stated interest rates for borrowers meeting certain criteria related to business type, performance, volume and whether they only borrow from us.

National Rural Loan Programs

Long-Term Loans

National Rural's long-term loans generally have the following characteristics:

- terms of up to 35 years on a senior secured basis;
- either amortizing or bullet loans with serial payment structures;
- used to finance electric plant and equipment which typically have a useful life equal to or in excess of the loan maturity;
- borrower can select a fixed interest rate for periods of one to 35 years or a variable rate; and
- may be divided into various tranches with either a fixed or variable interest rate for each tranche.

When a selected fixed interest rate term expires, the borrower may select another fixed-rate term or the variable rate. We set electric long-term fixed rates daily and the long-term variable rate is set on the first business day of each month. The fixed rate on a loan is determined on the day the loan is advanced or repriced based on the term selected.

In addition to our customary loan standards, to be eligible for long-term loan advances, distribution systems generally must maintain an average modified debt service coverage ratio ("MDSC"), as defined in the loan agreement, of 1.35 or greater. Similarly, power supply systems generally must maintain an average times interest earned ratio ("TIER") and MDSC, as defined in the loan agreement, of 1.0 or greater. We may make long-term loans to distribution and power supply systems that do not meet these criteria as these are only general guidelines.

Short-Term Loans

Our line of credit loans are generally advanced at variable interest rates. These variable interest rates may be set on the first business day of each month or mid-month. The principal amount of line of credit loans with maturities of greater than one year generally must be paid down to a zero outstanding principal balance for five consecutive days during each 12-month period.

Interim financing line of credit loans are also made available to our members that have a loan application pending with RUS and have received approval from RUS to obtain interim financing. Advances under these interim facilities must be repaid with advances from RUS long-term loans.

RTFC Loan Programs

The RTFC loan portfolio is concentrated in the core rural local exchange carrier ("RLEC") segment of the telecommunications market. Most of these RLECs have evolved from solely being voice service providers to being providers of voice, data and, often times, video and wireless services. RLECs are generally characterized by the low population density of their service territories. Services are generally delivered over networks that include fiber optic cable and digital switching. There is generally a significant barrier to competitive entry.

The businesses to which the remaining RTFC loans have been made support the operations of the RLECs and are owned, operated or controlled by RLECs. Many such loans are supported by payment guarantees from the sponsoring RLECs.

Long-Term Loans

RTFC makes long-term loans to rural telecommunications companies and their affiliates for the acquisition, construction or upgrade of wireline telecommunications systems, wireless telecommunications systems, fiber optic networks, cable television systems and other corporate purposes. RTFC's long-term loans generally have the following characteristics:

- terms not exceeding 10 years on a senior secured basis;
- borrower can select a fixed interest rate for periods from one year to the final loan maturity or a variable interest rate;
- may be divided into various tranches with either a fixed or variable interest rate for each tranche.

When a selected fixed interest rate term expires, the borrower may select another fixed-rate term or a variable rate. We set
long-term fixed rates for telecommunications loans daily and the long-term variable rate is set on the first business day of each month. The fixed rate on a loan is determined on the day the loan is advanced or converted to a fixed rate based on the term selected.

To borrow from RTFC, a wireline telecommunications system generally must be able to demonstrate the ability to achieve and maintain an annual debt service coverage ratio ("DSC") and an annual TIER of 1.25 and 1.50, respectively. To borrow from RTFC, a cable television system, fiber optic network or wireless telecommunications system generally must be able to demonstrate the ability to achieve and maintain an annual DSC of 1.25.

Short-Term Loans

RTFC provides line of credit loans to telecommunications systems for periods generally not to exceed five years. These line of credit loans are typically revolving facilities and generally require the borrower to pay off the principal balance for five consecutive business days at least once during each 12-month period. These line of credit loans may be provided on a secured or unsecured basis and are designed primarily to assist borrowers with liquidity and cash management.

Interim financing line of credit loans are also made available to telecommunications systems that have a loan application pending with RUS and have received approval from RUS to obtain interim financing. These loans are for terms up to 24 months and the borrower must repay the RTFC loan with advances from the RUS long-term loans.

NCSC Loan Programs

NCSC makes long-term and short-term loans to rural utility members and organizations affiliated with its members. Loans may be secured or unsecured. The loans to the affiliated organizations may have a guarantee of repayment to NCSC from the National Rural member cooperative with which it is affiliated.

Lease and General Loan Program

NCSC has, in the past, provided financing for the purchase of utility plant and/or related equipment, in some cases by a third party in a sale/leaseback transaction. Collateral for these loans consists of a senior secured mortgage on the leased utility asset, utility plant and/or related utility equipment. NCSC is not a party to these lease agreements. NCSC no longer provides new financing of this type.

Associate Member Loan Program
NCSC provides financing to for-profit or not-for-profit affiliated entities of member cooperatives for economic and community development purposes. Collateral for these loans generally consists of a first mortgage lien on the assets of the associate member and/or project. These loans are also generally guaranteed by the sponsoring cooperative.

RUS Guaranteed Loans for Rural Electric Systems
At May 31, 2009 and 2008, we had $244 million and $250 million, respectively, of loans outstanding on which RUS had guaranteed the repayment of all principal and interest. There are two programs under which these loans were advanced. We have been an eligible lender in the RUS loan guarantee program under the terms and conditions of a master loan guarantee and servicing agreement between RUS and National Rural since February 1999. Under this agreement, we may make long-term secured loans to eligible members for periods of up to 35 years, at fixed or variable rates established. RUS guarantees the full amount of principal and interest payments on the notes evidencing such loans. At May 31, 2009 and 2008, we had a total of $211 million and $215 million, respectively, under this program. In addition, at May 31, 2009 and 2008, we held certificates totaling $33 million and $35 million which represent interests in trusts that hold RUS guaranteed loans. These certificates were the result of a program in which RUS previously allowed certain qualifying cooperatives to repay loans held by the Federal Financing Bank ("FFB") early, and allowed the transfer of the guarantee to a new lender.

Conversion of Loans
A borrower may convert a long-term loan from a variable interest rate to a fixed interest rate at any time without a fee. Such conversion will be effective on the first day of the following month. Generally, in exchange for a fee, a borrower may convert its long-term loan from a fixed rate to another fixed rate or to a variable rate at any time. The fee on the conversion of a fixed interest rate to a variable interest rate is 25 basis points plus a make-whole premium, if applicable, per current loan policies.

Prepayment of Loans
Generally, borrowers may prepay long-term loans at any time, subject to a prepayment fee of 33 to 50 basis points and a make-whole premium, if applicable. Variable-rate line of credit loans may be repaid at any time without a premium.

Loan Security
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.

The following tables summarize our secured and unsecured loans outstanding by loan type and by segment at May 31:

(dollar amounts in thousands)	2009				2008			
Total by loan type:	Secured	%	Unsecured	%	Secured	%	Unsecured	%
Long-term fixed-rate loans	$14,044,469	96%	$ 557,896	4%	$14,732,058	97%	$ 472,556	3%
Long-term variable-rate loans	2,835,451	87	408,265	13	1,728,803	92	153,292	8
Loans guaranteed by RUS	243,997	100	-	-	250,169	100	-	-
Short-term loans	233,179	11	1,864,950	89	165,226	10	1,524,891	90
Total loans	$17,357,096	86	$ 2,831,111	14	$16,876,256	89	$ 2,150,739	11

Total by segment:								
National Rural	$15,562,761	86 %	$ 2,528,572	14%	$15,021,067	89%	$ 1,865,340	11%
RTFC	1,443,395	86	236,759	14	1,497,487	87	229,027	13
NCSC	350,940	84	65,780	16	357,702	86	56,372	14
Total loans	$17,357,096	86	$ 2,831,111	14	$16,876,256	89	$ 2,150,739	11

Guarantee Programs

We use the same credit policies and monitoring procedures for guarantees as for loans and commitments. The following table provides a breakout of guarantees outstanding by type and segment at May 31:

(dollar amounts in thousands)	2009	2008
Long-term tax-exempt bonds	$ 644,540	$ 498,495
Indemnifications of tax benefit transfers	81,574	94,821
Letters of credit	450,659	343,424
Other guarantees	98,682	100,400
Total	$1,275,455	$1,037,140

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(dollar amounts in thousands)				
National Rural:	2009		2008	
Distribution	$ 264,084	21%	$ 184,459	18%
Power supply	945,624	74	786,455	76
Statewide and associate	23,625	2	22,785	2
National Rural Total	1,233,333	97	993,699	96
RTFC	500	-	260	-
NCSC	41,622	3	43,181	4
Total	$1,275,455	100%	$1,037,140	100%

Guarantees of Long-Term Tax-Exempt Bonds

We guarantee debt issued for our members' construction or acquisition of pollution control, solid waste disposal, industrial development and electric distribution facilities. Governmental authorities issue such debt and the interest thereon is exempt from federal taxation. The proceeds of the offering are made available to the member system, which in turn is obligated to pay the governmental authority amounts sufficient to service the debt. The debt, which we guarantee, may include short- and long-term obligations.

If a system defaults because it doesn't make the debt payments, we are obligated to pay, after available debt service reserve funds have been exhausted, scheduled debt service under our guarantee. The bond issue may not be accelerated because of non-payment by the system as long as we perform under our guarantee. The system is required to repay, on demand, any amount that we advance pursuant to our guarantee. This repayment obligation is secured on parity with other lenders (including, in most cases, RUS), by a lien on substantially all of the system's assets. If the security instrument is a common mortgage with RUS, then in general, we may not exercise remedies for up to two years following default. However, if the debt is accelerated under the common mortgage because of a determination that the related interest is not tax-exempt, the system's obligation to reimburse us for any guarantee payments will be treated as a long-term loan. The system is required to pay us initial and/or on-going guarantee fees in connection with these transactions.

Certain guaranteed long-term debt bears interest at variable rates which are adjusted at intervals of one to 270 days, weekly, each five weeks or semi-annually to a level favorable to their resale or auction at par. If funding sources are available, the member who issued the debt may choose a fixed interest rate on the debt. When the variable rate is reset, holders of variable-rate debt have the right to tender the debt for purchase at par. We have committed to purchase this debt as liquidity provider if it cannot otherwise be remarketed. If we hold the securities, the cooperative pays interest to us at our short-term variable rate. At May 31, 2009, we were the guarantor and liquidity provider for $643 million of tax-exempt bonds issued for our member cooperatives. During the year ended May 31, 2009, we purchased $72 million of these securities pursuant to our obligation as the liquidity provider. At May 31, 2009, all tax-exempt bonds we held had been redeemed or repurchased by third-party investors with no gain or loss on the transactions.

Guarantees of Tax Benefit Transfers

We have also guaranteed members' obligations to indemnify against loss of tax benefits in certain tax benefit transfers that occurred in 1981 and 1982. A member's obligation to reimburse us for any guarantee payments would be treated as a long-term loan, secured proportionally with RUS by a first lien on substantially all the member's property to the extent of any cash received by the member at the outset of the transaction. 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 guarantees of this nature have been put in place since 1982. The maturities for this type of guarantee run through 2015.

Letters of Credit

In exchange for a fee, we issue irrevocable letters of credit to support members' obligations to energy marketers, other third parties and to the Rural Business and Cooperative Development Service. Letters of credit may be on a secured or unsecured basis. Each letter of credit is supported by a reimbursement agreement with the member on whose behalf the letter of credit was issued. In the event a beneficiary draws on a letter of credit, the agreement generally requires the member to reimburse us within one year from the date of the draw, with interest accruing from that date at our short-term variable interest rate.

Other Guarantees

We may provide other guarantees as requested by our members. These guarantees may be made on a secured or unsecured basis with guarantee fees set to cover our general and administrative expenses, a provision for losses and a reasonable margin.

Total guarantees outstanding by state and territory based on the location of the system's headquarters, is summarized as follows at May 31:

(dollar amounts in thousands)

State/Territory	2009	2008	2007	State/Territory	2009	2008	2007
Alabama	$198,506	$ 72,070	$ 72,348	Missouri	$ 68,363	$ 75,102	$ 85,268
Alaska	3,860	1,900	1,900	Montana	12,772	9,056	9,029
Arizona	29,869	33,745	38,301	Nebraska	7	4	6
Arkansas	6,166	8,008	12,027	Nevada	37,452	5,400	5,400
California	6,247	6,110	1,010	New Hampshire	24,763	32,767	34,550
Colorado	52,690	53,467	54,236	New Mexico	1,036	1,048	1,020
Delaware	8	-	-	New York	113	-	-
District of Columbia	16,000	17,448	20,998	North Carolina	105,905	99,729	100,630
Florida	2,851	3,725	4,623	North Dakota	5,825	6,474	7,115
Georgia	23,718	26,775	26,027	Ohio	7,000	8,000	5,500
Hawaii	1,300			Oklahoma	764	754	3,056
Idaho	3,173	3,173	3,173	Oregon	28,511	29,034	29,439
Illinois	82,927	229	219	Pennsylvania	18,747	17,416	17,519
Indiana	23	13	7	South Carolina	506	6,300	7,819
Iowa	6,961	8,271	8,240	South Dakota	19	20	6
Kansas	41,318	60,797	55,472	Tennessee	3,939	1,460	296
Kentucky	91,741	102,423	124,013	Texas	216,443	194,214	152,307
Louisiana	501	389	4,733	Utah	6,961	13,495	17,193
Maine	4	2	1	Vermont	1,350	1,250	3,500
Maryland	52,078	11,725	25,266	Virginia	2,874	3,447	3,935
Michigan	5,236	2,232	2,123	Washington	19,050	19,050	23,171
Minnesota	1,601	3,025	10,585	Wisconsin	305	320	32
Mississippi	81,143	83,549	88,312	Wyoming	4,829	13,724	13,969
				Total	$1,275,455	$1,037,140	$1,074,374

Member Regulation and Competition

Electric Systems

The movement toward electric competition at the retail level has faltered, while the wholesale level has become largely competitive. The electric utility industry has settled into a "hybrid" model in which there are significant differences in the retail regulatory approaches followed in different states and regions.

Customer choice regulation, where customers have a choice of alternative energy suppliers, has had little to no impact on distribution and power supply cooperatives and we do not expect a material impact going forward. As of May 31, 2009, retail customer choice has been implemented in 15 states. Those states are Arizona, Connecticut, Delaware, Illinois, Maine, Maryland, Massachusetts, Michigan, New Hampshire, New Jersey, New York, Ohio, Pennsylvania, Rhode Island, and Texas. In general, even in those states, very few customers have switched from the traditional supplier.

There are many factors that may influence the choices that customers have available to them and therefore have mitigated the effect of customer choice and competition in areas served by cooperatives. These factors include, but are not limited to, the following:

- Utilities in many states may still be regulated regarding rates on non-competitive services, such as distribution;
- 20 states regulate the securities issued by utilities, including cooperatives;
- FERC regulation of rates as well as terms and conditions of transmission service;
- The fact that few competitors have demonstrated much interest in providing electric energy to residential or rural customers;
- Distribution systems own the lines to the customer and it would not be feasible for a competitor to build a second line to serve the same customers in almost all situations. Therefore, the distribution systems will still be charging a fee or access tariff for the service of delivering power, regardless of who supplies the power.

In addition to retail customer choice laws, some state agencies regulate the rates and borrowing of electric cooperatives. There are 15 states that regulate the rates electric cooperative systems charge. Those states are Arizona, Arkansas, Georgia, Hawaii, Kentucky, Louisiana, Maine, Maryland, Michigan, New Mexico, New York, Utah, Vermont, Virginia, and West Virginia. In these 15 states, we had 161 distribution members and 14 power supply members with a total of $4,424 million of loans outstanding at May 31, 2009. Two of these states (Georgia and Utah) have partial oversight authority over the cooperatives' rates, but not the specific authority to set rates. As of May 31, 2009, we had loans outstanding in the amount of $2,035 million in those states. Ten states allow cooperatives the right to opt in or out of state regulation. There are 20 states that regulate electric systems' issuance of debt. FERC also has jurisdiction to regulate transmission rates, wholesale rates, terms and conditions of service, and the issuance of securities by public utilities within its jurisdiction, which includes only a few cooperatives.

Global climate legislation remains a hotly debated issue on Capitol Hill. On June 26, 2009, the House of Representatives passed H.R. 2454, the "American Clean Energy and Security Act of 2009", also known as the Waxman-Markey climate change bill. This bill would cap U.S. carbon dioxide emissions, including those of electric utilities. Specifically, the bill would require that carbon dioxide emissions be reduced below 2005 levels by 17 percent by 2020, 42 percent by 2030 and 83 percent by 2050. The bill would provide allowances free of charge to certain entities, including to electric utilities. These allowances would permit entities to emit above the capped level and would be allocated to certain entities to cover a portion of the required reductions.

Currently, the Senate is considering similar legislation. As of this time, it is unclear whether global climate change legislation will become law, and, if enacted, what specific requirements will be imposed on electric utilities. We closely monitor the legislative activity on climate change and we will continue to monitor this activity as well as the debate on the various proposals under consideration. Because of the continuing uncertainty regarding the context and timing of potential climate change legislation, we are unable, at this time, to determine the impact of such potential requirements on us or our members.

We compete with other electric lenders on price, the variety of financing options offered and additional services provided to our member/owners. We are primarily in competition with other banks for the business of electric members. Our main bank competitor is CoBank, ACB ("CoBank"), a government sponsored enterprise and member of the Farm Credit System whose status gives it the ability to access funding at a lower cost, therefore potentially enabling CoBank to offer lower interest rates in many situations. In addition, some members are large enough to directly access the capital markets for funding. In these instances, we are competing with the pricing and funding options the member is able to obtain in the capital markets. We attempt to minimize the impact of competition by offering a variety of loan options, complimentary services and by leveraging the working relationship we have developed with the majority of our members.

RUS is generally the members' first financing option because it can offer members interest rates that are generally lower than the rates National Rural and the other banks are able to offer. However, National Rural and other banks compete for bridge loans in anticipation of long-term funding from RUS, the portion of a loan that RUS is unable to provide, loans to members that cannot borrow from RUS and loans to members that have elected not to borrow from RUS.

According to financial data as of December 31, 2008 provided to us by our 809 reporting electric cooperative distribution and 59 reporting power supply systems and as of December 31, 2007 provided to us by our 810 reporting electric cooperative distribution and 58 reporting power supply systems, those entities had long-term debt outstanding to National Rural, RUS and other lenders in the electric cooperative industry as summarized below:

(dollar amounts in millions)	2008		2007	
National Rural	$ 16,787	27%	$ 15,888	27%
RUS	32,238	51	30,884	53
Other lenders	13,841	22	11,924	20
Total	$ 62,866	100%	$ 58,696	100%

National Rural's total long-term loan exposure is further summarized by type below at December 31:

(dollar amounts in millions)	2008	2007
Total by type:		
Distribution	$ 12,710	$ 12,226
Power supply	2,895	2,678
Total loans outstanding	15,605	14,904
Guarantees	1,182	984
Total long-term exposure	$ 16,787	$ 15,888

Since the enactment of the Rural Electrification Act in 1936 (the "RE Act"), RUS has financed the construction of electric generating plants, transmission facilities and distribution systems to provide electricity to rural areas. Principally through the creation of local electric cooperatives that were originally financed under the RE Act loan program in 48 states and three U.S. territories, the percentage of farms and residences in rural areas of the United States receiving central station electric service increased from 11 percent in 1934 to almost 100 percent currently. Rural electric systems currently serve approximately 12 percent of all consumers of electricity in the United States and its territories and account for approximately 8 percent of total sales of electricity and own about 5 percent of electricity generating capacity.

The RE Act provides for RUS to make insured loans and to provide other forms of financial assistance to electric borrowers. However, RUS is currently not offering loans to finance the construction of new coal or nuclear baseload electric generation facilities. RUS is authorized to make direct loans to systems that qualify for the hardship program (5 percent interest rate) or the municipal rate program (based on a municipal government obligation index). RUS is also authorized to guarantee loans that bear interest at a rate agreed upon by the borrower and the lender (which generally has been the FFB). RUS also provides financing at the U.S. Treasury rate. The RUS exercises financial and technical supervision over borrowers' operations. Its loans and guarantees are generally secured by a mortgage on substantially all of the system's property and revenues.

For the fiscal year ending September 30, 2010, the President’s budget requests $100 million for hardship loans and $6.5 billion for loan guarantees. It is unclear whether Congress will ultimately appropriate funds at the President’s requested budget levels. Electric funding levels for fiscal year 2009 were: $100 million for hardship loans and $6.5 billion in loan guarantees.

Telecommunications Systems

Rural telecommunications systems generally are regulated at the state and federal levels. Most state commissions regulate local service rates, intrastate access rates and telecommunications company borrowing. The Federal Communications Commission ("FCC") regulates interstate access rates and the issuance of licenses required to operate certain types of telecom operations. Some rural telecommunications systems have affiliated companies that are not regulated.

The Telecommunications Act of 1996 (the "Telecom Act") created a framework for competition and deregulation in the local telecommunications market. The Telecom Act has four basic goals:

1. Competition - to be achieved by requiring all carriers to interconnect with all others and requiring LECs to provide competitors with access to elements of their networks.
2. Universal service - that is, a mandate that telecommunications service in rural areas of the U.S. be comparable in quality and price to service in urban areas.
3. Deregulation – reducing the regulatory burden on incumbent LECs to allow them to compete with new, largely unregulated entities.
4. Fostering advanced telecommunications and information technologies – the dynamic environment created by a competitive telecommunications marketplace should result in new products and services.

Competition continues to be a significant factor in the telecommunications industry. An August 2008 FCC report on telecom trends states that as of June 2007, competitive local exchange carriers ("CLECs") provided service to 29 million access lines - 18 percent of the nation's 163 million end-user switched access lines. Wireless carriers are providing service to 238 million mobile telephone service subscriptions - more than LECs and CLECs combined. For the most part, local exchange competition has benefited RLECs by enabling them to enter nearby towns and cities as CLECs, leveraging their existing infrastructure and reputation for providing quality, modern telecommunications service. The Telecom Act grants RLECs an exemption from the requirement to provide competitors with access to their networks, absent a determination that it would be in the public interest. Relatively few RLECs have had CLECs request access to their networks.

The Telecom Act mandate for universal service is accomplished through a support mechanism (the “Universal Service Fund,” or “USF”) that is required to be: (1) sufficient to ensure that rural customers receive reasonably comparable rates and services when compared to urban customers; and (2) portable, that is, available to all eligible providers. The USF provides support for RLECs with costs significantly above the national average. In addition, implicit subsidies long contained in the access charges local telecommunications companies’ levy on long distance carriers have largely been eliminated. As these access charges have been reduced, RLECs have been made whole by cost recovery being moved to the Universal Service Fund. USF is an important revenue source for most RLECs.

The nexus between competition and universal service is the issue of competitor eligibility for universal service funding – the "portability" feature of USF. As noted above, few wireline competitors have attempted to enter rural markets. Numerous wireless carriers however have extended their coverage areas into rural markets. By obtaining competitive eligible telecommunications carrier ("CETC") status from state regulators (as provided for in the Telecom Act), these wireless carriers are able to receive universal service funds based on the incumbent LEC's costs (the "identical support" rule). This has led to growth in claims on the fund and great concern for its sustainability. USF's current funding base of interstate telecommunications revenues is shrinking as long distance minutes-of-use go down due to wireless, email and voice over internet protocol substitution. Increased demand for USF funding has resulted in the rate assessed on all participants in the nationwide network (the "contribution factor") becoming unsustainably high. The third quarter 2009 contribution factor is 12.9 percent of interstate and international long distance revenue.

While nearly all industry participants agree that changes need to be made regarding eligibility and the funding mechanism for USF, there is no agreement on what those changes should be. In May 2008, the FCC ordered that payments to CETCs be capped. Total support for a CETC is capped at what they were eligible to receive in March 2009. In January 2008 the FCC opened proceedings on universal service funding. These related proceedings addressed creation of separate funds for incumbents and CETCs, elimination of the "identical support" rule, and a transition to a reverse auction regime for determining amounts of USF support an eligible carrier would receive. No consensus solution was reached by the FCC and the same issues await the newly constituted FCC. It is unclear what action, if any, the FCC ultimately will take with respect to this matter.

The FCC also has a proceeding open on intercarrier compensation – the most important components of which are access fees LECs charge to interexchange carriers that originate or terminate long distance traffic on LEC networks. While the large LECs (most of which now own long distance companies) would like to see these fees transition to zero, RLECs depend heavily on access charges and have been active participants in the FCC proceeding. No action has yet been taken in this proceeding and, like USF, it awaits the newly constituted FCC. At this point, it is unclear what action, if any, will be taken.

While uncertainty exists regarding USF and access, we do not anticipate that any changes to the USF regime will result in our member RLECs suffering revenue losses significant enough to cause material losses on our outstanding loans.

Deregulation has not had a significant effect on the wireline LEC business segment thus far. The FCC has promulgated a series of rules to implement the Telecom Act, and eliminated very few existing regulatory requirements. States continue to regulate RLECs extensively. Internet, video, wireless and competitive local exchange services are much less regulated. Most RLECs are expanding their service offerings to customers in these business segments. With few competitors in the most rural parts of their service areas, RLECs have generally been successful in these growth and diversification efforts.

Finally the Telecom Act dealt with fostering advanced telecommunications and information technologies. RLECs have used the rate-of-return cost recovery mechanisms discussed above to modernize their infrastructure. Most have pushed fiber optic cable into their distribution networks, allowing for higher data speeds to customers. Many RLECs are evolving their networks from the traditional circuit-switched architecture to what is termed "soft switch", i.e., distributing intelligence throughout their networks, not just at the central office.

In 1949, the RE Act was amended to allow lending for furnishing and improving rural telecommunications service. For fiscal year 2009, RUS has $690 million in lending authority for rural telephone systems. To provide debt capital for RLEC modernization, Congress created the RUS broadband loan program in 2002. Congress authorized $406 million of broadband lending authority in fiscal year 2009. In addition, the American Recovery and Reinvestment Act (ARRA) provides RUS with $2.5 billion of budget authority to provide loans and grants. These funds are to be obligated by September 30, 2010. For fiscal year 2009, RUS was allocated $1 billion in ARRA lending authority. The appropriation for fiscal year 2010 broadband lending has been proposed at $532 million. ARRA broadband loans of $6.1 billion are proposed for fiscal year 2010. In addition to RUS, ARRA authorizes the Department of Commerce's National Telecommunications and Information Administration to administer $4.7 billion in budget authority to provide broadband grants for service to unserved and underserved areas.

RTFC does not compete with the RUS lending programs. Its focus is to be supplementary and complementary to RUS telecom lending. Given the increased availability of government financing for rural broadband, it is unlikely that we will be participating in this financing to any significant degree outside of incremental lending to existing RLEC borrowers to provide broadband services to their customers or interim financing in connection with the federal funding programs.

The competitive market for providing credit to the rural telecommunications industry is difficult to quantify. Many rural telecommunications companies are not RUS borrowers, and CoBank and commercial banks generally do not publish information solely on their telecom portfolios. At December 31, 2008, RUS had approximately $4.0 billion in loans outstanding to telecommunications borrowers. As noted previously, RTFC is not in direct competition with RUS, but rather competes with other lenders for supplemental lending and for the full lending requirement of the rural telecommunications companies that have decided not to borrow from RUS or for projects not eligible for RUS financing. RTFC's competition includes commercial banks, CoBank and insurance companies. At December 31, 2008, RTFC had a total of $1.6 billion in long-term loans outstanding to telecommunications borrowers.

Disaster Recovery

We have had a comprehensive disaster recovery and business continuity plan since May of 2001. The plan includes a duplication of our production information systems at an off-site facility coupled with an extensive business recovery plan to use those remote systems. Our production data is replicated in real time to the recovery site 24 hours a day, 7 days a week.

The plan also includes steps for each of our operating groups to conduct business with a view to minimizing disruption for customers. We conduct Disaster Recovery exercises twice a year that include both the information technology group and business areas. We contract with an external vendor for the facilities to house the backup systems that we own as well as office space and related office equipment. In January 2009, we moved our disaster recovery off-site facility from New Jersey to a location in western Virginia to allow for quicker access by employees to the site in the event of a disaster. We have also implemented data duplication technology to provide back-up to disks where backup data are also replicated to our Disaster Recovery site.

Tax Status

In 1969, National Rural obtained a ruling from the Internal Revenue Service recognizing National Rural's exemption from the payment of federal income taxes under Section 501(c)(4) of the Internal Revenue Code. Such exempt status could be revoked as a result of changes in legislation or in administrative policy or as a result of changes in National Rural's business. National Rural believes that its operations have not changed materially from those described to the Internal Revenue Service in its exemption filing. RTFC is a taxable cooperative under Subchapter T of the Internal Revenue Code. As long as RTFC continues to qualify under Subchapter T of the Internal Revenue Code, it is allowed to exclude from taxable income the amount of net income allocated to its members. RTFC pays income tax based on its net income, excluding net income allocated to its members. NCSC is a taxable corporation which pays income tax annually based on its net income for the period.

Investment Policy

Surplus funds are invested based on policies adopted by our board of directors. Under present policy, surplus funds may be invested in direct obligations of, or guaranteed by, the United States or agencies thereof or other highly liquid investment grade securities. Current investments may include highly-rated securities such as commercial paper, obligations of foreign governments, Eurodollar deposits, bankers' acceptances, bank letters of credit, certificates of deposit or working capital acceptances. The policy also permits investments in certain types of repurchase agreements with highly-rated financial institutions, whereby the assets consist of eligible securities of a type listed above set aside in a segregated account. In addition, this policy permits investments in the Federal Agricultural Mortgage Corporation.

Employees

At May 31, 2009, we had 232 employees, including financial and legal personnel, management specialists, credit analysts, accountants and support staff. We believe that our relations with our employees are good.

Item 1A. Risk Factors.

Our financial condition and results of operations are subject to various risks inherent in our business. The material risks and uncertainties that management believes affect us are described below. If any of the events or circumstances described in the following risks actually occur, our business, financial condition or results of operations could suffer. You should consider all of the following risks together with all of the other information in this Annual Report on Form 10-K.

Our ability to maintain and grow our business depends on access to external financing.
We depend on access to the capital markets to refinance our long-term and short-term debt, to fund new loan advances and, if necessary, to fulfill our obligations under our guarantee and repurchase agreements. At May 31, 2009, we had $2,288 million of commercial paper, daily liquidity fund, term loans, and bank bid notes and $2,580 million of medium-term notes, collateral trust bonds and long-term notes payable scheduled to mature during the next twelve

months. At May 31, 2009, we were the guarantor and liquidity provider for $643 million of tax-exempt bonds issued for our member cooperatives. We cannot assure that we will be able to raise capital in the future at all or on terms that are acceptable to us. Downgrades to our long-term debt ratings and/or commercial paper ratings or other events that may deny or limit our access to the capital markets could negatively affect our operations, including our ability to refinance our debt and make loans. We have no control over certain items that the credit rating agencies and investors consider when they analyze us, such as the overall outlook for the financial, electric and telecommunications industries.

The capital constraints of banks could affect future commitment levels under our revolving credit agreements. A restriction on access to the revolving lines of credit would impair our ability to issue short-term debt, as such lines are required for backup liquidity to maintain preferred rating levels on our short-term debt.

Fluctuating interest rates could adversely affect our income, margin and cash flow.
We are exposed to interest rate risk in our core lending and borrowing activities. If we do not set interest rates on our loans at levels to cover our cost of funding and to compensate for the credit risk on the loans, there would be an adverse effect on net interest income and net income.

We provide our members with many options on our loans related to interest rates, the term for the selected interest rate and the ability to prepay the loan. As a result, there is a possibility of significant changes in the composition of the loan portfolio. If we are unable to adjust the repricing and/ or maturities of our outstanding debt portfolio to match the changes in the loan portfolio, there could be an adverse impact on net interest income and net income.

In addition, the calculated impairment on non-performing and restructured loans will increase as our long-term variable and short-term interest rates increase. Based on the current balance of impaired loans at May 31, 2009, an increase or decrease of 25 basis points to our 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. As of August 1, 2009, we had decreased our long-term variable interest rates by 45 basis points, resulting in a decrease to the calculated impairment on loans of $6 million.

Competition from other lenders could impair our financial results.
The majority of our members are eligible to borrow from RUS. The rates that RUS offers are generally lower than our rates or rates that other lenders can offer. As a result, the members' first financing option generally is to borrow funds under the RUS program. The RUS funding level is determined by the U.S. Congress each year. Increases to the amount of RUS funding could limit the amount of our loan growth.

We compete with other lenders for the portion of the loan commitment that RUS will not lend, for the loans to members that cannot borrow from RUS or for loans to members that have elected not to borrow from RUS. If other lenders are more successful than us in the competition for this loan volume, it could have an adverse impact on our financial results.

We may not recover the value of amounts that we lend which could impair our financial results.
Our allowance for loan losses is established through a provision charged to expense that represents management's best estimate of probable losses that have been incurred within the existing loan portfolio. The level of the allowance reflects management's continuing evaluation of: industry concentrations; economic conditions; specific credit risks; loan loss experience; current loan portfolio quality; present economic, political and regulatory conditions and unidentified losses and risks inherent in the current loan portfolio. The determination of the appropriate level of the allowance for loan losses involves a high degree of subjectivity and requires us to make significant estimates of current credit risks and future trends, all of which may undergo material changes. Changes in economic conditions affecting borrowers, new information regarding existing loans, identification of additional problem loans and other factors, both within and outside of our control, may require an increase in the allowance for loan losses. In addition, if actual losses incurred exceed current estimates of probable losses currently included in the allowance for loan losses, we will need additional provisions to increase the allowance for loan losses. Any increases in the allowance for loan losses will result in a decrease in net income, and may have a material adverse effect on our financial results and credit ratings.

We have been and may in the future be in litigation with borrowers related to enforcement or collection actions pursuant to loan documents. In such cases, the borrower or others may assert counterclaims against us or initiate actions against us related to the loan documents. Unfavorable rulings in these cases which result in loan losses that exceed the related allowance could have a material adverse effect on our financial results and credit ratings.

The performance of assets we obtain through foreclosure could impair our financial results.

Periodically, we foreclose on assets that are pledged as collateral on loans as a result of the failure of the borrower to make the agreed upon payments. When we foreclose on these assets, we are attempting to maximize our recovery on the loan through the ongoing operations and future sale of the underlying assets.

As the owner of foreclosed assets, we are subject to the same performance and financial risks as any owner of similar assets. In particular, we are at risk that the value of the foreclosed assets deteriorates, negatively affecting our results of operations. Each quarter, the foreclosed assets are revalued at the lower of cost or market. Decreases in value in any period are recorded as a loss on the income statement. In the event that there is not an active market from which to gain a valuation, there is substantial judgment used in the determination of the fair value of the foreclosed assets. In addition, when the assets are sold to a third party, the sales price we receive may be below the amount previously recorded in our financial statements, which will result in a loss being recorded in the period of the sale. If these events occur, it could have a material adverse effect on our financial results, to the extent of the carrying value of such assets.

The non-performance of a counterparty to our derivative agreements could impair our financial results.
We use interest rate and cross currency swaps to manage our interest rate and currency risk. There is a risk that the counterparties to these agreements will not perform as agreed, which could adversely affect our results of operations. The non-performance of a counterparty on an agreement would result in the derivative no longer being an effective risk management tool which could negatively affect our overall interest rate risk position. In addition, if a counterparty fails to perform on our derivative obligation, we could incur a financial loss to replace the derivative with another counterparty and/or a loss through the failure of the counterparty to pay us amounts owed.

A decline in our credit rating could trigger payments under our derivative agreements and impair our financial results.
We have certain interest rate swaps that contain credit risk-related contingent features referred to as rating triggers. Under certain 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. These rating triggers are based on our senior unsecured credit rating from Standard & Poor's Corporation and Moody's Investors Service. Based on the fair market value of our interest rate exchange agreements subject to rating triggers at May 31, 2009, we may be required to make a payment of up to $147 million if our senior unsecured ratings from Moody's Investors Service falls to or below Baa1 or from Standard & Poor's Corporation falls to or below BBB+. In calculating the required payments, we only considered agreements which, when netted for each counterparty as allowed by the underlying master agreement, would require a payment upon termination. In the event that we are required to make a payment as a result of a rating trigger, it could have a material adverse impact on our financial results.

Our ability to comply with covenants related to our revolving credit agreements and debt indentures may affect our ability to obtain financing and maintain preferred rating levels on our debt.
We must maintain compliance with all covenants and conditions related to our revolving credit agreements, including the adjusted TIER, adjusted leverage and amount of loans pledged to have access to the funds available under the revolving lines of credit. See "Non-GAAP Financial Measures" for further explanation and a reconciliation of adjusted ratios. A restriction on access to the revolving lines of credit would impair our ability to issue short-term debt, as it is required for backup-liquidity to maintain preferred rating levels on our short-term debt.

If we do not maintain compliance with covenants and conditions on our collateral trust bond, medium-term note and subordinated deferrable debt indentures, the holders of such debt could declare an event of default and accelerate the repayment of the full amount of the outstanding debt principal before the stated maturity of such debt. Additionally, we could not issue new debt under such indentures. Such an event would require us to obtain new funding to repay the accelerated debt as a result of the covenant default and could have a material adverse impact on our financial results and credit ratings.

Our concentration of loans to borrowers within rural electric and telephone industries could impair our revenues if either or both of those industries experience economic difficulties.
Credit concentration is one of the risk factors considered by the rating agencies in the evaluation of our credit ratings. Substantially all of our credit exposure is to the rural electric and telecommunications industries and is subject to risks associated with those industries.

Our credit concentration to our ten largest borrowers could increase from the current 19 percent of total loans and guarantees outstanding, if:

- we extended additional loans and/or guarantees to the current ten largest borrowers;
- our total loans and/or guarantees outstanding decreased, with a disproportionately large share of the decrease to borrowers not in the current ten largest; or
- we advanced large new loans and/or guarantees to one of the borrowers below the ten largest.

We could jeopardize our federal tax exemption if we fail to conduct our business in accordance with our exemption from the Internal Revenue Service.

Legislation that removes or imposes new conditions on the federal tax exemption for 501(c)(4) social welfare organizations could have a negative impact on our net income. National Rural’s continued exemption depends on it conducting our business in accordance with our 501(c)(4) status.

Item 1B. Unresolved Staff Comments.

None.

Item 2. Properties

National Rural leases office space that serves as its headquarters in Fairfax County, Virginia. In October 2005, National Rural entered into a three-year lease with the building owner for approximately 107,228 square feet of the facility's office, meeting and storage space. In both September 2007 and 2008, we exercised the option to extend the lease for additional one-year periods. In March 2009, we amended the office space lease to extend the term until October 17, 2011 with the option to extend the lease for up to two additional one-year periods in fiscal year 2012 and 2013. The terms of these extensions are similar to the initial three-year lease.

National Rural finalized a contract in May 2008 to purchase 42 acres of land located in Loudoun County, Virginia. National Rural plans to use the purchased land to construct a new headquarters facility.

Item 3. Legal Proceedings.

None.

Item 4. Submission of Matters to a Vote of Security Holders.

None.

PART II

Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities.

Inapplicable.

Item 6. Selected Financial Data.

The following is a summary of selected financial data for the years ended and as of May 31:

(dollar amounts in thousands)	2009	2008 (10)	2007 (10)	2006 (10)	2005 (10)
For the year ended May 31:					
Interest income	$ 1,070,764	$ 1,051,393	$ 1,039,650	$ 995,882	$ 988,174
Net interest income	135,743	120,125	47,896	18,682	46,776
Derivative cash settlements (1)	112,989	27,033	86,442	80,883	78,287
Derivative forward value (1)	(160,017)	(98,743)	(79,281)	28,805	25,849
Foreign currency adjustments (2)	-	-	(14,554)	(22,594)	(22,893)
(Loss) income prior to income taxes, minority interest (3)	(78,871)	36,311	16,541	105,762	126,561
Net (loss) income	(69,870)	45,745	11,701	95,497	122,503
Fixed charge coverage ratio (TIER) (4)(5)	-	1.05	1.01	1.10	1.13
Adjusted fixed charge coverage ratio (Adjusted TIER) (6)	1.10	1.15	1.12	1.11	1.14
As of May 31:					
Loans to members	$20,192,309	$19,029,040	$18,131,873	$18,363,954	$18,974,108
Allowance for loan losses	(622,960)	(514,906)	(561,663)	(611,443)	(589,749)
Assets	20,982,705	19,379,381	18,575,181	19,179,621	20,060,314
Short-term debt (7)	4,867,864	6,327,453	4,427,123	5,343,824	7,952,579
Long-term debt (8)	12,720,055	10,173,587	11,295,219	10,642,028	8,701,955
Subordinated deferrable debt (9)	311,440	311,440	311,440	486,440	685,000
Members' subordinated certificates	1,740,054	1,406,779	1,381,447	1,427,960	1,490,750
Members' equity (1)	604,316	613,082	566,286	545,351	523,583
Total equity	508,938	665,965	710,041	784,408	764,934
Guarantees	1,275,455	1,037,140	1,074,374	1,078,980	1,157,752

Leverage ratio (5)	42.71	29.64	26.64	24.80	26.71
Adjusted leverage ratio (6)	7.11	7.50	6.81	6.38	6.50
Debt to equity ratio (5)	40.21	28.08	25.13	23.42	25.20
Adjusted debt to equity ratio (6)	6.63	7.06	6.37	5.97	6.07

(1) Derivative cash settlements represent the net settlements received/paid on interest rate and cross currency exchange agreements that do not qualify for hedge accounting. The derivative forward value represents the change in fair value on exchange agreements that do not qualify for hedge accounting, as well as amortization related to the transition adjustment recorded as an other comprehensive loss on June 1, 2001. Members' equity represents total equity excluding foreign currency adjustments, derivative forward value and accumulated other comprehensive income. See Non-GAAP Financial Measures in Management's Discussion and Analysis for further explanation of members' equity and a reconciliation to total equity.
(2) Foreign currency adjustments represent the change on foreign denominated debt that is not related to an exchange agreement that qualifies for hedge accounting during the period. The foreign denominated debt is revalued at each reporting date based on the current exchange rate. To the extent that the current exchange rate is different than the exchange rate at the time of issuance, there will be a change in the value of the foreign denominated debt. We enter into foreign currency exchange agreements at the time of each foreign denominated debt issuance to lock in the exchange rate for all principal and interest payments required through maturity.
(3) Includes $43 million gain on sale of building and land for the year ended May 31, 2006.
(4) For the years ended prior to May 31, 2009, the fixed charge coverage ratio is the same calculation as our Times Interest Earned Ratio ("TIER"). For the year ended May 31, 2009, the fixed charge coverage ratio includes capitalized interest in total fixed charges which is not included in our TIER calculation.
For the year ended May 31, 2009, earnings were insufficient to cover fixed charges by $70 million.
(5) See Non-GAAP Financial Measures in Management's Discussion and Analysis for the GAAP calculations of these ratios.
(6) For the years ended prior to May 31, 2009, the adjusted fixed charge coverage ratio is the same calculation as our adjusted TIER. For the year ended May 31, 2009, the adjusted fixed charge coverage ratio includes capitalized interest in total fixed charges which is not included in our adjusted TIER calculation. Adjusted ratios include non-GAAP adjustments that we make to financial measures in assessing our financial performance. See Non-GAAP Financial Measures in Management's Discussion and Analysis for further explanation of these calculations and a reconciliation of the adjustments.
(7) Includes the foreign currency valuation account of $245 million and $40 million at May 31, 2006 and 2005, respectively.
(8) Excludes $2,580 million, $3,177 million, $1,368 million, $1,839 million, and $3,591 million in long-term debt that comes due, matures and/or will be redeemed during fiscal years 2010, 2009, 2008, 2007 and 2006, respectively (see Note 5 to the consolidated financial statements). Includes the foreign currency valuation account of $221 million at May 31, 2005.
(9) Excludes $175 million called in June 2007 and $150 million called in June 2006 at May 31, 2007 and 2006, respectively, reported in short-term debt.
(10) See Note 1 (y) to the consolidated financial statements for further explanation of reclassifications of the consolidated statement of operations data for fiscal years 2008 and 2007. Prior year periods have been revised to reflect the adjustments related to the reclassification described in Note 1(y).

Item 7. 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.

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 were generally required to purchase membership subordinated certificates from us. Members may be 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. The membership subordinated certificates and the loan and guarantee subordinated certificates are unsecured and subordinate to our senior debt.

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 years covered by this Form 10-K.

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 and including minority interest. Adjusted TIER is calculated by using adjusted net income and including all derivative cash settlements in the 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 year ended May 31, 2009, we reported a net loss of $70 million, which resulted in a TIER calculation below 1.00 compared to a net income of $46 million and TIER of 1.05 for the prior year. For the year ended May 31, 2009, we reported an adjusted net income of $86 million with an adjusted TIER of 1.10, compared with an adjusted net income of $138 million and adjusted TIER of 1.15 for the prior-year period. The $116 million decrease in net income for the year ended May 31, 2009 compared with the prior-year period was primarily due to the $144 million increase in the provision for loan losses and the $61 million increase in the derivative forward value expense partially offset by the $86 million increase in derivative cash settlements.

Interest income of $1,071 million for the year ended May 31, 2009 increased two percent compared with the prior-year period. During the year ended May 31, 2009, there was an increase of $1.3 billion or seven percent to the average balance of loans outstanding which was largely offset by a 25 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 was relatively unchanged for the year ended May 31, 2009 as compared with the prior-year period despite lower short-term interest rates. The small increase in interest expense was the result of the following factors:

- The $2,707 million increase in average debt outstanding at May 31, 2009 compared with May 31, 2008.
- 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 which was significantly higher than the $900 million five-year collateral trust bonds issued at a rate of 5.50 percent in June 2008 due to the severe credit environment in the fall of calendar year 2008.
- For a short period of time during the latter part of calendar year 2008, the cost of issuing commercial paper increased because of disruptions in the financial markets.

These factors were mostly offset by the following:

- The lower interest rate environment: Lower interest rates on our variable-rate debt and commercial paper funding particularly in the latter half of the fiscal year.
    - Lower cost funding from Federal Agricultural Mortgage Corporation ("Farmer Mac"): Notes issued under note purchase agreements with Farmer Mac totaling $700 million at a blended spread over three-month LIBOR of 119 basis points and $500 million at a blended fixed rate of 3.871 percent between December 2008 and May 2009.
- Lower cost funding from the Rural Economic Development Loan and Grant ("REDLG") program: In September 2008, $500 million was advanced to us under the REDLG program at an interest rate of 57.5 basis points above the

comparable U.S. Treasury rate.

- Lower cost retail notes: Retail notes increased $783 million from May 31, 2008 to May 31, 2009. We issued retail notes at spread levels well below the indicative collateral trust bond funding levels with a weighted-average interest rate of 4.50 percent.

Our adjusted interest expense decreased by $82 million for the year ended May 31, 2009. In addition to the factors above, the decrease in the adjusted interest expense was largely due to the $97 million payment to us, recorded as derivative cash settlements, for the termination of certain receive fixed, pay variable interest rate swaps during fiscal year 2009.

During fiscal year 2009, there was an increase of $144 million to the loan loss provision as compared with the prior-year period. The increase to the loan loss provision during the year ended May 31, 2009 was due to the deterioration in the market value of collateral supporting impaired loans. The fair value of the collateral was negatively affected by the limited access to and high cost of capital to support acquisitions of assets similar to the collateral supporting these impaired loans, which resulted in a compression of the earning multiple that potential buyers were willing to pay for such assets. In addition, the current economic conditions caused consumers and businesses to reduce spending, which resulted in, at least for the short-term, reductions in the estimated earnings for companies whose stock is held as collateral for impaired loans. This increase was partially offset by payments received on impaired loans, changes in estimates of future expected cash flows and the net decrease in our variable interest rates from May 31, 2008 to May 31, 2009 as described below.

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 rate. 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 May 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. As of August 1, 2009, we had decreased our long-term variable interest rates by 45 basis points, resulting in a decrease to the calculated impairment on loans of $6 million.

Financial Condition

At May 31, 2009, total loans outstanding increased by $1,161 million or six percent as compared with May 31, 2008 due to a $929 million increase in power supply loans and a $292 million increase in distribution 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.

Our loan growth has not been significantly affected by the slowdown in the economy since most of our members serve residential customers as opposed to industrial customers. 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 significant rise in delinquencies or defaults in our members’ receivables. Calendar year 2008 data from member systems shows no significant 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 believe the impact of the recession on collections will likely be moderate.

Our total long-term and short-term debt outstanding increased by $1,087 million at May 31, 2009 as compared with the prior-year end. During the year ended May 31, 2009, there was a need to issue debt required to fund new loan advances, as well as to refinance maturing debt. During that period, we issued $5.8 billion of new term debt (collateral trust bonds, medium-term notes and private placement notes) to replace the $3.6 billion of debt that matured (mostly extendible collateral trust bonds). Some of the debt issued during fiscal year 2009 was to prefund debt maturing in the first quarter of fiscal year 2010. As part of our ongoing efforts to manage the liquidity risks associated with maturing debt, we regularly pre-fund large expected debt obligations prior to the maturity to ensure the availability of funds.

Total equity decreased $157 million from May 31, 2008 to May 31, 2009 primarily due to the board authorized patronage capital retirement totaling $85 million and the net loss of $70 million for the year ended May 31, 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. 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 will be returned to members in cash at the end of September 2009.

Liquidity

After Lehman Brothers Holdings Inc. ("LBHI") filed for bankruptcy protection under Chapter 11 of the U.S. Bankruptcy Code in September 2008 and through the latter part of November 2008, there were significant disruptions in the capital markets that resulted in limited investor demand for corporate debt and a significant decrease in the investor demand for commercial paper investments with maturities of more than two weeks. The majority of the investor demand for commercial paper during that time was for maturities of one week or less and the rates required to replace such funding were at significantly higher than historical spreads over the federal funds rate. As a result, we had large volumes of commercial paper to roll over that were, on certain days during that period, at rates that were higher than normal. During that time, we met our funding needs by issuing member and dealer commercial paper, collateral trust bonds, and through private placements of debt. Those disruptions in the capital markets, while continuing, eased during the third and fourth quarters of fiscal year 2009.

We evaluate and make decisions about our daily cash needs early in the day to be certain we can meet our funding requirements. On October 7, 2008, we were uncertain of our ability to issue the required amount of commercial paper for that day and drew down $418.5 million on our bank lines. We repaid the $418.5 million borrowed under our revolving lines of credit on November 13, 2008.

As part of the effort to support the capital markets, on October 7, 2008, the Federal Reserve Board announced the creation of the Commercial Paper Funding Facility ("CPFF"), to provide a source of liquidity to highly-rated U.S. issuers of commercial paper through a special purpose vehicle that purchased three-month unsecured and asset-backed commercial paper directly from eligible issuers. During the last half of November 2008, investors began to accept longer maturities in limited amounts, which allowed us to issue larger volumes of commercial paper on a daily basis. On days during the second quarter of fiscal year 2009 when investor demand was concentrated at shorter-term maturities, and we preferred to issue longer-term commercial paper to maintain a certain percentage of the portfolio with longer maturities, we were able to issue commercial paper with 90-day maturities through the CPFF. We did not issue any commercial paper through the CPFF during the third and fourth quarter of fiscal year 2009. The $1 billion of commercial paper we issued through the CPFF in the second quarter of fiscal year 2009 matured in March 2009. We have not issued additional commercial paper through the CPFF due to our ability to roll over maturing commercial paper with our existing investor base and finance our balance sheet growth with lower cost alternative sources of funding. We are still qualified to use the CPFF as the expiration date of the program was extended to February 1, 2010. However, there is no intention at this time to use the more expensive funding through the CPFF since there is sufficient demand in the commercial paper market.

As with other companies, we were negatively affected by the severe credit crisis in the fall of 2008 as the demand in the capital markets for corporate debt was reduced and corporate debt that was issued was at historically high spreads over comparable U.S. Treasury rates.

After the LBHI bankruptcy, there was limited demand in the capital markets for corporate debt. As a result, companies experienced difficulty issuing long-term debt, and for the companies that were able to issue long-term debt, the interest rate on the debt issued was at historically high spreads over comparable U.S. Treasury rates. In October 2008, we issued $1 billion of ten-year collateral trust bonds to refinance maturing long-term debt and meet member loan growth demand. This debt was issued with a coupon interest rate of 10.375 percent. This interest rate represented a significant increase in the credit spread over Treasury rates compared with the $900 million 5.50 percent, five-year collateral trust bonds issued in June 2008. We used other lower-cost funding sources during fiscal year 2009, as described in the Results of Operations section of this Financial Overview.

On March 13, 2009, we replaced our $1,500 million 364-day revolving credit agreement with a new $1,000 million 364-day revolving credit agreement. Since the revolving credit lines are required to maintain backup liquidity on our commercial paper, we cannot issue as much commercial paper in the future because of the $500 million reduction in the facility. We will issue long-term debt and swap the debt to a variable rate to make up for the reduction to commercial paper. This is a more expensive form of funding.

As a result of the bankruptcy filing of LBHI, we terminated interest rate swaps with Lehman Brothers Special Financing ("LBSF") as counterparty (with an LBHI guarantee) on September 26, 2008. The payment due to us from LBSF of $26 million was recorded in derivative cash settlements representing the termination net settlement amount on that day, based on the terms of the contract. On October 3, 2008, LBSF filed a petition under Chapter 11 of the U.S. Bankruptcy Code with the United States Bankruptcy Court for the Southern District of New York. We have a claim of $26 million on the assets of both LBHI and LBSF. We used market data that indicated values for LBHI bonds of 10 cents and 15 cents on the dollar as a proxy for the potential recovery from both LBHI and LBSF. As a result, the receivable has been reduced to $7 million. The amount recorded as a receivable does not reduce or limit our claim of $26 million against LBHI and LBSF. The ultimate recovery will depend on the ability of LBHI and LBSF to maximize the value of assets through sale or assignment or the price that we can obtain through the sale of our claim. As of July 24, 2009, market sales for similar claims against LBHI and LBSF were between 37 cents and 41 cents on the dollar.

At May 31, 2009, we had $2,288 million of commercial paper, daily liquidity fund, term loans, and bank bid notes and $2,580 million of medium-term notes, collateral trust bonds and long-term notes payable scheduled to mature during the next 12 months. Members held commercial paper (including the daily liquidity fund) totaling $1,226 million or approximately 67 percent of the total commercial paper and daily liquidity fund outstanding at May 31, 2009. Commercial paper issued through dealers and bank bid notes totaled $850 million and represented four percent of total debt outstanding at May 31, 2009. We intend to maintain the balance of dealer commercial paper and bank bid notes at 15 percent or less of total debt outstanding during fiscal year 2010. During the next 12 months, we plan to replace the maturing $2,580 million of medium-term notes, collateral trust bonds and long-term notes payable and fund new loan growth by issuing a combination of commercial paper, medium-term notes, collateral trust bonds and other debt. At May 31, 2009, we had $1.2 billion available under note purchase agreements with Farmer Mac, $625 million of which was advanced through August 2009.

We began offering member capital securities, unsecured and subordinate voluntary debt investments, to members in December 2008. As of May 31, 2009, a total of $278 million of member capital securities had been sold. Subsequent to our fiscal year-end, we met our target of issuing at least $300 million of member capital securities. After the end of the fiscal year through August 7, 2009, an additional $53 million of member capital securities were sold bringing the total to $331 million.

At May 31, 2009 and 2008, we were the guarantor and liquidity provider for $643 million and $330 million, respectively of tax-exempt bonds issued for our member cooperatives. During the year ended May 31, 2009, we were required to purchase $72 million of tax-exempt bonds pursuant to our obligation as liquidity provider. As a result, we were required to hold the bonds until the remarketing agent was able to place them with third-party investors. At May 31, 2009, all tax-exempt bonds we held during fiscal year 2009 had been redeemed or repurchased by third-party investors with no gain or loss on the transactions.

Critical Accounting Estimates

Our significant accounting principles, as described in Note 1, General Information and Accounting Polices, to the consolidated financial statements are essential in understanding the Management's Discussion and Analysis of Financial Condition and Results of Operations. Many of our significant accounting principles require complex judgments to estimate values of assets and liabilities. We have procedures and processes to facilitate making these judgments.

We have identified the allowance for loan losses and the determination of fair value of certain items on our balance sheet as critical accounting policies because they require significant estimations and judgments by management. The more judgmental estimates are summarized below. We have identified and described the development of the variables most important in the estimation process. In many cases, there are numerous alternative judgments that could be used in the process of determining the inputs to the model. Where alternatives exist, we have used the factors that we believe represent the most reasonable value in developing the inputs. Actual performance that differs from our estimates of the key variables could affect net income. Separate from the possible future effect to net income from our model inputs, market sensitive assets and liabilities may change subsequent to the balance sheet date, often significantly, due to the nature and magnitude of future credit and market conditions. Such credit and market conditions may change quickly and in unforeseen ways and the resulting volatility could have a significant, negative effect on future operating results.

Below is a description of the process used in determining the adequacy of the allowance for loan losses and the determination of fair value for certain items on our balance sheet.

Allowance for Loan Losses
At May 31, 2009 and 2008, our loan loss allowance totaled $623 million and $515 million, representing 3.09 percent and 2.71 percent of total loans outstanding, respectively. GAAP requires loans receivable to be reported on the consolidated balance sheets at net realizable value. The net realizable value is the total principal amount of loans outstanding less an estimate of the probable losses inherent in the portfolio. We calculate the loss allowance on a quarterly basis. The loan loss allowance is calculated by segmenting the portfolio into three categories of loans: impaired, high risk and general portfolio. There are significant subjective assumptions and estimates used in

calculating the amount of the loss allowance required by each of the three categories. Different assumptions and estimates could also be reasonable. Changes in these assumptions and estimates could have a material impact on our financial statements.

Impaired Loans

We calculate the impairment on loans based on GAAP. A loan is impaired when a creditor does not expect to collect all principal and interest due under the original terms of the loan, other than an insignificant delay or an insignificant shortfall in amount. We review our portfolio to identify impairments at least quarterly. Factors considered in determining an impairment include, but are not limited to:

- the review of the borrower's audited financial statements and interim financial statements if available,
- the borrower's payment history,
- communication with the borrower,
- economic conditions in the borrower's service territory,
- pending legal action involving the borrower,
- restructure agreements between us and the borrower, and
- estimates of the value of the borrower's assets that have been pledged as collateral to secure our loans.

We calculate the impairment by comparing the future expected cash flow discounted at the interest rate on the loans at the time the loans became impaired, against our current investment in the receivable. If the current investment in the receivable is greater than the net present value of the future payments discounted at the original contractual interest rate, the impairment is equal to that difference. If it is not possible to estimate the future cash flow associated with a loan, then the impairment calculation is based on the value of the collateral pledged as security for the loan.

At May 31, 2009 and 2008, we reserved a total of $414 million and $331 million specifically against impaired loans totaling $1,056 million and $1,078 million, respectively, representing 39 percent and 31 percent, respectively, of total impaired loans. The $414 million and $331 million specific reserves represented 66 percent and 64 percent of the total loan loss allowance at May 31, 2009 and 2008, respectively. The original contract interest rate on a portion of the impaired loans at May 31, 2009 will vary with the changes in our variable interest rates. Based on the current balance of impaired loans at May 31, 2009, a 25 basis point increase or decrease to our variable interest rates would result in an increase or decrease, respectively, of approximately $9 million to the calculated impairment irrespective of a change in the credit fundamentals of the impaired borrower.

In calculating the impairment on a loan, the estimates of the expected future cash flow or collateral value are the key estimates made by management. Changes in the estimated future cash flow or collateral value would impact the amount of the calculated impairment. The change in cash flow required to make the change in the calculated impairment material will be different for each borrower and depend on the period covered, the original contract interest rate and the amount of the loan outstanding. Estimates are not used to determine our investment in the receivables or the discount rate since, in all cases, the investment is equal to the loan balance outstanding at the reporting date and the discount rate is equal to the interest rate on the loans at the time the loans became impaired.

High Risk Loans

We define a loan exposure as high risk when:

- the borrower has a history of late payments;
- the borrower's financial results do not satisfy loan financial covenants;
- the borrower contacts us to discuss pending financial difficulties; or
- for some other reason, we believe the borrower's financial results could deteriorate resulting in an elevated potential for loss.

Our corporate credit committee determines which loans to classify as high risk. The committee meets at least quarterly to review all loan facilities with an internal risk rating above a certain level.

The corporate credit committee sets the required reserve for each borrower based on their facts and circumstances, such as:

- the borrower's financial condition;
- the borrower’s payment history;
- our estimate of the collateral value;
- pending litigation, if any; and
- other factors.

This is an objective and subjective exercise where the committee uses the available information to make its best estimate of the reserve. At any reporting date, the reserve required could vary significantly depending on the facts and circumstances, which could include, but are not limited to:

- changes in collateral value;
- deterioration in financial condition;
- bankruptcy of the borrower;
- payment default on our loans; and

- other factors.

The borrowers in the high risk category will generally either move to the impaired category or back to the general portfolio within 12 to 24 months. At May 31, 2009 and 2008, we reserved $11 million and $3 million against the $30 million and $8 million of exposure classified as high risk, representing coverage of 37 percent and 38 percent, respectively. The $11 million and $3 million reserved for loans in the high risk category represented 2 percent and less than 1 percent of the total loan loss allowance at May 31, 2009 and 2008, respectively.

General Portfolio

We determine the required loan loss allowance for the general portfolio by using our internal risk rating system, Standard & Poor's historical default data on corporate bonds and our specific loss recovery data. We use the following factors to determine the loan loss allowance for the general portfolio category:

- Internal risk ratings - We maintain risk ratings for each credit facility outstanding to our borrowers. The ratings are updated at least annually and are based on the following:
  - general financial condition of the borrower;
  - our estimated value of the collateral securing our loans;
  - our judgment of the borrower's management;
  - our judgment of the borrower's competitive position within its service territory and industry;
  - our estimate of potential impact of proposed regulation and litigation; and
  - other factors specific to individual borrowers or classes of borrowers.
- Standard corporate bond default table - The table provides expected default rates based on rating level and the remaining maturity of the bond. We use the standard default table for all corporate bonds published by Standard and Poor's Corporation to assist in estimating our reserve levels because we have limited history from which to develop loss expectations and because we have been unable to identify utility specific default rates.
  - Recovery rates - Estimated recovery rates based on historical experience of loan balance at the time of default compared with the total loss on the loan to date.

We aggregate the loans in the general portfolio by borrower type (distribution, power supply, telecommunications, associate and other member) and by internal risk rating within borrower type. We correlate our internal risk ratings to the ratings used in the standard default table for borrowers with ratings from Standard and Poor's Corporation and based on a standard matching used by banks.

At May 31, 2009 and 2008, we had a total of $18,858 million and $17,690 million of loans, respectively, in the general portfolio. This total excludes $244 million and $250 million of loans at May 31, 2009 and 2008, respectively, that have a U.S. Government guarantee of all principal and interest payments. We do not maintain a loan loss allowance on loans that are guaranteed by the U.S. Government. At May 31, 2009 and 2008, we reserved a total of $162 million and $155 million, respectively, for loans in the general portfolio representing coverage of approximately one percent of the total loans for the general portfolio at both dates.

In addition to the general portfolio reserve requirement as calculated above, we maintain an unallocated reserve to cover the additional risk associated with large loan exposures and to cover economic and environmental factors that may be currently affecting the financial results of borrowers, but have not shown up in the borrower's annual audited financial statements.

The first component of the unallocated reserve is a single obligor reserve to cover the additional risk related to large loan exposures. We set the exposure threshold at one percent of total loans and guarantees outstanding and provide coverage equal to one percent times the internal risk rating associated with the loan exposure. We believe this reflects our assessment of the additional risk related to large loan exposures. At May 31, 2009 and 2008, our single obligor reserve was $30 million and $23 million, respectively.

The second component of the unallocated reserve is an economic and environmental reserve to cover factors that we believe are currently affecting the financial results of borrowers, but are not reflected in our internal risk rating process and therefore present an increased risk of losses incurred as of the balance sheet date. We use annual audited financial statements from our borrowers as part of our internal risk rating process. There could be a lag between the time that various environmental and economic factors occur and the time when these factors are reflected in the annual audited financial statements of the borrower and therefore the internal risk rating we determine for the borrower. This reserve component may be set at up to five percent of the amount of the calculated general reserve for each type of loan exposure. Our corporate credit committee will make a quarterly determination of the percentage of general reserve to be held and the portions of the loan portfolio that the additional reserve percentage shall be applied. At May 31, 2009, the corporate credit committee set the economic and environmental component of the unallocated reserve to be $6 million or four percent of the total general reserve, representing 3.5 percent of electric loans and five percent of telecommunications loans. This amount took into consideration the effect on electric and telecommunications borrowers from (1) the current economic downturn, (2) the increase in the unemployment rate, (3) the decline in the housing market that has led to a significant increase in foreclosures and (4) specifically for telecommunications borrowers, reduced discretionary spending for telecommunications services, increased competition from wireless providers and continued loss of access lines among rural local exchange carriers. At May 31, 2008, the economic and environmental component of the unallocated reserve was $3 million or two percent of the total general reserve.

Senior management reviews the estimates and assumptions used in the calculations of the loan loss allowance for impaired loans, high risk loans, the general portfolio and the unallocated reserve on a quarterly basis. Senior management discusses estimates with the board of directors and audit committee and reviews all loan loss-related disclosures included in our Form 10-Qs and Form 10-Ks filed with the SEC.

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

Fair Value

We have determined the accounting for certain items on our balance sheet at fair value to be a critical accounting policy because of the subjective nature and the requirement for management to make significant estimations in determining the amounts to be recorded. Different assumptions and estimates could also be reasonable and changes in the assumptions used and estimates made could have a material effect on our financial statements.

The primary instruments recorded on our balance sheet at fair value are derivative financial instruments. Because we generally do not apply hedge accounting to these instruments, the accounting guidance requires us to record all derivative instruments at fair value on the balance sheet with changes in fair value reported in earnings. 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.

Because there is not an active secondary market for the types of derivative instruments we use, we obtain market quotes from our dealer counterparties. The market quotes are based on the expected future cash flow and estimated yield curves. We perform our own analysis to confirm the values obtained from the counterparties. The counterparties are estimating future interest rates as part of the quotes they provide to us. We adjust all derivatives to fair value on a quarterly basis. The fair value we record will change as estimates of future interest rates change. To estimate the impact of changes to interest rates on the forward value of derivatives, we would need to estimate all changes to interest rates through the maturity of our outstanding derivatives. We have derivatives in the current portfolio that do not mature until 2045. Because many of the derivative instruments we use for risk management have such long-dated maturities, the valuation of these derivatives may require extrapolation of market data that is subject to significant judgment. Accounting guidance on fair value requires that credit risk be considered in determining the market value of any asset or liability carried at fair value. We adjust the market values of our derivatives received from the counterparties based on our counterparties' and our credit spreads observed in the credit default swap market. The credit default swap levels represent the credit risk premium required by a market participant based on the available information related to the creditor.

In addition to the valuation associated with derivative financial instruments, we also periodically are required to record foreclosed assets at the lower of cost or fair value. In many instances the valuation of these assets are judgmental and dependent upon comparisons to similar assets or estimations of future cash flows that are expected to be generated by the underlying foreclosed properties. In both of these instances, management uses its best estimates, based upon available market data and/or projections of future cash flows. However, because of the subjective nature of these estimates, other estimates could be reasonable and changes in the assumptions used and our estimates could have a material effect on our financial statements.

New Accounting Pronouncements

In May 2009, the FASB issued SFAS 165, Subsequent Events ("SFAS 165") to establish a general standard of accounting for the disclosure of events that occur after the balance sheet date, but before financial statements are issued or are available to be issued. SFAS 165 does not change the kinds of events that an entity must recognize or disclose in its financial statements. It does, however, require the disclosure of the date through which an entity has evaluated subsequent events and the basis for that date. This statement is effective on a prospective basis for interim or annual periods ending after June 15, 2009. Our adoption of SFAS 165 in the first quarter of fiscal year 2010 is not expected to have a material impact on our financial position or results of operations.

In April 2009, FASB issued FSP SFAS 115-2 and SFAS 124-2, Recognition and Presentation of Other-Than-Temporary Impairments which amends the recognition guidance for other-than-temporary impairments ("OTTI") of debt securities and expands the financial statement disclosures for OTTI on debt and equity securities. Under this FSP, the difference between the amortized cost basis and fair value on debt securities that an entity intends to sell or would more-likely-than-not be required to sell before the expected recovery of the amortized cost basis is recorded in earnings. For available-for-sale and held-to-maturity debt securities that management has no intent to sell and believes that it is more-likely-than-not will not be required to be sold prior to recovery, only the credit loss component of the impairment is recognized in earnings, while the rest of the fair value loss is recognized in accumulated other comprehensive income. This FSP is effective for interim and annual periods ending after June 15, 2009, with early adoption permitted for periods ending after March 15, 2009. Our adoption of this FSP in the first quarter of fiscal year 2010 is not expected to have a material impact on our financial position or results of operations.

In April 2009, FASB issued FSP SFAS 157-4, Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly. The FSP reaffirms that fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date under current market conditions. The FSP also reaffirms the need to use judgment in determining if a formerly active market has become inactive and in determining fair values when the market has become inactive. This FSP is effective for interim and annual reporting periods ending after June 15, 2009, and shall be applied prospectively. Early adoption is permitted for periods ending after March 15, 2009. Our adoption of this FSP in the first quarter of fiscal year 2010 is not expected to have a material impact on our financial position or results of operations.

In April 2009, FASB issued FSP SFAS 107-1 and APB 28-1, Interim Disclosures about Fair Value of Financial Instruments. The FSP requires disclosing qualitative and quantitative information about the fair value of all financial instruments on a quarterly basis, including methods and significant assumptions used to estimate fair value during the period. These disclosures were previously only done annually. The disclosures required by the FSP are effective for interim reporting periods ending after June 15, 2009, with early adoption permitted for periods ending after March 15, 2009. Our adoption of this FSP in the first quarter of fiscal year 2010 is not expected to have a material impact on our financial position or results of operations.

In December 2007, the FASB issued SFAS 160, Noncontrolling Interests in Consolidated Financial Statements, an amendment of ARB 51 (“SFAS 160”), to establish accounting and reporting standards for the noncontrolling interests in a subsidiary and for the deconsolidation of a subsidiary. It also amends certain consolidation procedures for consistency with the requirements of guidance covering business combinations. Noncontrolling interests shall be reclassified to equity, consolidated net income shall be adjusted to include net income attributable to noncontrolling interests and consolidated comprehensive income shall be adjusted to include comprehensive income attributable to the noncontrolling interests. This statement is effective for fiscal years beginning on or after December 15, 2008. SFAS 160 shall be applied prospectively as of the beginning of the fiscal year in which it is initially applied, except for the presentation and disclosure requirements. The presentation and disclosure requirements shall be applied retrospectively for all periods presented.

The principal effect of recasting the consolidated balance sheets upon the adoption of the new standard on June 1, 2009 is to move the noncontrolling interests from long-term liabilities to equity attributable to noncontrolling interests, thus increasing the total of consolidated equity by that amount. The following table shows the expected effect of adopting SFAS 160 on the periods presented on the consolidated balance sheets as of May 31:

(dollar amounts in thousands)	2009	2008
Balance Sheet:		
Total equity, as previously reported	$ 508,938	$ 665,965
Increase for SFAS 160 reclassification of noncontrolling interests	10,162	14,247
Total equity, as adjusted	$ 519,100	$ 680,212

Additionally, the adoption of SFAS 160 requires that net income, as previously reported prior to the adoption of SFAS 160, be adjusted to include the net income attributable to the noncontrolling interests in the consolidated statement of earnings. Thus, after the adoption of SFAS 160, consolidated net loss increases by $4 million for the year ended May 31, 2009 and net income decreases by $6 million for the year ended May 31, 2008.

Our adoption of SFAS 160 in the first quarter of fiscal year 2010 is not expected to have a material impact on our financial position or results of operations.

Results of Operations

Reclassifications of prior period amounts for fiscal years 2008 and 2007 have been made to conform to the current reporting format for the following two items. Fees and other income totaling $18 million and $15 million for the years ended May 31, 2008 and 2007 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 May 31, 2009 presentation. The loss on early extinguishment of debt and other expense totaling $6 million and $5 million for the years ended May 31, 2008 and 2007 have been reclassified from interest expense to those line items in non-interest expense on the consolidated statements of operations to conform with the May 31, 2009 presentation.

Fiscal Year 2009 versus 2008 Results

The following table presents the results of operations for the years ended May 31, 2009 and 2008.

	For the year ended May 31,		Increase/
(dollar amounts in thousands)	2009	2008	(Decrease)
Interest income	$1,070,764	$1,051,393	$ 19,371
Interest expense	(935,021)	(931,268)	(3,753)
Net interest income	135,743	120,125	15,618
(Provision for) recovery of loan losses	(113,699)	30,262	(143,961)
Net interest income after (provision for) recovery of loan losses	22,044	150,387	(128,343)
Non-interest income:			
Fee and other income	13,163	19,608	(6,445)
Derivative cash settlements	112,989	27,033	85,956
Results of operations of foreclosed assets	3,774	7,528	(3,754)
Total non-interest income	129,926	54,169	75,757
Non-interest (expense) income:			
Salaries and employee benefits	(36,865)	(36,428)	(437)
Other general and administrative expenses	(23,977)	(24,041)	64
(Provision for) recovery of guarantee liability	(1,615)	3,104	(4,719)
Market adjustment on foreclosed assets	(8,014)	(5,840)	(2,174)
Derivative forward value	(160,017)	(98,743)	(61,274)
Loss on sale of loans	-	(676)	676
Loss on early extinguishment of debt	-	(5,509)	5,509
Other	(353)	(112)	(241)
Total non-interest expense	(230,841)	(168,245)	(62,596)
(Loss) income prior to income taxes and minority interest	(78,871)	36,311	(115,182)
Income tax benefit	5,101	3,335	1,766
Minority interest, net of income taxes	3,900	6,099	(2,199)
Net (loss) income	$ (69,870)	$ 45,745	$ (115,615)
TIER (1)	-	1.05	
Adjusted TIER (2)	1.10	1.15	

(1) For the year ended May 31, 2009, earnings were insufficient to cover the fixed charges by $70 million.

(2) Adjusted to exclude the effect of the derivative forward value from net income, to include minority interest in 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 rate 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 our interest expense.

Average balances and interest rates – Assets

(dollar amounts in thousands)	Average volume			Interest income			Average yield		
	2009	2008	2007	2009	2008	2007	2009	2008	2007
Long-term fixed-rate loans (1)	$ 15,052,425	$ 14,782,141	$ 14,542,951	$ 890,367	$ 872,488	$ 833,247	5.92 %	5.90 %	5.73 %
Long-term variable-rate loans (1)	2,255,538	1,803,553	2,086,792	92,975	86,787	114,786	4.12	4.81	5.50
Short-term loans (1)	1,895,563	1,310,313	1,028,585	75,604	77,145	72,632	3.99	5.89	7.06
Non-performing loans	495,014	504,310	534,701	-	-				