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

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FORM 10-Q

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

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934
For the Quarterly Period Ended February 29, 2008

OR

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

Commission File Number 1-7102

NATIONAL RURAL UTILITIES COOPERATIVE
FINANCE CORPORATION

(Exact name of registrant as specified in its charter)

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

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

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

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

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

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

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

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

The Registrant is a cooperative and consequently, does not issue any equity capital stock.

PART 1. FINANCIAL INFORMATION

Item 1. Financial Statements.

NATIONAL RURAL UTILITIES COOPERATIVE FINANCE CORPORATION

CONSOLIDATED BALANCE SHEETS
(UNAUDITED)
(in thousands)

A S S E T S

	February 29, 2008	May 31, 2007
Cash and cash equivalents	$ 237,741	$ 304,107
Restricted cash	17,738	2,032
Loans to members	18,665,439	18,131,873
Less: Allowance for loan losses	(497,260)	(561,663)
Loans to members, net	18,168,179	17,570,210
Accrued interest and other receivables	291,732	291,637
Fixed assets, net	20,794	4,555
Debt service reserve funds	54,993	54,993
Bond issuance costs, net	40,074	45,611
Foreclosed assets	57,651	66,329
Derivative assets	347,857	222,774
Other assets	22,919	12,933
	$19,259,678	$18,575,181

See accompanying notes.

NATIONAL RURAL UTILITIES COOPERATIVE FINANCE CORPORATION

CONSOLIDATED BALANCE SHEETS
(UNAUDITED)
(in thousands)

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

	February 29, 2008	May 31, 2007
Short-term debt	$ 6,439,129	$ 4,427,123
Accrued interest payable	314,834	281,458
Long-term debt	9,732,902	11,295,219
Deferred income	23,915	27,990
Guarantee liability	13,658	18,929
Other liabilities	38,739	27,611
Derivative liabilities	370,761	71,934
Subordinated deferrable debt	311,440	311,440
Members' subordinated certificates:		
Membership subordinated certificates	649,461	649,424
Loan and guarantee subordinated certificates	771,424	732,023
Total members' subordinated certificates	1,420,885	1,381,447
Commitments and contingencies		
Minority interest	12,086	21,989
Equity:		
Retained equity	569,712	697,837
Accumulated other comprehensive income	11,617	12,204
Total equity	581,329	710,041
	$19,259,678	$18,575,181

See accompanying notes.

NATIONAL RURAL UTILITIES COOPERATIVE FINANCE CORPORATION

CONSOLIDATED STATEMENTS OF OPERATIONS
(UNAUDITED)
(in thousands)

For the Three and Nine Months Ended February 29, 2008 and February 28, 2007

	Three months ended		Nine months ended	
	February 29, 2008	February 28, 2007 (As restated)*	February 29, 2008	February 28, 2007 (As restated)*
Interest income	$ 266,576	$ 264,873	$ 797,817	$ 789,806
Interest expense	(233,468)	(247,441)	(720,810)	(752,036)
Net interest income	33,108	17,432	77,007	37,770
Recovery of loan losses	33,599	-	47,900	-
Net interest income after recovery of loan losses	66,707	17,432	124,907	37,770
Non-interest income:				
Rental and other income	367	417	1,070	1,042
Derivative cash settlements	10,463	44,442	30,299	76,190
Results of operations of foreclosed assets	2,401	1,896	6,217	7,887
Total non-interest income	13,231	46,755	37,586	85,119
Non-interest expense:				
Salaries and employee benefits	(9,398)	(8,461)	(27,049)	(25,222)
Other general and administrative expenses	(5,862)	(3,177)	(16,278)	(11,921)
Recovery of (provision for) guarantee liability	1,000	-	4,300	(400)
Market adjustment on foreclosed assets	(5,840)	-	(5,840)	-
Derivative forward value	(64,266)	(4,189)	(173,278)	(120,779)
Foreign currency adjustments	-	1,886	-	(15,413)
Loss on sale of loans	(158)	(1,550)	(676)	(1,550)
Total non-interest expense	(84,524)	(15,491)	(218,821)	(175,285)
	(4,586)	48,696	(56,328)	(52,396)

(Loss) income prior to income taxes and minority interest								
Income taxes		2,175		(627)		6,186		573
(Loss) income prior to minority interest		(2,411)		48,069		(50,142)		(51,823)
Minority interest		2,088		566		8,211		1,244
Net (loss) income	$	(323)	$	48,635	$	(41,931)	$	(50,579)

See accompanying notes.
*See Note 1(j)

NATIONAL RURAL UTILITIES COOPERATIVE FINANCE CORPORATION

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

For the Nine Months Ended February 29, 2008 and February 28, 2007

								Patronage Capital Allocated	
	Total	Accumulated Other Comprehensive Income (Loss)	Subtotal Retained Equity	Membership Fees	Unallocated Net Income	Education Fund	Members' Capital Reserve	General Reserve Fund	Other
Nine months ended February 29, 2008:									
Balance as of May 31, 2007	$ 710,041	$ 12,204	$ 697,837	$ 997	$ 131,528	$ 1,406	$ 158,308	$ 498	$ 405,100
Patronage capital retirement	(85,494)	-	(85,494)	-	-	-	-	-	(85,494)
Loss prior to income taxes and minority interest	(56,328)	-	(56,328)	-	(56,328)	-	-	-	-
Other comprehensive loss	(587)	(587)	-	-	-	-	-	-	-
Income taxes	6,186	-	6,186	-	6,186	-	-	-	-
Minority interest	8,211	-	8,211	-	8,211	-	-	-	-
Other	(700)	-	(700)	(3)	-	(697)	40	-	(40)
Balance as of February 29, 2008	$ 581,329	$ 11,617	$ 569,712	$ 994	$ 89,597	$ 709	$ 158,348	$ 498	$ 319,566
Nine months ended February 28, 2007:									
Balance as of May 31, 2006	$ 784,408	$ 13,208	$ 771,200	$ 994	$ 225,849	$ 1,281	$ 156,844	$ 497	$ 385,735
Patronage capital retirement	(84,247)	-	(84,247)	-	-	-	-	-	(84,247)
Loss prior to income taxes and minority interest (As restated)*	(52,396)	-	(52,396)	-	(52,396)	-	-	-	-

Other comprehensive loss	(753)	(753)	-	-	-	-	-	-	-
Income taxes	573	-	573	-	573	-	-	-	-
Minority interest	1,244	-	1,244	-	1,244	-	-	-	-
Other	(590)	-	(590)	(1)	-	(589)	-	-	-
Balance as of February 28, 2007 (As restated)*	$ 648,239	$ 12,455	$ 635,784	$ 993	$ 175,270	$ 692	$ 156,844	$ 497	$ 301,488

See accompanying notes.
*See Note 1(j)

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NATIONAL RURAL UTILITIES COOPERATIVE FINANCE CORPORATION

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

For the Nine Months Ended February 29, 2008 and February 28, 2007

	February 29, 2008	February 28, 2007 (As restated)*
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net loss	$ (41,931)	$ (50,579)
Add (deduct):		
Amortization of deferred income	(5,769)	(10,377)
Amortization of bond issuance costs and deferred charges	14,048	14,096
Depreciation	1,698	1,643
Recovery of loan losses	(47,900)	-
(Recovery of) provision for guarantee liability	(4,300)	400
Results of operations of foreclosed assets	(6,217)	(7,887)
Market adjustment on foreclosed assets	5,840	-
Derivative forward value	173,278	120,779
Foreign currency adjustments	-	15,413
Loss on sale of loans	676	1,550
Changes in operating assets and liabilities:		
Accrued interest and other receivables	(12,684)	(26,057)
Accrued interest payable	33,375	82,262
Other	2,469	(8,871)
Net cash provided by operating activities	112,583	132,372
CASH FLOWS FROM INVESTING ACTIVITIES:		
Advances made on loans	(6,018,988)	(5,245,383)
Principal collected on loans	5,388,629	5,411,973
Net investment in fixed assets	(16,426)	(380)
Net cash provided by foreclosed assets	9,055	62,831
Net proceeds from sale of foreclosed assets	-	487
Net proceeds from sale of loans	73,972	364,100
Change in restricted cash	(15,706)	-
Net cash (used in) provided by investing activities	(579,464)	593,628
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from (repayments of) issuances of short-term debt, net	347,544	(266,334)
Proceeds from issuance of long-term debt, net	1,566,151	863,808
Payments for retirement of long-term debt	(1,293,720)	(592,485)
Payments for retirement of subordinated deferrable debt	(175,000)	(150,000)

Proceeds from issuance of members' subordinated certificates	58,714	27,089
Payments for retirement of members' subordinated certificates	(16,025)	(27,886)
Payments for retirement of patronage capital	(77,378)	(74,094)
Payments for retirement of RTFC patronage capital	(9,771)	(12,414)
Net cash provided by (used in) financing activities	400,515	(232,316)
NET (DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS	(66,366)	493,684
BEGINNING CASH AND CASH EQUIVALENTS	304,107	260,338
ENDING CASH AND CASH EQUIVALENTS	$ 237,741	$ 754,022

See accompanying notes.
*See Note 1(j)

NATIONAL RURAL UTILITIES COOPERATIVE FINANCE CORPORATION

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

For the Nine Months Ended February 29, 2008 and February 28, 2007

	February 29, 2008	February 28, 2007 (As restated)*
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:		
Cash paid for interest	$ 673,387	$ 655,678
Cash paid for income taxes	1,088	1,149

See accompanying notes.
*See Note 1(j)

NATIONAL RURAL UTILITIES COOPERATIVE FINANCE CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)

(1) General Information and Accounting Policies

(a) General Information

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

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

National Cooperative Services Corporation ("NCSC") was incorporated in 1981 in the District of Columbia as a private non-profit cooperative association. The principal purpose of NCSC is to provide financing to the for-profit or non-profit entities that are owned, operated or controlled by or provide substantial benefit to, members of National Rural. NCSC also markets, through its cooperative members, a consumer loan program for home improvements and an affinity credit card program. NCSC's membership consists of National Rural and distribution systems that are members of National Rural or are eligible for such membership. NCSC's results of operations and financial condition are consolidated with those of National Rural in the accompanying financial statements. NCSC is headquartered with National Rural in Herndon, Virginia. NCSC is a taxable corporation.

The Company's consolidated membership was 1,540 as of February 29, 2008 including 899 utility members, the majority of which are consumer-owned electric cooperatives, 511 telecommunications members, 66 service members and 64 associates in 49 states, the District of Columbia and two U.S. territories. The utility members included 830 distribution systems and 69 generation and transmission ("power supply") systems. Memberships among National Rural, RTFC and NCSC have been eliminated in consolidation. All references to members within this document include members and associates.

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

These interim unaudited consolidated financial statements should be read in conjunction with the audited consolidated financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the fiscal year ended May 31, 2007.

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

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

(b) Principles of Consolidation

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

National Rural is the sole lender to and manages the lending and financial affairs of RTFC through a management agreement in effect through December 1, 2016. Under a guarantee agreement, RTFC pays National Rural a fee in exchange for which National Rural reimburses RTFC for loan losses. All loans that require RTFC board approval also require National Rural approval. National Rural is not a member of RTFC and does not elect directors to the RTFC board. RTFC is an associate member of National Rural.

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

RTFC and NCSC creditors have no recourse against National Rural in the event of default by RTFC and NCSC, unless there is a guarantee agreement under which National Rural has guaranteed NCSC or RTFC debt obligations to a third party. At February 29, 2008, National Rural had guaranteed $280 million of NCSC debt and derivative instruments with third parties. The maturities for NCSC debt guaranteed by National Rural run through 2031. As of February 29, 2008, National Rural's maximum potential exposure totaled $298 million related to guarantees of NCSC debt and derivatives. Guarantees related to NCSC debt and derivative instruments are not included in Note 12 at February 29, 2008 as the debt and derivatives are reported on the consolidated balance sheet. At February 29, 2008, National Rural had no guarantees of RTFC debt to third party creditors. All National Rural loans to RTFC and NCSC are secured by all assets and revenues of RTFC and NCSC. At February 29, 2008, RTFC had total assets of $1,921 million including loans outstanding to members of $1,727 million and NCSC had total assets of $465 million including loans outstanding of $417 million. At February 29, 2008 and May 31, 2007, National Rural had committed to lend RTFC up to $4 billion of which $2 billion was outstanding at February 29, 2008. At February 29, 2008 and May 31, 2007, National Rural had committed to provide credit to NCSC of up to $1 billion. At February 29, 2008, National Rural had provided a total of $461 million of credit to NCSC, representing $181 million of outstanding loans and $280 million of credit enhancements.

National Rural established limited liability corporations and partnerships to hold foreclosed assets and effect loan securitization transactions. National Rural has full ownership and control of all such companies and thus consolidates their financial results. National Rural presents the companies formed to hold foreclosed assets in one line on the consolidated balance sheets and the consolidated statements of operations. A full consolidation is presented for the company formed to effect loan securitization transactions.

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

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

(c) Restricted Cash

Restricted cash represents cash and cash equivalents for which use is contractually restricted. Restricted cash is disclosed separately on the balance sheet. At February 29, 2008, the Company has four different contractual restrictions on the use of certain cash. Three of the restricted cash accounts totaling $16 million are related to the issuance of the Clean Renewable Energy Bonds (“CREBs”) in February 2008. The fourth restricted cash account represents cash pledged as collateral for collateral trust bonds issued under the Company’s 1972 indenture. At May 31, 2007, the $2 million of cash pledged as collateral under the 1972 indenture was the only restricted cash, which was classified in other assets due to immateriality.

Restricted cash at February 29, 2008 represents:

- cash proceeds from the issuance of CREBs that may only be used for the funding of CREBs loan advances to participating members to reimburse them for costs related to qualifying projects;
- cash proceeds from the issuance of CREBs that may only be used to reimburse the Company for the costs of issuing the CREBs;
- cash from principal payments from members on CREBs loans that may only be used to make debt service payments to bond investors; and
  - cash held as collateral for the Company's collateral trust bonds issued under the 1972 indenture.

The Company uses the proceeds from the issuance of CREBs to make loans to borrowers for the construction, refinancing, and reimbursement of capital expenditures related to qualified projects. These funds may be invested by the Company. The interest earned is restricted and may only be used to fund qualifying projects.

The Company also uses the proceeds from the issuance of CREBs to cover all costs associated with the issuance of the CREBs. These funds are held by the trustee and may only be released to the Company to cover the cost of issuance. The Company must submit invoices to support the issuance cost for which it is seeking reimbursement. These funds may be invested by the Company. The interest earned is restricted and may only be used to cover issuance expenses and to fund qualifying projects.

The Company collects principal and interest payments from borrowers quarterly. The Company may withdraw the interest collected on CREBs loans at any time. The principal collected on CREBs loans may only be used to repay principal to bond investors. These funds may be invested by the Company. The interest earned is not restricted and may be withdrawn by the Company at any time.

At February 29, 2008 and May 31, 2007, $2 million of cash was pledged to secure the Company's collateral trust bonds under the 1972 indenture. This cash is classified in restricted cash because the funds are on deposit with the Company's collateral trust bond trustee. These funds may be invested by the Company. The interest earned is not restricted and may be withdrawn by the Company at any time.

The restricted cash may be invested by the Company. Interest earned on the Company's restricted cash is not restricted. Interest earned on restricted cash accounts is presented as an operating activity in the statement of cash flows. Changes in the principal balances of restricted cash accounts are reported as investing activities in the statement of cash flows.

(d) Allowance for Loan Losses

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

Management makes recommendations of loans to be written off to the board of directors of National Rural. 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.

Activity in the loan loss allowance account is summarized below:

(in thousands)	For the nine months ended and as of February 29, 2008	February 28, 2007	Year ended and as of May 31, 2007
Balance at beginning of period	$561,663	$ 611,443	$611,443
Recovery of loan losses	(47,900)	-	(6,922)
Write-offs	(16,827)	(397)	(44,668)
Recoveries of prior write-offs	324	320	1,810
Balance at end of period	$497,260	$ 611,366	$561,663

(e) Interest Income

Interest income includes the following:

(in thousands)	For the three months ended February 29, 2008	February 28, 2007	For the nine months ended February 29, 2008	February 28, 2007
Interest on long-term fixed rate loans (1)	$220,117	$208,262	$649,860	$619,889
Interest on long-term variable rate loans (1)	20,785	28,028	68,024	90,199
Interest on short-term loans (1)	20,224	17,761	59,816	53,691
Interest on investments (2)	1,832	2,626	6,668	6,075
Conversion fees (3)	1,587	2,412	5,096	7,366
Make-whole and prepayment fees (4)	533	3,368	2,287	4,193
Commitment and guarantee fees (5)	822	1,658	3,742	7,127
Other fees	676	758	2,324	1,266
Total interest income	$266,576	$264,873	$797,817	$789,806

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

Deferred income on the consolidated balance sheets is comprised primarily of deferred conversion fees totaling $21 million and $25 million at February 29, 2008 and May 31, 2007, respectively.

(f) Interest Expense

Interest expense includes the following:

(in thousands)	For the three months ended February 29, 2008	February 28, 2007	For the nine months ended February 29, 2008	February 28, 2007
Interest expense - commercial paper and bid notes (1)	$ 30,639	$ 38,758	$102,117	$134,760
Interest expense - medium-term notes (1)	82,555	93,876	249,422	282,050
Interest expense - collateral trust bonds (1)	61,213	56,069	189,968	156,629
Interest expense - subordinated deferrable debt (1)	4,916	8,153	14,747	24,936
Interest expense - subordinated certificates (1)	12,297	11,755	36,451	35,671
Interest expense - long-term private debt (1)	34,359	29,180	100,102	89,484
Debt issuance costs (2)	2,328	5,230	7,625	9,332
Commitment and guarantee fees (3)	4,602	3,967	13,277	11,981
Loss on extinguishment of debt (4)	-	-	5,509	4,806

Other fees	559	453	1,592	2,387
Total interest expense	$233,468	$247,441	$720,810	$752,036

(1) Represents interest expense and the amortization of discounts on debt.
(2) Includes amortization of all deferred charges related to debt issuance, principally underwriter's fees, legal fees, printing costs and comfort letter fees. Amortization is calculated on the effective interest method. Also includes issuance costs related to dealer commercial paper.
(3) Includes various fees related to funding activities, including fees paid to banks participating in the Company's revolving credit agreements and fees paid under bond guarantee agreements with RUS as part of the Rural Economic Development Loan and Grant ("REDLG") program. Fees are recognized as incurred or amortized on a straight-line basis over the life of the respective agreement.
(4) Represents the loss on the early retirement of debt including the write-off of unamortized discount, premium and issuance costs.

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

(g) Comprehensive Income

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

	For the three months ended		For the nine months ended	
(in thousands)	February 29, 2008	February 28, 2007	February 29, 2008	February 28, 2007
Net (loss) income	$ (323)	$ 48,635	$ (41,931)	$ (50,579)
Other comprehensive income:				
Reclassification adjustment for realized gain on derivatives	(256)	(251)	(587)	(753)
Comprehensive (loss) income	$ (579)	$ 48,384	$ (42,518)	$ (51,332)

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(h) Reclassifications

Certain reclassifications of prior period amounts have been made to conform to the current reporting format. The May 31, 2007 balance of deferred loan origination costs totaling $4 million was reclassified from other assets to loans to members on the consolidated balance sheet to conform with the February 29, 2008 presentation. The May 31, 2007 balance of cash held as collateral totaling $2 million was reclassified from other assets to restricted cash on the consolidated balance sheet to conform with the February 29, 2008 presentation.

(i) New Accounting Pronouncements

On June 1, 2007, the Company adopted Statement of Financial Accounting Standard (“SFAS”) 155, Accounting for Certain Hybrid Financial Instruments – an amendment of SFAS 133 and 140. SFAS 155 permits fair value measurement of any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation. SFAS 155 also clarifies which interest-only strips and principal-only strips are not subject to the requirements of SFAS 133, Accounting for Derivative Instruments and Hedging Activities, as amended. It establishes a requirement to evaluate interests in securitized financial assets to identify interests that are freestanding derivatives or that are hybrid financial instruments that contain an embedded derivative requiring bifurcation. SFAS 155 also clarifies that concentrations of credit risk in the form of subordination are not embedded derivatives. SFAS 155 is effective for all financial instruments acquired or issued after the beginning of an entity’s first fiscal year that begins after September 15, 2006. The Company’s adoption of SFAS 155 did not have a material impact on the Company's financial position or results of operations.

On June 1, 2007, the Company adopted SFAS 156, Accounting for Servicing of Financial Assets. SFAS 156 requires the initial measurement of all separately recognized servicing assets and liabilities at fair value and permits, but does not require, the subsequent measurement of servicing assets and liabilities at fair value. SFAS 156 is effective as of the beginning of the first fiscal year that begins after September 15, 2006. The Company’s adoption of SFAS 156 did not have a material impact on the Company's financial position or results of operations.

On June 1, 2007, the Company adopted FIN No. 48, Accounting for Uncertainty in Income Taxes, an interpretation of SFAS 109. FIN 48 clarifies the accounting for income taxes by prescribing a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006. The Company’s adoption of FIN 48 did not have a material impact on the Company's financial position or results of operations. The Company classifies interest and penalties assessed as tax expense.

In September 2006, the FASB issued SFAS 157, Fair Value Measurements. SFAS 157 clarifies the principle that fair value should be based on the assumptions market participants would use when pricing an asset or liability and establishes a fair value hierarchy that prioritizes the information used to develop those assumptions. Under the standard, fair value measurements would be separately disclosed by level within the fair value hierarchy. SFAS 157 is effective as of the beginning of the first fiscal year that begins after November 15, 2007. The Company's adoption of SFAS 157 as of June 1, 2008 is not expected to have a material impact on the Company's financial position or results of operations.

In February 2007, the FASB issued SFAS 159, The Fair Value Option for Financial Assets and Financial Liabilities. The fair value option established by SFAS 159 permits entities to choose to measure eligible financial instruments at fair value. The unrealized gains and losses on items for which the fair value option has been elected should be reported in earnings. The decision to elect the fair value option is determined on an instrument by instrument basis and is irrevocable. Assets and liabilities measured at fair value pursuant to the fair value option should be reported separately in the balance sheet from those instruments measured using other measurement attributes. SFAS 159 is effective as of the beginning of the first fiscal year that begins after November 15, 2007. As part of the Company's adoption of SFAS 159 as of June 1, 2008, it does not plan to choose the option to measure eligible financial instruments at fair value and therefore the adoption of SFAS 159 is not expected to have a material impact on the Company's 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. This statement amends ARB 51, Consolidated Financial Statements, to establish accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. It also amends certain of ARB 51’s consolidation procedures for consistency with the requirements of SFAS 141, Business Combinations. Noncontrolling interests shall be reclassified to equity, consolidated net income shall be adjusted to include net income attributable to noncontrolling interests and consolidated comprehensive income shall be adjusted to include comprehensive income attributable to the noncontrolling interests. This statement is effective for fiscal years beginning on or after December 15, 2008. The Company’s adoption of SFAS 160 on June 1, 2009 is not expected to have a material impact on the Company’s financial position or results of operations.

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

(j) Restatement

Subsequent to the issuance of the May 31, 2006 consolidated financial statements, the Company's management identified an error in the recording of interest expense on foreign denominated debt and the cash settlement income from foreign currency exchange agreements, as well as the related accrued interest payable and accrued interest receivable. The Company was using the agreed upon foreign exchange rate from the foreign currency exchange agreement rather than the average spot foreign currency exchange rate during the income statement period to convert the interest expense on the foreign denominated debt and foreign exchange agreement income to U.S. dollars. The Company was also using the agreed upon foreign exchange rate from the foreign currency exchange agreement rather than the spot foreign currency exchange rate at the end of the balance sheet period to convert the accrued interest payable and accrued interest receivable to U.S. dollars. The interest expense on the foreign denominated debt and the cash settlement income from the foreign currency exchange agreement are equal and offsetting amounts, as the Company uses the amount received under the exchange agreement to pay the interest expense on the foreign denominated debt. The amounts for the accrued interest payable and accrued interest receivable are also offsetting. As a result of this error, interest expense and cash settlement income were understated by $3 million and $10 million for the three and nine months ended February 28, 2007, respectively. The Company subtracts the net accrual from the last settlement date on its derivatives at each period end in the calculation of the related fair value, so the error in the calculation of the income receivable on the foreign exchange agreements also impacted the fair value of the derivatives recorded as a derivative asset. Thus, this correction also impacts the change in the fair value of the derivatives reported in the derivative forward value line on the consolidated statement of operations. The derivative forward value loss line was understated by $4 million and $11 million for the three and nine months ended February 28, 2007, respectively. The net income line was overstated by $4 million for the three months ended February 28, 2007 and the net loss line was understated by $11 million for the nine months ended February 28, 2007. There is no impact on cash flows from operating activities or the total change in cash in the consolidated statements of cash flows.

A summary of the effects of the restatement on the consolidated statements of operations for the three and nine months ended February 28, 2007 is as follows:

	For the three months ended February 28, 2007		
(in thousands)	As previously reported	Adjustment	As restated
Interest expense	$ (243,969)	$ (3,472)	$(247,441)
Net interest income	20,904	(3,472)	17,432
Net interest income after recovery of loan losses	20,904	(3,472)	17,432
Derivative cash settlements	40,970	3,472	44,442
Total non-interest income	43,283	3,472	46,755
Derivative forward value	(583)	(3,606)	(4,189)
Total non-interest expense	(11,885)	(3,606)	(15,491)
Income prior to income taxes and minority interest	52,302	(3,606)	48,696
Income prior to minority interest	51,675	(3,606)	48,069
Net income	52,241	(3,606)	48,635

	For the nine months ended February 28, 2007		
(in thousands)	As previously reported	Adjustment	As restated
Interest expense	$ (741,685)	$(10,351)	$(752,036)
Net interest income	48,121	(10,351)	37,770
Net interest income after recovery of loan losses	48,121	(10,351)	37,770
Derivative cash settlements	65,839	10,351	76,190
Total non-interest income	74,768	10,351	85,119
Derivative forward value	(110,117)	(10,662)	(120,779)
Total non-interest expense	(164,623)	(10,662)	(175,285)
Loss prior to income taxes and minority interest	(41,734)	(10,662)	(52,396)
Loss prior to minority interest	(41,161)	(10,662)	(51,823)
Net loss	(39,917)	(10,662)	(50,579)

(2) Loans and Commitments

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

(in thousands)	February 29, 2008 Loans Outstanding	February 29, 2008 Unadvanced Commitments (1)	May 31, 2007 Loans Outstanding	May 31, 2007 Unadvanced Commitments (1)
Total by loan type (2):				
Long-term fixed rate loans	$14,851,196	$ -	$ 14,663,340	$ -
Long-term variable rate loans	1,978,068	5,577,717	1,993,534	5,703,313
Loans guaranteed by RUS	251,135	491	255,903	491
Short-term loans	1,580,813	7,416,504	1,215,430	7,200,156
Total loans outstanding	18,661,212	12,994,712	18,128,207	12,903,960
Deferred origination fees	4,227	-	3,666	-
Less: Allowance for loan losses	(497,260)	-	(561,663)	-
Net loans	$18,168,179	$12,994,712	$ 17,570,210	$12,903,960
Total by segment:				
National Rural:				
Distribution	$13,213,526	$ 9,120,408	$ 12,827,772	$ 9,176,686
Power supply	3,198,956	2,960,783	2,858,040	2,798,124
Statewide and associate	104,258	129,415	119,478	139,156
National Rural total	16,516,740	12,210,606	15,805,290	12,113,966
RTFC	1,727,344	488,081	1,860,379	473,762
NCSC	417,128	296,025	462,538	316,232
Total loans outstanding	$18,661,212	$12,994,712	$ 18,128,207	$12,903,960

(in thousands) Non-performing and restructured loans (2):	February 29, 2008 Loans Outstanding	February 29, 2008 Unadvanced Commitments (1)	May 31, 2007 Loans Outstanding	May 31, 2007 Unadvanced Commitments (1)
Non-performing loans (3):				
RTFC:				
Long-term fixed rate loans	$ 219,853	$ -	$ 212,984	$ -
Long-term variable rate loans	253,480	2,160	261,081	-
Short-term loans	31,042	-	27,799	418
Total non-performing loans	$ 504,375	$ 2,160	$ 501,864	$ 418
Restructured loans (3):				
National Rural:				
Long-term fixed rate loans	$ 52,420	$ -	$ 52,420	$ -
Long-term variable rate loans	526,365	186,673	544,697	186,673
Short-term loans	-	12,500	-	12,500
National Rural total restructured loans	578,785	199,173	597,117	199,173
RTFC:				

Long-term fixed rate loans	5,710	-	6,188	-
Total restructured loans	$ 584,495	$ 199,173	$ 603,305	$ 199,173

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

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

Loan Security
The Company evaluates each borrower's creditworthiness on a case-by-case basis. It is generally the Company's policy to require collateral for long-term loans. Such collateral usually consists of a first mortgage lien on the borrower's total system, including plant and equipment, and a pledge of future revenues. The loan and security documents also contain various

provisions with respect to the mortgaging of the borrower's property and debt service coverage ratios, maintenance of adequate insurance coverage as well as certain other restrictive covenants.

The following tables summarize the Company's secured and unsecured loans outstanding by loan program and by segment

(Dollar amounts in thousands)	February 29, 2008				May 31, 2007			
Total by loan program:	Secured	%	Unsecured	%	Secured	%	Unsecured	%
Long-term fixed rate loans	$ 14,430,587	97%	$ 420,609	3%	$14,180,956	97%	$ 482,384	3%
Long-term variable rate loans	1,837,562	93%	140,506	7%	1,865,821	94%	127,713	6%
Loans guaranteed by RUS	251,135	100%	-	-	255,903	100%	-	-
Short-term loans	164,613	10%	1,416,200	90%	191,231	16%	1,024,199	84%
Total loans	$16,683,897	89%	$ 1,977,315	11%	$16,493,911	91%	$ 1,634,296	9%
Total by segment:								
National Rural	$14,826,254	90%	$ 1,690,486	10%	$14,462,448	92%	$ 1,342,842	8%
RTFC	1,497,634	87%	229,710	13%	1,630,079	88%	230,300	12%
NCSC	360,009	86%	57,119	14%	401,384	87%	61,154	13%
Total loans	$16,683,897	89%	$ 1,977,315	11%	$16,493,911	91%	$ 1,634,296	9%

Pledging of Loans

As of February 29, 2008 and May 31, 2007, distribution system mortgage notes related to outstanding long-term loans totaling $4,593 million and $5,797 million, respectively, and RUS guaranteed loans qualifying as permitted investments totaling $216 million and $219 million, respectively, were pledged as collateral to secure National Rural's collateral trust bonds under the 1994 indenture totaling $4,015 million and $5,020 million, respectively. Under the 2007 indenture, distribution system mortgage notes related to outstanding long-term loans totaling $935 million as of February 29, 2008 were pledged as collateral to secure National Rural's collateral trust bonds totaling $700 million. In addition, $2 million of cash was pledged to secure $2 million of collateral trust bonds outstanding under the 1972 indenture at February 29, 2008 and May 31, 2007.

As of February 29, 2008 and May 31, 2007, distribution system mortgage notes totaling $577 million and $592 million, respectively, were pledged as collateral to secure National Rural's notes to the Federal Agricultural Mortgage Corporation ("Farmer Mac") totaling $500 million.

In addition to the loans pledged as collateral at February 29, 2008 and May 31, 2007, National Rural had $3,204 million and $2,765 million, respectively, of mortgage notes on deposit with the trustee for the $2.5 billion and $2 billion, respectively, of notes payable to the Federal Financing Bank ("FFB") of the United States Treasury as part of the REDLG program (see Note 6). The $2.5 billion of notes payable to the FFB contain a rating trigger related to the Company's senior secured credit ratings from Standard & Poor's Corporation, Moody's Investors Service and Fitch Ratings. A rating trigger event exists if the Company's senior secured debt does not have at least two of the following ratings: (i) A- or higher from Standard & Poor's Corporation, (ii) A3 or higher from Moody's Investors Service, (iii) A- or higher from Fitch Ratings and (iv) an equivalent rating from a successor rating agency to any of the above rating agencies. If the Company's senior secured credit ratings fall below the levels listed above, the mortgage notes on deposit at that time, which totaled $3,204 million at February 29, 2008, would be pledged as collateral rather than held on deposit. At February 29, 2008, the Company's senior secured debt ratings were above the rating trigger threshold.

A total of $1.5 billion of notes payable to the FFB has a second trigger event related to a financial expert to the Company's board of directors. A rating trigger event will exist if the financial expert position (as defined by Section 407 of the Sarbanes-Oxley Act of 2002) remains vacant for more than 90 consecutive days. If the Company does not satisfy the financial expert rating trigger, the mortgage notes on deposit at that time, which totaled $1,848 million at February 29, 2008, would be pledged as collateral rather than held on deposit. The financial expert position on National Rural's board of directors has been filled since March 2007.

(3) Loan Securitizations

The Company accounts for the sale of loans in securitization transactions according to the provisions of SFAS 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, as amended. The Company derecognizes financial assets when control has been surrendered. The Company has no retained interest in securitized loans. The Company services the loans in return for a market fee and therefore does not record a servicing asset or liability. The Company recognizes the service fee on an accrual basis over the period for which servicing activity is provided. Deferred transactions costs and unamortized deferred loan origination costs related to the loans sold are expensed as part of the calculation of the gain or loss on the sale.

On August 10, 2007, the Company entered into an agreement to sell $74 million of distribution mortgage loans to Farmer Mac for $74 million. The distribution mortgage loans were sold at 100% of the outstanding principal balance on that date. A total of $40 million of the distribution mortgage loans were transferred on August 10, 2007 and the remaining $34 million were transferred on January 2, 2008. The transaction qualifies for sale treatment under SFAS 140.

The Company recorded a loss on sale of loans totaling $0.7 million related to costs associated with the transaction and unamortized deferred loan origination costs for the loans sold. The Company does not hold any continuing interest in the loans sold and has no obligation to repurchase loans from the purchaser. The holders of the certificates of beneficial interest issued by the purchaser have no claim against the Company or any of the Company's assets in the event of a default on the loans held by the purchaser.

The Company will service the loans for the purchaser in exchange for a fee of 30 basis points of the outstanding loan principal. The Company considers the 30 basis point fee to be a market fee based on market quotes from other providers. As a result, the Company has not recorded a servicing asset or liability. The servicing fee has a payment priority over any other disbursement made by the trust holding the assets.

During the three and nine months ended February 29, 2008, the Company recognized $0.3 million and $0.9 million, respectively, in servicing fees on all loan securitization transactions.

(4) Foreclosed Assets

Assets received in satisfaction of loan receivables are recorded at the lower of cost or market and classified on the consolidated balance sheets as foreclosed assets. At February 29, 2008 and May 31, 2007, the balance of foreclosed assets included real estate developer notes receivable and limited partnership interests in certain real estate developments.

At February 29, 2008, the Company determined that there was a reduction of $6 million to the market value of one of the land development loans held as a foreclosed asset. The reduction to the market value was primarily as a result of the slow down in lot sales due to residential home market weakness.

The activity for foreclosed assets is summarized below:

	Nine months ended		Year ended
(in thousands)	February 29, 2008	February 28, 2007	May 31, 2007
Beginning balance	$ 66,329	$120,889	$ 120,889
Results of operations	6,217	7,887	9,758
Net cash provided by foreclosed assets	(9,055)	(62,831)	(63,831)
Market adjustment	(5,840)	-	-
Sale of foreclosed assets	-	(487)	(487)
Ending balance of foreclosed assets	$ 57,651	$ 65,458	$ 66,329

(5) Short-Term Debt and Credit Arrangements

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

(in thousands)	February 29, 2008	May 31, 2007
Short-term debt:		

Commercial paper sold through dealers, net of discounts	$1,479,506	$ 1,017,879
Commercial paper sold directly to members, at par	1,113,316	1,383,090
Commercial paper sold directly to non-members, at par	141,582	133,087
Total commercial paper	2,734,404	2,534,056
Daily liquidity fund sold directly to members, at par	297,759	250,563
Bank bid notes	200,000	100,000
Subtotal short-term debt	3,232,163	2,884,619
Long-term debt maturing within one year:		
Medium-term notes sold through dealers	595,748	133,801
Medium-term notes sold to members	281,437	231,158
Secured collateral trust bonds	1,824,993	999,560
Secured notes payable	500,000	-
Subordinated deferrable debt (1)	-	175,000
Unsecured notes payable	4,788	2,985
Total long-term debt maturing within one year	3,206,966	1,542,504
Total short-term debt	$6,439,129	$4,427,123
(1) Redeemed in June 2007.		

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

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

(Dollar amounts in thousands)	February 29, 2008	May 31, 2007	Termination Date	Facility fee per annum (1)
364-day agreement (2)	$ 1,125,000	$ 1,125,000	March 14, 2008	0.05 of 1%
Five-year agreement	1,125,000	1,125,000	March 16, 2012	0.06 of 1%
Five-year agreement	1,025,000	1,025,000	March 22, 2011	0.06 of 1%
Total	$ 3,275,000	$ 3,275,000		

(1) Facility fee determined by National Rural's senior unsecured credit ratings based on the pricing schedules put in place at the initiation of the related agreement.
(2) Any amount outstanding under these agreements may be converted to a one-year term loan at the end of the revolving credit periods. If converted to a term loan, the fee on the outstanding principal amount of the term loan is 0.10 of 1% per annum.

Upfront fees of between 0.03 and 0.05 of 1% were paid to the banks based on their commitment level to the five-year agreements in place at February 29, 2008, totaling in aggregate $1 million, which will be amortized on a straight-line basis over the life of the agreements. No upfront fees were paid to the banks for their commitment to the 364-day facility. Each agreement contains a provision under which if borrowings exceed 50% of total commitments, a utilization fee must be paid on the outstanding balance. The utilization fees are 0.05 of 1% for all three agreements in place at February 29, 2008.

At February 29, 2008 and May 31, 2007, the Company was in compliance with all covenants and conditions under its revolving credit agreements in place at that time and there were no borrowings outstanding under such agreements.

For the purpose of calculating the required financial covenants contained in its revolving credit agreements, the Company adjusts net income, senior debt and total equity to exclude the non-cash adjustments related to SFAS 133 and SFAS 52, Foreign Currency Translation. The adjusted times interest earned ratio ("TIER"), as defined by the agreements, represents the interest expense adjusted to include the derivative cash settlements, plus minority interest net income, plus net income prior to the cumulative effect of change in accounting principle and dividing that total by the interest expense adjusted to include the derivative cash settlements. In addition to the non-cash adjustments related to SFAS 133 and 52, senior debt also excludes RUS guaranteed loans, subordinated deferrable debt, members' subordinated certificates and minority interest. Total equity is adjusted to include subordinated deferrable debt, members' subordinated certificates and minority interest. Senior debt includes guarantees; however, it excludes:

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

The following represents the Company's required and actual financial ratios under the revolving credit agreements at or for the periods ended February 29, 2008 and May 31, 2007:

		Actual	
	Requirement	February 29, 2008	May 31, 2007
Minimum average adjusted TIER over the six most recent fiscal quarters	1.025	1.16	1.09
Minimum adjusted TIER at fiscal year end (1)	1.05	1.12	1.12
Maximum ratio of senior debt to total equity	10.00	7.26	6.65

(1) The Company must meet this requirement in order to retire patronage capital. The adjusted TIER reported at February 29, 2008 is the amount from the prior year end, the last measurement date for this ratio.

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

Subsequent to the end of the quarter, the 364-day revolving credit agreement in place at February 29, 2008 totaling $1,125 million was replaced on March 14, 2008 with a new 364-day agreement totaling $1,500 million expiring on March 13, 2009. Any amount outstanding under the new 364-day agreement may be converted to a one-year term loan at the end of the revolving credit period with a 0.10 of 1% per annum fee on the outstanding principal amount of the term loan. The facility fee for the 364-day facility is 0.05 of 1% per annum based on the pricing schedule in place at March 14, 2008. Upfront fees of $147,000 were paid to the banks based on their commitment level to the 364-day agreement. The agreement contains a provision under which if borrowings exceed 50% of total commitments, a utilization fee of 0.05 of 1% must be paid on the outstanding balance. National Rural's five-year agreement totaling $1,025 million is still in effect and expires on March 22, 2011. National Rural's five-year agreement totaling $1,125 million is still in effect and expires on March 16, 2012. The total committed credit available under these three current facilities was $3,650 million at March 14, 2008.

(6) Long-Term Debt

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

(in thousands)	February 29, 2008	May 31, 2007
Unsecured long-term debt:		
Medium-term notes, sold through dealers	$4,216,284	$ 4,676,176
Medium-term notes, sold directly to members	76,632	76,464
Subtotal	4,292,916	4,752,640
Unamortized discount	(5,984)	(7,408)
Total unsecured medium-term notes	4,286,932	4,745,232
Unsecured notes payable	2,559,612	2,032,630
Total unsecured long-term debt	6,846,544	6,777,862
Secured long-term debt:		
Collateral trust bonds	2,891,927	4,021,953
Unamortized discount	(5,569)	(4,596)
Total secured collateral trust bonds	2,886,358	4,017,357
Secured notes payable	-	500,000
Total secured long-term debt	2,886,358	4,517,357
Total long-term debt	$9,732,902	$11,295,219

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

Unsecured Notes Payable

At February 29, 2008 and May 31, 2007, National Rural had outstanding a total of $2.5 billion and $2 billion, respectively, under a bond purchase agreement with the FFB and a bond guarantee agreement with RUS as part of the funding mechanism for the REDLG program. On August 7, 2007, National Rural received the advance of the remaining $500 million under the REDLG program. The $500 million advance has a July 2027 maturity date. As part of the REDLG program, National Rural will pay to RUS a fee of 30 basis points per annum on the total amount borrowed. At February 29, 2008, the $2.5 billion of unsecured notes payable issued as part of the REDLG program require National Rural to place on deposit mortgage notes in an amount at least equal to the principal balance of the notes outstanding. See Note 2 for additional information on the mortgage notes held on deposit.

Secured Notes Payable

At May 31, 2007, the Company had outstanding a total of $500 million of 4.656% notes to Farmer Mac due in 2008. See Note 2 for additional information on the collateral pledged to secure the Company's notes payable. Based on the July 29, 2008 maturity, this debt was reclassified to short-term debt during the quarter ended August 31, 2007.

(7) Subordinated Deferrable Debt

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

(Dollar amounts in thousands)	February 29, 2008	May 31, 2007
6.75% due 2043 (1)	$125,000	$125,000
6.10% due 2044 (2)	88,201	88,201
5.95% due 2045 (3)	98,239	98,239
Total	$311,440	$311,440

(1) The 6.75% subordinated deferrable securities due 2043 are callable by the Company at par starting on February 15, 2008.
(2) The 6.10% subordinated deferrable securities due 2044 are callable by the Company at par starting on February 1, 2009.
(3) The 5.95% subordinated deferrable securities due 2045 are callable by the Company at par starting on February 15, 2010.

(8) Derivative Financial Instruments

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

Consistent with SFAS 133, as amended, the Company records derivative instruments on the consolidated balance sheet as either an asset or liability measured at fair value. Changes in the fair value of derivative instruments are recognized in the derivative forward value line item of the consolidated statement of operations unless specific hedge accounting criteria are met. Net settlements paid and received for derivative instruments that qualify for hedge accounting are recorded in interest expense. Net settlements related to derivative instruments that do not qualify for hedge accounting are recorded as derivative cash settlements in the consolidated statement of operations. The Company formally documents, designates, and assesses the effectiveness of transactions that receive hedge accounting.

Interest Rate Exchange Agreements
Generally, the Company's interest rate exchange agreements do not qualify for hedge accounting under SFAS 133. At February 29, 2008 and May 31, 2007, the Company did not have any interest rate exchange agreements that were accounted for using hedge accounting.

The Company was a party to the following interest rate exchange agreements:

	Notional Amounts Outstanding	
(in thousands)	February 29, 2008	May 31, 2007
Pay fixed and receive variable	$ 7,700,865	$ 7,276,473
Pay variable and receive fixed	5,256,440	5,256,440
Total interest rate exchange agreements	$ 12,957,305	$ 12,532,913

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

Interest rate exchange agreements had the following impact on the Company:

	Three months ended		Nine months ended	
(in thousands)	February 29, 2008	February 28, 2007	February 29, 2008	February 28, 2007
Statement of Operations Impact				
Agreements that do not qualify for hedge accounting:				
Derivative cash settlements	$ 10,463	$ 41,527	$ 30,299	$ 67,529
Derivative forward value	(64,266)	(770)	(173,278)	(127,318)
Total (loss) gain on interest rate exchange agreements	$ (53,803)	$ 40,757	$ (142,979)	$ (59,789)
Comprehensive Income Impact				
Amortization of transition adjustment	$ (256)	$ (251)	$ (587)	$ (753)

Total comprehensive loss	$	(256)	$	(251)	$	(587)	$	(753)

A transition adjustment of $62 million was recorded as an other comprehensive loss on June 1, 2001, the date the Company implemented SFAS 133. The transition adjustment will be amortized into earnings over the remaining life of the related interest rate exchange agreements. Approximately $0.8 million of the transition adjustment is expected to be amortized to income over the next twelve months and will continue through April 2029.

Cross Currency Interest Rate Exchange Agreements

There were no cross currency interest rate exchange agreements outstanding at February 29, 2008 and May 31, 2007. As of February 28, 2007, the Company was a party to cross currency interest rate exchange agreements with a total notional amount of $434 million related to medium-term notes denominated in foreign currencies in which the Company received Euros and paid U.S. dollars. These cross currency interest rate exchange agreements did not qualify for hedge accounting. Generally, the Company's cross currency interest rate exchange agreements do not qualify for hedge accounting under SFAS 133.

Cross currency interest rate exchange agreements had the following impact on the Company:

(in thousands)	Three months ended February 29, 2008	Three months ended February 28, 2007	Nine months ended February 29, 2008	Nine months ended February 28, 2007
Statement of Operations Impact				
Agreements that do not qualify for hedge accounting				
Derivative cash settlements	$ -	$ 2,915	$ -	$ 8,661
Derivative forward value	-	(3,419)	-	6,539
Total (loss) gain on interest rate exchange agreements	$ -	$ (504)	$ -	$ 15,200

Rating Triggers

The Company has certain interest rate exchange agreements that contain a provision called a rating trigger. Under a rating trigger, if the credit rating for either counterparty falls to the level specified in the agreement, the other counterparty may, but is not obligated to, terminate the agreement. If either counterparty terminates the agreement, a net payment may be due from one counterparty to the other based on the fair value of the underlying derivative instrument. Rating triggers are not separate financial instruments and are not separate derivatives under SFAS 133. The rating triggers contained in certain of the Company's derivative contracts are based on its senior unsecured credit rating from Standard & Poor's Corporation and Moody's Investors Service.

At February 29, 2008, the Company had the following notional amount and fair values associated with exchange agreements that contain rating triggers. For the purpose of the presentation, the Company has grouped the rating triggers into two categories, (1) ratings from Moody's Investors Service falls to Baa1 or from Standard & Poor's Corporation falls to BBB+ and (2) ratings from Moody's Investors Service falls below Baa1 or from Standard & Poor's Corporation falls below BBB+.

(in thousands)	Notional Amount	Required Company Payment	Amount Company Would Collect	Net Total
Rating Level:				
Fall to Baa1/BBB+	$ 1,739,419	$ (45,283)	$ 82,534	$ 37,251
Fall below Baa1/BBB+	7,183,620	(203,636)	136,855	(66,781)
Total	$ 8,923,039	$ (248,919)	$ 219,389	$ (29,530)

Additionally, if ratings from Moody's Investors Service fall below Baa2 or from Standard & Poor's Corporation fall below BBB, the Company would be required to pledge collateral equal to the net obligation, or net fair value, of the related exchange agreements due to the affected counterparty, if any. At February 29, 2008, the net obligation totaled $18 million for the $718 million notional amount of exchange agreements subject to this rating trigger.

(9) Members' Subordinated Certificates

Membership Subordinated Certificates

National Rural's members are required to purchase membership certificates as a condition of membership. Such certificates are interest-bearing, unsecured, subordinated debt of National Rural. Members may purchase the certificates over time as a percentage of the amount they borrow from National Rural. RTFC and NCSC members are not required to purchase membership certificates as a condition of membership. National Rural membership certificates typically have an original maturity of 100 years and pay interest at 5% semi-annually. The weighted average maturity for all membership subordinated certificates outstanding at February 29, 2008 and May 31, 2007 was 68 years and 69 years, respectively.

Loan and Guarantee Subordinated Certificates

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

Certificates currently purchased in conjunction with long-term loans are generally non-interest bearing. National Rural's policy regarding the purchase of loan subordinated certificates requires members with a debt to equity ratio with National Rural in excess of the limit in the policy to purchase a non-amortizing/non-interest bearing subordinated certificate in the amount of 2% for distribution systems and 7% for power supply systems. National Rural associates and RTFC members are required to purchase loan subordinated certificates of 10% of each long-term loan advance. For non-standard credit facilities, the borrower is required to purchase interest bearing certificates in amounts determined appropriate by National Rural based on the circumstances of the transaction.

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The maturity dates and the interest rates payable on guarantee subordinated certificates purchased in conjunction with National Rural's guarantee program vary in accordance with applicable National Rural policy. Members may be required to purchase non-interest-bearing debt service reserve subordinated certificates in connection with National Rural's guarantee of long-term tax-exempt bonds (see Note 12). National Rural pledges proceeds from the sale of such certificates to the debt service reserve fund established in connection with the bond issue and any earnings from the investments of the fund inure solely to the benefit of the members for whom the bonds are issued. These certificates have varying maturities not exceeding the longest maturity of the guaranteed obligation.

(10) Minority Interest

At February 29, 2008 and May 31, 2007, the Company reported minority interests of $12 million and $22 million, respectively, on the consolidated balance sheets. Minority interest represents 100% of RTFC and NCSC equity as the members of RTFC and NCSC own or control 100% of the interest in their respective companies.

During the nine months ended February 29, 2008, NCSC’s net loss of $10.1 million exceeded its equity balance by $1.6 million, which eliminated the minority interest equity in NCSC. In accordance with ARB 51, Consolidated Financial Statements, National Rural is required to absorb the $1.6 million NCSC excess loss. NCSC’s losses during the nine months ended February 29, 2008 were primarily due to its $18 million in derivative forward value losses. NCSC’s equity balance included in minority interest on the consolidated balance sheets was $8.6 million at May 31, 2007.

Minority interest at February 29, 2008 also decreased due to the retirement of $2 million of patronage capital to RTFC members in January 2008.

(11) Equity

National Rural is required by the District of Columbia cooperative law to have a methodology to allocate its net earnings to its members. National Rural maintains the current year net earnings as unallocated through the end of its fiscal year. Subsequent to the end of the fiscal year, National Rural's board of directors allocates its net earnings to members in the form of patronage capital and to board approved reserves. Currently, National Rural has two such board approved reserves, the education fund and the members' capital reserve. National Rural allocates a small portion, less than 1%, of net earnings annually to the education fund. The allocation to the education fund must be at least 0.25% of net earnings as required by National Rural's bylaws. Funds from the education fund are disbursed annually to fund cooperative education in the service territories of each state. The board of directors determines the amount of net earnings that is allocated to the members' capital reserve, if any. The members' capital reserve represents earnings that are held by National Rural to increase equity retention. The net earnings held in the members' capital reserve have not been allocated to any member, but may be allocated to individual members in the future as patronage capital if authorized by National Rural's board of directors. All remaining net earnings are allocated to National Rural's members in the form of patronage capital. National Rural bases the amount of net earnings allocated to each member on the members' patronage of the National Rural lending programs in the year that the net earnings were earned. There is no impact on National Rural's total equity as a result of allocating net earnings to members in the form of patronage capital or to board approved reserves. National Rural's board of directors has annually voted to retire a portion of the patronage capital allocated to members in prior years. National Rural's total equity is reduced by the amount of patronage capital retired to members and by amounts disbursed from board approved reserves. National Rural adjusts the net earnings it allocates to members and board approved reserves to exclude the non-cash impacts of SFAS 133 and 52.

In July 2007, National Rural's board of directors authorized the allocation of the fiscal year 2007 adjusted net earnings as follows: $1 million to the education fund and $104 million to members in the form of patronage capital. The board of directors also authorized the allocation of $1 million to the members' capital reserve. In July 2007, National Rural's board of directors authorized the retirement of allocated net earnings totaling $86 million, representing 70% of the fiscal year 2007 allocation and one-ninth of the fiscal years 1991, 1992 and 1993 allocated net earnings. This amount was returned to members in cash in September 2007. Future allocations and retirements of net earnings will be made annually as determined by National Rural's board of directors with due regard for National Rural's financial condition. The board of directors for National Rural has the authority to change the policy for allocating and retiring net earnings at any time, subject to applicable cooperative law.

At February 29, 2008 and May 31, 2007, equity included the following components:

(in thousands)	February 29, 2008	May 31, 2007
Membership fees	$ 994	$ 997
Education fund	709	1,406
Members' capital reserve	158,348	158,308
Allocated net income	320,064	405,598
Unallocated net income (1)	113,440	(23)
Total members' equity	593,555	566,286
Prior years cumulative derivative forward value and foreign currency adjustments	131,551	225,849
Current period derivative forward value (2)	(155,394)	(79,744)
Current period foreign currency adjustments	-	(14,554)
Total retained equity	569,712	697,837
Accumulated other comprehensive income	11,617	12,204
Total equity	$ 581,329	$710,041

(1) Excludes derivative forward value and foreign currency adjustments. Unallocated net income at February 29, 2008 includes National Rural's obligation to absorb NCSC losses in excess of their equity balance totaling $1.6 million.
(2) Represents the derivative forward value loss recorded by National Rural for the period.

(12) Guarantees

The Company guarantees certain contractual obligations of its members so that they may obtain various forms of financing. With the exception of letters of credit, the underlying obligations may not be accelerated so long as the Company performs under its guarantee. At February 29, 2008 and May 31, 2007, the Company had recorded a guarantee liability totaling $14 million and $19 million, respectively, which represents the contingent and non-contingent exposure related to guarantees of members' debt obligations. The contingent guarantee liability at February 29, 2008 and May 31, 2007 totaled $9 million and $13 million, respectively, based on management's estimate of exposure to losses within the guarantee portfolio. The Company uses factors such as internal risk rating, remaining term of guarantee, corporate bond default probabilities and estimated recovery rates in estimating its contingent exposure. The remaining balance of the total guarantee liability of $5 million and $6 million, respectively, at February 29, 2008 and May 31, 2007 relates to the Company's non-contingent obligation to stand ready to perform over the term of its guarantees that it has entered into or modified since January 1, 2003 in accordance with FIN No. 45, Guarantor's Accounting and Disclosure Requirement for Guarantees, Including Indirect Guarantees of Indebtedness of Others (an interpretation of FASB Statements No. 5, 57, and 107 and rescission of FASB Interpretation No. 34). The non-contingent obligation is estimated based on guarantee fees collectible over the life of the guarantee. The fees are deferred and amortized using the straight-line method into interest income over the term of the guarantees.

Activity in the guarantee liability account is summarized below:

	For the nine months ended		Year ended
(in thousands)	February 29, 2008	February 28, 2007	May 31, 2007
Beginning balance	$ 18,929	$ 16,750	$ 16,750
Net change in non-contingent liability	(971)	1,527	3,879
	(4,300)	400	(1,700)

(Recovery of) provision for contingent guarantee losses			
Ending balance	$ 13,658	$ 18,677	$ 18,929
Liability as a percentage of total guarantees	1.29%	1.58%	1.76%

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The following chart summarizes total guarantees by type and segment:

(in thousands)	February 29, 2008	May 31, 2007
Total by type:		
Long-term tax exempt bonds (1)	$ 499,605	$ 526,185
Indemnifications of tax benefit transfers (2)	97,393	107,741
Letters of credit (3)	381,436	365,766
Other guarantees (4)	80,415	74,682
Total	$1,058,849	$1,074,374
Total by segment:		
National Rural:		
Distribution	$ 203,591	$ 211,320
Power supply	763,226	797,009
Statewide and associate	23,655	25,359
National Rural total	990,472	1,033,688
RTFC	260	-
NCSC	68,117	40,686
Total	$1,058,849	$1,074,374

(1) The maturities for this type of guarantee run through 2037. National Rural has guaranteed debt issued in connection with the construction or acquisition of pollution control, solid waste disposal, industrial development and electric distribution facilities. National Rural has unconditionally guaranteed to the holders or to trustees for the benefit of holders of these bonds the full principal, premium, if any, and interest on each bond when due. National Rural has debt service reserve funds in the amount of $55 million at February 29, 2008 and May 31, 2007 on deposit with the bond trustee that can only be used for the purpose of covering any deficiencies in the bond principal, premium or interest payments. The member systems have agreed to make up deficiencies in the debt service reserve funds for certain of these issues of bonds. In the event of default by a system for non-payment of debt service, National Rural is obligated to pay any required amounts under its guarantees, which will prevent the acceleration of the bond issue. The system is required to repay, on demand, any amount advanced by National Rural and interest thereon pursuant to the documents evidencing the system's reimbursement obligation.

Of the amounts shown above, $261 million and $277 million as of February 29, 2008 and May 31, 2007, respectively, are adjustable or floating/fixed rate bonds that may be converted to a fixed rate as specified in the indenture for each bond offering. During the variable rate period (including at the time of conversion to a fixed rate), National Rural has unconditionally agreed to purchase bonds tendered or put for redemption if the remarketing agents have not previously sold such bonds to other purchasers. National Rural's maximum potential exposure includes guaranteed principal and interest related to the bonds. In addition to these tax-exempt bonds, National Rural was the guarantor, but not liquidity provider, for $224 million of tax-exempt bonds that were in the auction rate mode at February 29, 2008 and May 31, 2007. National Rural is unable to determine the maximum amount of interest that it could be required to pay related to the adjustable, floating and auction rate bonds. As of February 29, 2008, National Rural's maximum potential exposure for the $15 million of fixed rate tax-exempt bonds is $22 million. Many of these bonds have a call provision that in the event of a default would allow National Rural to trigger the call provision. This would limit National Rural's exposure to future interest payments on these bonds. National Rural's maximum potential exposure is secured by a mortgage lien on all of the system's assets and future revenues. However, if the debt is accelerated because of a determination that the interest thereon is not tax-exempt, the system's obligation to reimburse National Rural for any guarantee payments will be treated as a long-term loan.

(2) The maturities for this type of guarantee run through 2015. National Rural has unconditionally guaranteed to lessors certain indemnity payments, which may be required to be made by the lessees in connection with tax benefit transfers. In the event of default by a system for non-payment of indemnity payments, National Rural is obligated to

pay any required amounts under its guarantees, which will prevent the acceleration of the indemnity payments. The member is required to repay any amount advanced by National Rural and interest thereon pursuant to the documents evidencing the system's reimbursement obligation. The amounts shown represent National Rural's maximum potential exposure for guaranteed indemnity payments. A member's obligation to reimburse National Rural for any guarantee payments would be treated as a long-term loan to the extent of any cash received by the member at the outset of the transaction. This amount is secured by a mortgage lien on substantially all of the system's assets and future revenues. The remainder would be treated as a short-term loan secured by a subordinated mortgage on substantially all of the member's property. Due to changes in federal tax law, no further guarantees of this nature are anticipated.
(3) The maturities for this type of guarantee run through 2017. Additionally, letters of credit totaling $6 million at February 29, 2008 have a term of one year and automatically extend for a period of one year unless the Company cancels the agreement within 120 days of maturity (in which case, the beneficiary may draw on the letter of credit). The Company issues irrevocable letters of credit to support members' obligations to energy marketers and other third parties and to the Rural Business and Cooperative Development Service with issuance fees as may be determined from time to time. Each letter of credit issued 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 the Company within one year from the date of the draw. Interest would accrue from the date of the draw at the line of credit variable rate of interest in effect on such date. The agreement also requires the member to pay, as applicable, a late payment charge and all costs of collection, including reasonable attorneys' fees. As of February 29, 2008, the Company's maximum potential exposure is $381 million, of which $239 million is secured. When taking into consideration reimbursement obligation agreements that National Rural has in place with other lenders, National Rural's maximum potential exposure related to $49 million of letters of credit would be reduced to $14 million in the event of default. Security provisions include a mortgage lien on substantially all of the system's assets, future revenues, and the system's commercial paper invested at the Company. In addition to the letters of credit listed in the table, under master letter of credit facilities, the Company may be required to issue up to an additional $402 million in letters of credit to third parties for the benefit of its members at February 29, 2008. At May 31, 2007, this amount was $339 million.
(4) The maturities for this type of guarantee run through 2025. National Rural provides other guarantees for its members. In the event of default by a system for non-payment of the obligation, National Rural must pay any required amounts under its guarantees, which will prevent the acceleration of the obligation. Such guarantees may be made on a secured or unsecured basis with guarantee fees set to cover National Rural's general and administrative expenses, a provision for losses and a reasonable margin. The member is required to repay any amount advanced by National Rural and interest thereon pursuant to the documents evidencing the system's reimbursement obligation. Of National Rural's maximum potential exposure for guaranteed principal and interest totaling $80 million at February 29, 2008, $3 million is secured by a mortgage lien on all of the system's assets and future revenues and the remaining $77 million is unsecured.

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

At February 29, 2008 and May 31, 2007, National Rural had a total of $219 million and $221 million of guarantees, respectively, representing 21% of total guarantees at each date under which its right of recovery from its members was not secured.

(13) Restructured /Non-performing Loans and Contingencies

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

(in thousands)	February 29, 2008	May 31, 2007	February 28, 2007
Non-performing loans	$ 504,375	$ 501,864	$ 541,510
Restructured loans	584,495	603,305	609,570
Total	$ 1,088,870	$ 1,105,169	$ 1,151,080

(a) At February 29, 2008, May 31, 2007 and February 28, 2007, all loans classified as non-performing were on non-accrual status with respect to the recognition of interest income. At February 29, 2008 and May 31, 2007, $526 million and $545 million, respectively, of restructured loans were on non-accrual status with respect to the recognition of interest income. At February 28, 2007, there were $551 million of restructured loans on non-accrual status. A total of $1 million and $3 million of interest income was accrued on restructured loans during the three and nine months, respectively, ended February 29, 2008 and February 28, 2007.

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

	Three months ended		Nine months ended	
(in thousands)	February 29, 2008	February 28, 2007	February 29, 2008	February 28, 2007
Non-performing loans	$ 8,166	$ 10,297	$25,893	$31,200
Restructured loans	8,168	9,828	26,479	29,640
Total	$ 16,334	$ 20,125	$52,372	$60,840

(b) The Company classified $1,083 million and $1,099 million of loans as impaired pursuant to the provisions of SFAS 114, Accounting by Creditors for Impairment of a Loan - an Amendment of SFAS 5 and SFAS 15, as amended, at February 29, 2008 and May 31, 2007, respectively. The Company reserved $317 million and $397 million of the loan loss allowance for such impaired loans at February 29, 2008 and May 31, 2007, respectively. The amount included in the loan loss allowance for such loans was based on a comparison of the present value of the expected future cash flow associated with the loan discounted at the original contract interest rate and/or the estimated fair value of the collateral securing the loan to the recorded investment in the loan. Impaired loans may be on accrual or non-accrual status with respect to the recognition of interest income based on a review of the terms of the restructure agreement and borrower performance. The Company accrued a total of $1 million and $3 million of interest income on impaired loans for the three and nine months ended February 29, 2008, respectively. The Company accrued a total of $1 million and $3 million of interest income on impaired loans for the three and nine months ended February 28, 2007, respectively. The average recorded investment in impaired loans for the nine months ended February 29, 2008 and February 28, 2007 was $1,088 million and $1,150 million, respectively.

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

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

(c) At February 29, 2008 and May 31, 2007, National Rural had a total of $526 million and $545 million, respectively, of restructured loans outstanding to Denton County Electric Cooperative, d/b/a CoServ Electric ("CoServ"), a large electric distribution cooperative located in Denton County, Texas, that provides retail electric service to residential and business customers. All restructured loans have been on non-accrual status since January 1, 2001. In addition, a total of $20 million was outstanding under the capital expenditure loan facility which was classified as a performing loan at both February 29, 2008 and May 31, 2007. Total loans to CoServ at February 29, 2008 and May 31, 2007 represented 2.8% and 2.9% respectively, of the Company's total loans and guarantees outstanding.

Under the terms of a bankruptcy settlement, National Rural restructured its loans to CoServ. CoServ is scheduled to make quarterly payments to National Rural through December 2037. As part of the restructuring, National Rural may be obligated to provide up to $204 million of senior secured capital expenditure loans to CoServ for electric distribution infrastructure through December 2012. When CoServ requests capital expenditure loans from National Rural, these loans are provided at the standard terms offered to all borrowers and require debt service payments in addition to the quarterly payments that CoServ is required to make to National Rural. As of February 29, 2008, a total of $20 million was outstanding to CoServ under this loan facility. To date, CoServ has made all payments required under the restructure agreement and capital expenditure loan facility. Under the terms of the restructure agreement, CoServ has the option to prepay the loan for $415 million plus an interest payment true up on or after December 13, 2007 and for $405 million plus an interest payment true up on or after December 13, 2008. National Rural has received no notice from CoServ that it intends to prepay the loan.

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

Based on its analysis, the Company believes that it is adequately reserved for its exposure to CoServ at February 29, 2008.

(d) VarTec Telecom, Inc. ("VarTec") was a telecommunications company and RTFC borrower located in Dallas, Texas. The Company was VarTec's principal senior secured creditor.

VarTec and 16 of its U.S.-based affiliates, which were guarantors of VarTec's debt to RTFC, filed voluntary petitions under Chapter 11 of the United States Bankruptcy Code on November 1, 2004 in Dallas, Texas. The cases were converted in 2006 to Chapter 7 proceedings, administered by a Chapter 7 trustee.

Non-performing loans at May 31, 2007 included $9 million to VarTec. On June 4, 2007, the Bankruptcy Court approval of a settlement of litigation against the Company became final, pursuant to which (a) all claims against the Company were dismissed with prejudice and fully released, (b) a portion of the proceeds from the collateral that had been provisionally applied to the Company’s secured debt was reallocated to VarTec creditors, including the Company, and (c) an administrative debtor-in-possession (“DIP”) financing facility owed by the VarTec bankruptcy estates to the Company was reduced to $6 million. The Company’s remaining DIP and unsecured claims will share in further recoveries by the bankruptcy estates. As a result of the settlement of the litigation, the Company wrote off $44 million of pre-petition debt during the fourth quarter of fiscal year 2007 and wrote off $17 million in the first quarter of fiscal year 2008.

On December 26, 2007, the Company received $3 million, which is a share of the settlement proceeds from the VarTec estates’ litigation against certain former directors and officers. At February 29, 2008, the Company had a receivable for $3 million, which has a payment priority from the bankruptcy estates; in addition, the Company will share in recoveries that are in excess of the amount required to repay the DIP financing and cover expenses of the estates.

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

As of February 29, 2008 and May 31, 2007, RTFC had $498 million and $493 million, respectively, in loans outstanding to ICC. Loans outstanding to ICC continue to increase due to accrued legal costs associated with ongoing litigation to recover the outstanding loan balance. All loans to ICC have been on non-accrual status since February 1, 2005. ICC has not made debt service payments to the Company since June 2005.

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

Beginning on June 1, 2004, RTFC filed a series of lawsuits against ICC, Prosser and others for failure to comply with the terms of ICC's loan agreement with RTFC dated August 27, 2001 as amended on April 4, 2003 (hereinafter, the "RTFC Lawsuits"). In response to the RTFC Lawsuits, ICC, Vitelco and Prosser denied liability and asserted claims, by way of

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counterclaim and by filing its own lawsuits against RTFC, National Rural and certain of RTFC's officers, seeking various remedies, including reformation of the loan agreement, injunctive relief, and damages. The remedies were based on various theories including a claim that RTFC breached an alleged funding obligation for the settlement of litigation brought by Emcom shareholders (the "Greenlight Entities") against ICC-LLC, ICC and some of ICC's directors, and a claim that Emcom and ICC-LLC were entitled to contribution from RTFC and National Rural in connection with judgments that the Greenlight Entities had been awarded (the "ICC Claims," together with the RTFC Lawsuits, the "Loan Litigation"). Venue of the Loan Litigation ultimately was fixed in the United States District Court for the District of the Virgin Islands.

On February 10, 2006, Greenlight filed petitions for involuntary bankruptcy against Prosser, Emcom and ICC-LLC in the United States Bankruptcy Court for the District of Delaware, later transferred to the United States District Court for the Virgin Islands, Bankruptcy Division. RTFC appeared in the proceedings as a party-in-interest in accordance with the provisions of the United States Bankruptcy Code.

On April 26, 2006, RTFC reached a settlement of the Loan Litigation with ICC, Vitelco, ICC-LLC, Emcom, their directors and Prosser, individually. Under the settlement, RTFC obtained entry of judgments in the District Court for the District of the Virgin Islands against ICC for approximately $525 million and Prosser for approximately $100 million. RTFC also obtained dismissals with prejudice of all counterclaims, affirmative defenses and other lawsuits alleging wrongful acts by RTFC, certain of its officers, and National Rural. Various parties also reached agreement for ICC to satisfy the RTFC judgments in the third quarter of calendar year 2006, subject to certain terms and conditions, however, on July 31, 2006, certain of the parties obligated to satisfy the RTFC judgments under the agreement filed voluntary bankruptcy proceedings, as described below, in order to obtain additional time to satisfy the judgments.

On July 31, 2006, ICC-LLC, Emcom and Prosser, individually, each filed a voluntary petition under Chapter 11 of the United States Bankruptcy Code, now pending in the United States District Court for the Virgin Islands, Division of St. Thomas and St. John, Bankruptcy Division. Each of the debtors is obligated to RTFC for certain obligations of ICC, including court judgments. On February 13, 2007, the Bankruptcy Court ordered the appointment of a Chapter 11 trustee for the ICC-LLC and Emcom bankruptcy estates and an examiner for Prosser’s bankruptcy estate.

On August 2, 2007, the Bankruptcy Court entered an order declaring that the debtors could not satisfy the RTFC judgments at a discount. Prosser, individually, has filed a notice of appeal of the order; none of the other debtors has sought review of the order.

On September 7, 2007, the Bankruptcy Court entered an order authorizing the Chapter 11 trustee for the Emcom bankruptcy estate to exercise control over the common stock of ICC, including authority to vote the stock to, among other things, facilitate a refinancing or sale of ICC and its assets.

On September 21, 2007, the United States District Court for the Virgin Islands, Bankruptcy Division, in response to an involuntary petition filed by the Greenlight Entities, entered an order for relief under Chapter 11 of the United States Bankruptcy Code thereby placing ICC in its own bankruptcy proceeding. In response to a motion by RTFC, the Bankruptcy Court ordered appointment of a Chapter 11 trustee on October 3, 2007. Certain parties have moved for reconsideration of and/or appealed one or more orders of the Bankruptcy Court and have requested a stay pending ruling by the District Court. RTFC believes both that the moving parties have no standing and that the motions to reconsider and appeal have no merit. Pending the appeal, the Chapter 11 trustee of ICC has assumed ownership and control of ICC, including its subsidiaries, and has begun to marshal RTFC collateral and other assets for disposition and eventual payment in respect of RTFC’s claims and the claims of other parties-in-interest. On January 2, 2008, the Chapter 11 trustee of ICC filed a motion seeking authority to sell substantially all of ICC’s assets, including stock in ICC’s operating subsidiaries. The Court has entered an order approving certain sale motions presented on February 1, 2008.

In response to a motion by the Greenlight Entities, joined by RTFC, the Bankruptcy Court converted Prosser's individual Chapter 11 bankruptcy to a Chapter 7 liquidation on October 3, 2007. Prosser has filed a notice of appeal of the conversion order. RTFC believes that the appeal has no merit. Pending the appeal, the Chapter 7 trustee has advised that he intends to marshal Prosser's non-exempt assets for disposition and eventual payment in respect of creditor claims. On December 3, 2007, the Chapter 7 trustee of Prosser's estate filed a motion to approve sale procedures and for authority to sell Prosser's controlling shares in the Virgin Islands Community Bank Corp. The sale has closed, with net proceeds of approximately $2.2 million.

In most cases, the sale (as part of the reorganization process) of ICC or any of its subsidiaries engaged in a regulated telecommunications or cable television business, or of the regulated assets of ICC or its subsidiaries, will require the prior consent of the respective regulators in the United States (including the Federal Communications Commission and the U.S. Virgin Islands Public Services Commission), the British Virgin Islands, France and its Caribbean territories, and the Netherlands Antilles. In certain limited cases, only a post-transaction notification will be required.

Based on its analysis, the Company believes that it is adequately reserved for its exposure to ICC at February 29, 2008.

(f) Pioneer Electric Cooperative, Inc. ("Pioneer") is an electric distribution cooperative located in Greenville, Alabama. Pioneer had also invested in a propane gas operation, which it has sold. Pioneer has experienced deterioration in its financial condition as a result of losses in the gas operation. At February 29, 2008 and May 31, 2007, National Rural had a total of $52 million in loans outstanding to Pioneer. Pioneer was current with respect to all debt service payments at February 29, 2008. All loans to Pioneer remain on accrual status with respect to the recognition of interest income. National Rural is the principal creditor to Pioneer.

On March 9, 2006, National Rural and Pioneer agreed on the terms of a debt modification that resulted in the loans being classified as restructured. Under the amended agreement, National Rural extended the maturity of the outstanding loans and granted a two-year deferral of principal payments. In addition, National Rural agreed to make available a line of credit for general corporate purposes. The restructured loans are secured by first liens on substantially all of the assets and revenues of Pioneer.

Based on its analysis, the Company believes that it is adequately reserved for its exposure to Pioneer at February 29, 2008.

(14) Segment Information

The Company's consolidated financial statements include the financial results of National Rural, RTFC and NCSC. Financial statements are produced for each of the three companies and are the primary reports that management reviews in evaluating performance. The National Rural segment includes the consolidation of entities controlled by National Rural and created to hold foreclosed assets and effect loan securitization transactions and intercompany transaction elimination entries. The segment presentation for the nine months ended February 29, 2008 and February 28, 2007 reflect the operating results of each of the three companies as a separate segment.

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

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

The following chart contains the consolidating statement of operations for the nine months ended February 29, 2008 and consolidating balance sheet information as of February 29, 2008.

(in thousands)	National Rural	RTFC	NCSC	Consolidated
Statement of Operations:				
Interest income	$ 702,284	$ 69,152	$ 26,381	$ 797,817
Interest expense	(633,472)	(65,041)	(22,297)	(720,810)
Net interest income	68,812	4,111	4,084	77,007
Recovery of loan losses	47,777	-	123	47,900
Net interest income after recovery of loan losses	116,589	4,111	4,207	124,907
Non-interest income:				
Rental and other income	604	-	466	1,070
Derivative cash settlements	30,572	-	(273)	30,299
Results of operations of foreclosed assets	6,217	-	-	6,217
Total non-interest income	37,393	-	193	37,586
Non-interest expense:				
General and administrative expenses	(36,719)	(3,792)	(2,816)	(43,327)
Recovery of guarantee liability	4,300	-	-	4,300
Market adjustment on foreclosed assets	(5,840)	-	-	(5,840)
Derivative forward value	(155,395)	-	(17,883)	(173,278)
Loss on sale of loans	(676)	-	-	(676)
Total non-interest expense	(194,330)	(3,792)	(20,699)	(218,821)
(Loss) income prior to income taxes and minority interest	(40,348)	319	(16,299)	(56,328)
Income taxes	-	(1)	6,187	6,186
Net (loss) income per segment reporting	$ (40,348)	$ 318	$ (10,112)	$ (50,142)
Reconciliation of net loss:				
Net loss per segment reporting				$ (50,142)
Minority interest, net of income taxes				8,211
Net loss per consolidated statement of operations				$ (41,931)
Assets:				
Total loans	$16,516,740	$1,727,344	$417,128	$18,661,212
Deferred origination fees	4,227	-	-	4,227
	(496,891)	-	(369)	(497,260)

Less: Allowance for loan losses				
Loans to members, net	16,024,076	1,727,344	416,759	18,168,179
Other assets	849,970	193,518	48,011	1,091,499
Total assets	$16,874,046	$1,920,862	$464,770	$19,259,678

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The following chart contains the consolidating statement of operations for the nine months ended February 28, 2007 and consolidating balance sheet information at February 28, 2007.

(in thousands)	National Rural	RTFC	NCSC	Consolidated
Statement of Operations:				
Interest income	$ 685,758	$ 81,070	$ 22,978	$ 789,806
Interest expense	(656,005)	(76,110)	(19,921)	(752,036)
Net interest income	29,753	4,960	3,057	37,770
Provision for loan losses	-	-	-	-
Net interest income after provision for loan losses	29,753	4,960	3,057	37,770
Non-interest income:				
Rental and other income	570	-	472	1,042
Derivative cash settlements	75,927	-	263	76,190
Results of operations of foreclosed assets	7,887	-	-	7,887
Total non-interest income	84,384	-	735	85,119
Non-interest expense:				
General and administrative expenses	(30,698)	(4,007)	(2,438)	(37,143)
Provision for guarantee liability	(400)	-	-	(400)
Derivative forward value	(116,654)	-	(4,125)	(120,779)
Foreign currency adjustments	(15,413)	-	-	(15,413)
Loss on sale of loans	(1,550)	-	-	(1,550)
Total non-interest expense	(164,715)	(4,007)	(6,563)	(175,285)
(Loss) income prior to income taxes and minority interest	(50,578)	953	(2,771)	(52,396)
Income taxes	-	(479)	1,052	573
Net (loss) income per segment reporting	$ (50,578)	$ 474	$ (1,719)	$ (51,823)
Reconciliation of net loss:				
Net loss per segment reporting				$ (51,823)
Minority interest				1,244
Net loss per consolidated statement of operations				$ (50,579)
Assets:				
Loans to members	$15,556,390	$1,929,552	$342,646	$17,828,588
Deferred origination fees	3,353	-	-	3,353
Less: Allowance for loan losses	(610,778)	-	(588)	(611,366)

Loans to members, net	14,948,965	1,929,552	342,058	17,220,575
Other assets	1,466,705	221,327	32,437	1,720,469
Total assets	$16,415,670	$2,150,879	$374,495	$18,941,044

The following chart contains the consolidating statement of operations for the three months ended February 29, 2008.

(in thousands)	National Rural	RTFC	NCSC	Consolidated
Statement of Operations:				
Interest income	$ 236,494	$ 21,786	$ 8,296	$ 266,576
Interest expense	(206,308)	(20,490)		