

NATIONAL RURAL UTILITIES COOPERATIVE FINANCE CORP /DC/  
Form 10-Q  
April 14, 2010

---

---

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

FORM 10-Q

- QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d)  
OF THE SECURITIES EXCHANGE ACT OF 1934  
For the Quarterly Period Ended February 28, 2010

OR

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

Commission File Number 1-7102

NATIONAL RURAL UTILITIES COOPERATIVE  
FINANCE CORPORATION

(Exact name of registrant as specified in its charter)

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

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

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

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

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

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

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

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

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

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

## PART 1. FINANCIAL INFORMATION

## Item 1. Financial Statements.

## NATIONAL RURAL UTILITIES COOPERATIVE FINANCE CORPORATION

## CONSOLIDATED BALANCE SHEETS

(in thousands)

## A S S E T S

|  | (UNAUDITED)<br>February 28,<br>2010 | May 31,<br>2009 |
|--|-------------------------------------|-----------------|
| Cash and cash equivalents              | \$ 380,291}                         | \$ 504,999      |
| Restricted cash                        | 16,173}                             | 8,207           |
| Investments in equity securities       | 58,220}                             | 47,000          |
| Loans to members                       | 19,461,785}                         | 20,192,309      |
| Less: Allowance for loan losses        | (618,498)                           | (622,960)       |
| Loans to members, net                  | 18,843,287}                         | 19,569,349      |
| Accrued interest and other receivables | 226,490}                            | 260,428         |
| Fixed assets, net                      | 51,223}                             | 43,162          |
| Debt service reserve funds             | 45,662}                             | 46,662          |
| Bond issuance costs, net               | 48,639}                             | 50,414          |
| Foreclosed assets, net                 | 45,929}                             | 48,721          |
| Derivative assets                      | 373,814}                            | 381,356         |
| Other assets                           | 19,826}                             | 22,407          |
|  | \$ 20,109,554}                      | \$20,982,705    |

See accompanying notes.



## NATIONAL RURAL UTILITIES COOPERATIVE FINANCE CORPORATION

## CONSOLIDATED BALANCE SHEETS

(in thousands)

## LIABILITIES AND EQUITY

|  | (UNAUDITED)<br>February 28,<br>2010 | May 31,<br>2009 |
|--|-------------------------------------|-----------------|
| Short-term debt                              | \$ 4,250,558}                       | \$ 4,867,864    |
| Accrued interest payable                     | 310,571}                            | 249,601         |
| Long-term debt                               | 12,282,807}                         | 12,720,055      |
| Deferred income                              | 18,546}                             | 18,962          |
| Guarantee liability                          | 25,691}                             | 29,672          |
| Other liabilities                            | 50,134}                             | 32,955          |
| Derivative liabilities                       | 461,030}                            | 493,002         |
| Subordinated deferrable debt                 | 311,440}                            | 311,440         |
| Members' subordinated certificates:          |                                     |                 |
| Membership subordinated certificates         | 643,148}                            | 642,960         |
| Loan and guarantee subordinated certificates | 787,463}                            | 818,999         |
| Member capital securities                    | 397,850}                            | 278,095         |
| Total members' subordinated certificates     | 1,828,461}                          | 1,740,054       |
| Commitments and contingencies                |                                     |                 |
| CFC equity:                                  |                                     |                 |
| Retained equity                              | 551,694}                            | 500,823         |
| Accumulated other comprehensive income       | 7,772}                              | 8,115           |
| Total CFC equity                             | 559,466}                            | 508,938         |
| Noncontrolling interest                      | 10,850}                             | 10,162          |
| Total equity                                 | 570,316}                            | 519,100         |
|  | \$ 20,109,554}                      | \$20,982,705    |

See accompanying notes.

## NATIONAL RURAL UTILITIES COOPERATIVE FINANCE CORPORATION

CONSOLIDATED STATEMENTS OF OPERATIONS  
(UNAUDITED)  
(in thousands)

|  | Three months ended<br>February 28, |            | Nine months ended<br>February 28, |            |
|--|------------------------------------|------------|-----------------------------------|------------|
|  | 2010                               | 2009       | 2010                              | 2009       |
| Interest income  | \$ 256,519}                        | \$ 268,453 | \$ 790,895}                       | \$ 798,316 |
| Interest expense   | (221,898)                          | (239,744)  | (691,504)                         | (694,080)  |
| Net interest income  | 34,621}                            | 28,709     | 99,391}                           | 104,236    |
| (Provision for) recovery of<br>loan losses                                     | (10,000)                           | 10,415     | 4,594}                            | (126,577)  |
| Net interest income (loss)<br>after (provision for) recovery<br>of loan losses | 24,621}                            | 39,124     | 103,985}                          | (22,341)   |
| Non-interest income:   |                                    |            |                                   |            |
| Fee and other income   | 5,638}                             | 3,200      | 13,478}                           | 9,519      |
| Settlement income  | 22,906}                            | -          | 22,906}                           | -          |
| Derivative gains (losses)  | 22,571}                            | 50,966     | 5,099}                            | (86,511)   |
| Results of operations of<br>foreclosed assets                                  | 338}                               | 801        | 946}                              | 3,258      |
| Total non-interest income  | 51,453}                            | 54,967     | 42,429}                           | (73,734)   |
| Non-interest expense:  |                                    |            |                                   |            |
| Salaries and employee<br>benefits  | (9,286)                            | (10,036)   | (28,970)                          | (29,799)   |
| Other general and<br>administrative expenses                                   | (8,840)                            | (6,430)    | (22,598)                          | (16,354)   |
| (Provision for) recovery<br>of guarantee liability                             | (451)                              | (338)      | 2,765}                            | (5,319)    |
| Market adjustment on<br>foreclosed assets                                      | (988)                              | (1,652)    | (2,738)                           | (1,805)    |
| Other  | (111)                              | (372)      | (432)                             | (670)      |
| Total non-interest expense   | (19,676)                           | (18,828)   | (51,973)                          | (53,947)   |
| Income (loss) prior to income<br>taxes   | 56,398}                            | 75,263     | 94,441}                           | (150,022)  |

Edgar Filing: NATIONAL RURAL UTILITIES COOPERATIVE FINANCE CORP /DC/ - Form 10-Q

|   |            |           |            |             |
|---|------------|-----------|------------|-------------|
| Income tax (expense) benefit  | (1,465)    | (183)     | (656)      | 6,977       |
| Net income (loss)   | 54,933}    | 75,080    | 93,785}    | (143,045)   |
| Less: Net (income) loss attributable to the noncontrolling interest | (2,130)    | 159       | (753)      | 3,138       |
| Net income (loss) attributable to CFC                               | \$ 52,803} | \$ 75,239 | \$ 93,032} | \$(139,907) |

See accompanying notes.



## NATIONAL RURAL UTILITIES COOPERATIVE FINANCE CORPORATION

## CONSOLIDATED STATEMENT OF CHANGES IN EQUITY

(UNAUDITED)

(in thousands)

|                                       | Noncontrolling |            | Accumulated            |                                  |                           | Unallocated<br>Net Loss | Members'<br>Capital<br>Reserve | Patronage<br>Capital<br>Allocated | Membership<br>Fees and<br>Education<br>Fund |
|---------------------------------------|----------------|------------|------------------------|----------------------------------|---------------------------|-------------------------|--------------------------------|-----------------------------------|---|
|                                       | Total          | Interest   | Total<br>CFC<br>Equity | Other<br>Comprehensive<br>Income | CFC<br>Retained<br>Equity |                         |                                |                                   |   |
| Balance as of<br>May 31, 2009         | \$ 519,100}    | \$ 10,162} | \$ 508,938}            | \$ 8,115}                        | \$ 500,823}               | \$ (109,691)            | \$ 187,098}                    | \$ 420,834}                       | \$ 2,582}                                   |
| Patronage<br>capital<br>retirement    | (41,400)       | -}         | (41,400)               | -}                               | (41,400)                  | -}                      | -}                             | (41,400)                          | -}  |
| Net income                            | 93,785}        | 753}       | 93,032}                | -}                               | 93,032}                   | 93,032}                 | -}                             | -}                                | -}  |
| Other<br>comprehensive<br>loss        | (364)          | (21)       | (343)                  | (343)                            | -}                        | -}                      | -}                             | -}                                | -}  |
| Total<br>comprehensive<br>income      | 93,421}        | 732}       | 92,689}                | -}                               | (761)                     | -}                      | -}                             | -}                                | (761)                                       |
| Other                                 | (805)          | (44)       | (761)                  | -}                               | (761)                     | -}                      | -}                             | -}                                | (761)                                       |
| Balance as of<br>February 28,<br>2010 | \$ 570,316}    | \$ 10,850} | \$ 559,466}            | \$ 7,772}                        | \$ 551,694}               | \$ (16,659)             | \$ 187,098}                    | \$ 379,434}                       | \$ 1,821}                                   |

See accompanying notes.

## NATIONAL RURAL UTILITIES COOPERATIVE FINANCE CORPORATION

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

|   | Nine months ended February 28, |              |
|---|--------------------------------|--------------|
|   | 2010                           | 2009         |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES</b>   |                                |              |
| Net income (loss)   | \$ 93,785}                     | \$ (143,045) |
| Adjustments to reconcile net income (loss) to net cash provided by operating activities |                                |              |
| Amortization of deferred income   | (5,901)                        | (4,757)      |
| Amortization of bond issuance costs and deferred charges                                | 16,313}                        | 8,060        |
| Depreciation  | 1,533}                         | 1,710        |
| (Recovery of) provision for loan losses   | (4,594)                        | 126,577      |
| (Recovery of) provision for guarantee liability   | (2,765)                        | 5,319        |
| Results of operations of foreclosed assets  | (946)                          | (3,258)      |
| Market adjustment on foreclosed assets  | 2,738}                         | 1,805        |
| Derivative forward value  | (24,935)                       | 203,457      |
| Purchases of trading securities   | -}                             | (71,405)     |
| Sales of trading securities   | -}                             | 59,870       |
| Changes in operating assets and liabilities:  |                                |              |
| Accrued interest and other receivables  | 22,798}                        | (15,039)     |
| Accrued interest payable  | 60,970}                        | 104,714      |
| Other   | 10,176}                        | 23,920       |
| Net cash provided by operating activities   | 169,172}                       | 297,928      |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>  |                                |              |
| Advances made on loans  | (5,145,820)                    | (7,508,239)  |
| Principal collected on loans  | 5,809,639}                     | 6,360,213    |
| Net investment in fixed assets  | (9,594)                        | (16,339)     |
| Net cash provided by foreclosed assets  | 1,000}                         | 6,000        |
| Net proceeds from sale of loans   | 66,531}                        | -            |
| Investments in equity securities  | (11,092)                       | (35,000)     |
| Change in restricted cash   | (7,966)                        | 6,768        |
| Net cash provided by (used in) investing activities                                     | 702,698}                       | (1,186,597)  |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>  |                                |              |

Edgar Filing: NATIONAL RURAL UTILITIES COOPERATIVE FINANCE CORP /DC/ - Form 10-Q

|   |             |             |
|---|-------------|-------------|
| Repayments of short-term debt, net                            | (300,834)   | (136,883)   |
| Proceeds from issuance of long-term debt, net                 | 1,621,307}  | 4,341,725   |
| Payments for retirement of long-term debt                     | (2,379,170) | (3,130,886) |
| Proceeds from issuance of members' subordinated certificates  | 149,005}    | 187,603     |
| Payments for retirement of members' subordinated certificates | (47,446)    | (17,402)    |
| Payments for retirement of patronage capital                  | (39,440)    | (80,150)    |
| Net cash (used in) provided by financing activities           | (996,578)   | 1,164,007   |
| NET (DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS          | (124,708)   | 275,338     |
| BEGINNING CASH AND CASH EQUIVALENTS                           | 504,999}    | 177,809     |
| ENDING CASH AND CASH EQUIVALENTS                              | \$ 380,291} | \$ 453,147  |

See accompanying notes.

NATIONAL RURAL UTILITIES COOPERATIVE FINANCE CORPORATION

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

Nine months ended February 28,  
2010 2009

SUPPLEMENTAL DISCLOSURE OF CASH  
FLOW INFORMATION:

|  |            |            |
|--|------------|------------|
| Cash paid for interest   | \$ 614,221 | \$ 581,876 |
| Cash paid for income taxes   | 206        | 31         |
| Non-cash financing and investing activities:                                 |            |            |
| Subordinated certificates applied against loan balances                      | \$ -       | \$ 1,447   |
| Patronage capital applied against loan balances                              | -          | 81         |
| Membership fee applied against loan balances                                 | 1          | -          |
| Net decrease in debt service reserve funds/debt service reserve certificates | (1,000)    | (7,354)    |
| Noncontrolling interest patronage capital applied against loan balances      | -          | 29         |

See accompanying notes.

NATIONAL RURAL UTILITIES COOPERATIVE FINANCE CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(UNAUDITED)

(1) General Information and Accounting Policies

(a) General Information

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

Rural Telephone Finance Cooperative ("RTFC") was incorporated as a cooperative association in the state of South Dakota in September 1987. In February 2005, RTFC reincorporated as a member-owned cooperative association in the District of Columbia. RTFC's principal purpose is to provide and arrange financing for its rural telecommunications members and their affiliates. As a member owned cooperative, RTFC's objective is not to maximize its net income, but to offer its members financial products and services at the lowest cost that is consistent with sound financial management. RTFC's results of operations and financial condition are consolidated with CFC in the accompanying financial statements. RTFC is headquartered with CFC 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 member-owned cooperative association. NCSC's principal purpose is to provide financing to the for-profit or non-profit entities that are owned, operated or controlled by or provide substantial benefit to, members of CFC. As a member-owned cooperative, its objective is not to maximize its net income, but to offer its members financial products and services at the lowest cost that is consistent with sound financial management. NCSC's membership consists of CFC and distribution systems that are members of CFC or are eligible for such membership. NCSC's results of operations and financial condition are consolidated with those of CFC in the accompanying financial statements. NCSC is headquartered with CFC in Herndon, Virginia. NCSC is a taxable corporation.

At February 28, 2010, we had 1,461 members and 59 associates. Our membership includes the following:

- 832 distribution systems;
- 68 power supply systems;
- 495 telecommunications members; and
  - 66 service members.

Associates are eligible to borrow, however, they are not eligible to vote on matters submitted to the membership for approval. Our members and associates are located in 49 states, the District of Columbia and two U.S. territories. Memberships between CFC, RTFC and NCSC have been eliminated in consolidation. All references to members within this document include members and associates.

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

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

(b) Principles of Consolidation

The accompanying financial statements include the consolidated accounts of CFC, RTFC and NCSC and certain entities created and controlled by CFC to hold foreclosed assets and accommodate loan securitization transactions, after elimination of intercompany accounts and transactions. We are required to consolidate the financial results of RTFC and NCSC because

we are the primary beneficiary of variable interests in RTFC and NCSC due to our exposure to absorbing the majority of expected losses.

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

CFC 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 lending programs either through loans from CFC or commercial paper and long-term notes issued by NCSC and guaranteed by CFC. In connection with these guarantees, NCSC must pay a guarantee fee and purchase from CFC interest-bearing subordinated term certificates in proportion to the related guarantee. Under a guarantee agreement, NCSC pays CFC a fee to reimburse NCSC for its loan losses, excluding losses in the consumer loan program. All loans that require NCSC board approval also require CFC approval. CFC controls the nomination process for one out of 11 NCSC directors. NCSC members elect directors to the NCSC board based on one vote for each member. NCSC is a service organization member of CFC.

RTFC and NCSC creditors have no recourse against CFC in the event of a default by RTFC and NCSC, unless there is a guarantee agreement under which CFC has guaranteed NCSC or RTFC debt obligations to a third party. At February 28, 2010, CFC had guaranteed \$319 million of NCSC debt, derivative instruments and guarantees with third parties. The maturities for NCSC obligations guaranteed by CFC run through 2031. At February 28, 2010, CFC's maximum potential exposure totaled \$334 million for guarantees of NCSC debt, derivatives and guarantees with third parties. Guarantees related to NCSC debt and derivative instruments are not included in Note 10, Guarantees at February 28, 2010 as the debt and derivatives are reported on the consolidated balance sheet. At February 28, 2010, CFC guaranteed \$0.6 million of RTFC guarantees with third parties. The maturities for RTFC obligations guaranteed by CFC run through 2011. All CFC loans to RTFC and NCSC are secured by all assets and revenues of RTFC and NCSC. At February 28, 2010, RTFC had total assets of \$1,879 million including loans outstanding to members of \$1,703 million and NCSC had total assets of \$398 million including loans outstanding of \$356 million. At February 28, 2010, CFC had committed to lend RTFC up to \$4 billion of which \$1,691 million was outstanding. At February 28, 2010, CFC had committed to provide up to \$1.5 billion of credit to NCSC of which \$447 million was outstanding, representing \$128 million of outstanding loans and \$319 million of credit enhancements.

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

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

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

(c) Use of Estimates

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

(d) Reclassifications

Reclassifications of prior period amounts have been made to conform to the current reporting format and the presentation in our Form 10-K for the year ended May 31, 2009. Fees and other income totaling \$3 million and \$9 million for the three and nine months ended February 28, 2009, respectively, have been reclassified from interest income to the fee and other income line of non-interest income on the consolidated statements of operations to conform with the February 28, 2010 presentation. Other expense totaling \$0.4 million and \$0.6 million for the three and nine months ended February 28, 2009, respectively, has been



reclassified from interest expense to the other expense line item in non-interest expense on the consolidated statements of operations to conform with the February 28, 2010 presentation.

To conform with the February 28, 2010 presentation, derivative forward value loss totaling \$53 million and \$203 million and derivative cash settlements gain totaling \$104 million and \$117 million for the three and nine months ended February 28, 2009, respectively, have been reclassified to derivative gains (losses) in non-interest income on the consolidated statements of operations. The derivative forward value was classified in non-interest expense and the derivative cash settlements were classified in non-interest income in the February 28, 2009 10-Q. These reclassifications were made to present the unrealized and realized gains and losses on our derivatives in the same line on the statement of operations.

(e) Interest Income

Interest income on loans is recognized using the effective interest method.

The following table presents the components of interest income:

| (dollar amounts in thousands)                 | For the three months ended<br>February 28, |            | For the nine months ended<br>February 28, |            |
|---|--|------------|---|------------|
|   | 2010                                       | 2009       | 2010                                      | 2009       |
| Interest on long-term fixed rate loans (1)    | \$ 224,201 }                               | \$ 220,791 | \$ 673,277 }                              | \$ 669,454 |
| Interest on long-term variable rate loans (1) | 15,964 }                                   | 27,035     | 64,215 }                                  | 60,684     |
| Interest on short-term loans (1)              | 13,612 }                                   | 18,208     | 44,288 }                                  | 58,654     |
| Interest on investments (2)                   | 1,328 }                                    | 990        | 4,314 }                                   | 4,615      |
| Fee income                                    | 1,414 }                                    | 1,429      | 4,801 }                                   | 4,909      |
| Total interest income                         | \$ 256,519 }                               | \$ 268,453 | \$ 790,895 }                              | \$ 798,316 |

(1) Represents interest income on loans to members.

(2) Represents interest income on the investment of cash and trading securities.

Deferred income on the consolidated balance sheets is comprised primarily of deferred conversion fees totaling \$13 million and \$16 million at February 28, 2010 and May 31, 2009, respectively.

(f) Interest Expense

The following table presents the components of interest expense:

| (dollar amounts in thousands)       | For the three months ended<br>February 28, |            | For the nine months ended<br>February 28, |            |
|-------------------------------------|--|------------|---|------------|
|                                     | 2010                                       | 2009       | 2010                                      | 2009       |
| Interest expense (1):               |  |            |   |            |
| Commercial paper and bank bid notes | \$ 1,114 }                                 | \$ 13,424  | \$ 6,300 }                                | \$ 53,500  |
| Medium-term notes                   | 64,683 }                                   | 80,503     | 215,180 }                                 | 242,016    |
| Collateral trust bonds              | 80,618 }                                   | 80,111     | 240,796 }                                 | 211,066    |
| Subordinated deferrable debt        | 4,916 }                                    | 4,916      | 14,747 }                                  | 14,747     |
| Subordinated certificates           | 20,064 }                                   | 13,475     | 58,871 }                                  | 38,723     |
| Long-term private debt              | 45,588 }                                   | 41,146     | 139,142 }                                 | 119,501    |
| Debt issuance costs (2)             | 2,676 }                                    | 2,692      | 8,281 }                                   | 7,218      |
| Fee expense (3)                     | 2,239 }                                    | 3,477      | 8,187 }                                   | 7,309      |
| Total interest expense              | \$ 221,898 }                               | \$ 239,744 | \$ 691,504 }                              | \$ 694,080 |

(1) Represents interest expense and the amortization of discounts on debt.

(2) Includes amortization of all deferred charges related to the issuance of debt, principally underwriter's fees, legal fees, printing costs and comfort letter fees. Amortization is calculated utilizing the effective interest method. Also includes issuance costs related to dealer commercial paper which are expensed as incurred

(3) Includes various fees related to funding activities, including fees paid to banks participating in our revolving credit agreements. Fees are expensed as incurred or amortized on a straight-line basis over the life of the respective agreement.

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

(g) Settlement Income

On February 25, 2010, CoBank, ACB, a government-sponsored enterprise that lends to agribusinesses and rural utilities throughout the United States, agreed to a settlement relating to our discovery that for a period of years, CoBank, ACB employees improperly accessed confidential and proprietary information from our password-protected, web-based "Extranet". The settlement included a monetary payment of \$23 million to us as well as non-monetary commitments, including an agreement not to engage in the challenged conduct in the future. The settlement income, classified as non-interest income on the statement of operations, is net of legal and other related expenses.

(h) Loan Sales

During the nine months ended February 28, 2010, we sold distribution loans with outstanding principal balances totaling \$67 million to the Federal Agricultural Mortgage Corporation. We received \$67 million of cash in exchange for the loans, which represents the full principal amount of the loans sold. We had less than \$1 million of unamortized deferred loan origination costs for the loans sold, which was recorded as a loss on sale of loans. We do not hold any continuing interest in the loans sold and have no obligation to repurchase loans from the purchaser, however, we retain the servicing rights on these loans in return for a market fee.

(i) Debt Service Reserve Fund

At February 28, 2010 and May 31, 2009, we had \$46 million and \$47 million of amounts pledged to the trustee for our members' obligations to repay tax-exempt bonds, for which we are the guarantor. The member cooperatives are required to purchase debt service reserve subordinated certificates as a condition to obtaining the guarantee. We are required to pledge the proceeds from the members' purchase of the debt service reserve subordinated certificates to the trustee.

If there is a deficiency in the bond payment due from the member, the trustee will first use the pledged amounts in the debt service reserve fund to make up the deficiency. If there is still a deficiency after the debt service reserve fund amount is used, then we are required to perform under our guarantee. The member cooperatives are required to make up any deficiency in the debt service reserve fund. There were no deficiencies in the debt service reserve fund at February 28, 2010 or May 31, 2009. Earnings on the debt service reserve fund inure to the benefit of the member cooperatives but are pledged to the trustee and used to reduce the periodic interest payments due from the member cooperatives.

During the nine-month period ended February 28, 2010, \$20 million of guaranteed bonds requiring a debt service reserve fund were fully repaid and no new guarantees requiring a debt service reserve fund were made. This resulted in a net reduction of \$1 million to the debt service reserve fund and member investments in debt service reserve subordinated certificates. During the nine month period ended February 28, 2009, \$80 million of guaranteed bonds requiring a debt service reserve fund were fully repaid and \$51 million of new guarantees requiring a debt service reserve fund were made. This resulted in a net reduction of \$7.4 million to the debt service reserve fund and member investments in debt service reserve subordinated certificates. At maturity, the trustee uses the debt service reserve fund to repay the bonds reducing the amount that the member must pay. The member is obligated to replenish the debt service reserve fund so that the trustee can return the pledged funds to us since the guaranteed tax-exempt bonds have been repaid. We offset our requirement to repay the member the amount of the debt service reserve subordinated certificate against our right to collect the amount of the debt service reserve fund from the trustee. As a result, the member's obligation to replenish the debt service reserve fund is met. The reduction to the debt service reserve fund and the debt service reserve subordinated certificates on our consolidated balance sheet are offsetting and disclosed as a non-cash transaction in the consolidated statement of cash flows. At inception of the guarantee transaction, the trustee sets aside the required debt service reserve fund amount out of the bond proceeds to be held as the asset

pledged by CFC. CFC records a liability for the member's investment in debt service reserve subordinated certificates and records an asset for the debt service reserve fund. Since the trustee holds the cash out of the proceeds, the increase to the debt service reserve fund and increase to the debt service reserve subordinated certificates are disclosed as a non-cash transaction in the consolidated statement of cash flows.

## (2) Investments in Equity Securities

Our investments in equity securities at February 28, 2010 and May 31, 2009 include the Federal Agricultural Mortgage Corporation Series C preferred stock totaling \$58 million and \$32 million, respectively. At May 31, 2009, our investments in equity securities also included the Federal Agricultural Mortgage Corporation Series B-1 preferred stock totaling \$15 million. On January 25, 2010, the Federal Agricultural Mortgage Corporation repurchased and retired its \$15 million Series B-1 preferred stock at par plus the pro-rata dividends calculated through the repurchase date. The preferred stock is valued at original cost. At February 28, 2010, our investments in equity securities also include investments in the Federal Agricultural Mortgage Corporation Series A common stock totaling less than \$1 million, which is accounted for as available-for-sale securities and recorded in the consolidated balance sheets at fair value.

## (3) Loans and Commitments

We are a cost-plus lender that offers long-term fixed and variable-rate loans and short-term variable-rate loans. On long-term loans, borrowers choose between a variable interest rate or a fixed interest rate for periods of one to 35 years. When a selected fixed interest rate term expires, the borrower may select another fixed-rate term or the variable rate. Unadvanced commitments are loan contracts that have been approved and executed, but for which the funds have not yet been advanced. It would be unlikely for our members to draw all of their unadvanced commitments in the near term because of the nature of our members' multi-year work plans, the amount of cash generated from customers invoices to cover operating cash flow needs, and the expiration date of the draw period for the unadvanced commitments (generally within five years of the first advance on a loan). Since commitments may expire without being fully drawn upon, a significant amount are for standby liquidity purposes, and some may have preconditions to advance funds that have not been met by borrowers, as a result, the total unadvanced loan commitments do not necessarily represent our future cash requirements.

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

| (dollar amounts in thousands)     | February 28, 2010 |                        | May 31, 2009      |                        |
|-----------------------------------|-------------------|------------------------|-------------------|------------------------|
|                                   | Loans Outstanding | Unadvanced Commitments | Loans Outstanding | Unadvanced Commitments |
| Total by loan type (1) (2):       |                   |                        |                   |                        |
| Long-term fixed-rate loans (3)    | \$ 15,363,157}    | \$ -}                  | \$ 14,602,365}    | \$ -}                  |
| Long-term variable-rate loans (3) | 2,201,954}        | 5,322,968}             | 3,243,716}        | 5,609,977}             |
| Loans guaranteed by RUS (4)       | 238,423}          | -}                     | 243,997}          | -}                     |
| Short-term loans                  | 1,654,402}        | 8,374,805}             | 2,098,129}        | 7,941,146}             |
| Total loans outstanding           | 19,457,936}       | 13,697,773}            | 20,188,207}       | 13,551,123}            |
| Deferred origination costs        | 3,849}            | -}                     | 4,102}            | -}                     |
| Less: Allowance for loan losses   | (618,498)}        | -}                     | (622,960)}        | -}                     |
| Net loans outstanding             | \$ 18,843,287}    | \$ 13,697,773}         | \$ 19,569,349}    | \$ 13,551,123}         |
| Total by segment (1):             |                   |                        |                   |                        |
| CFC:                              |                   |                        |                   |                        |
| Distribution                      | \$ 13,523,257}    | \$ 9,328,381}          | \$ 13,730,511}    | \$ 9,472,849}          |

Edgar Filing: NATIONAL RURAL UTILITIES COOPERATIVE FINANCE CORP /DC/ - Form 10-Q

|                         |                |                |               |               |
|-------------------------|----------------|----------------|---------------|---------------|
| Power supply            | 3,792,196}     | 3,489,313}     | 4,268,244     | 3,178,471     |
| Statewide and associate | 84,268}        | 119,595}       | 92,578        | 152,701       |
| CFC total               | 17,399,721}    | 12,937,289}    | 18,091,333    | 12,804,021    |
| RTFC                    | 1,702,640}     | 444,930}       | 1,680,154     | 457,022       |
| NCSC                    | 355,575}       | 315,554}       | 416,720       | 290,080       |
| Total loans             | \$ 19,457,936} | \$ 13,697,773} | \$ 20,188,207 | \$ 13,551,123 |

outstanding

(1) Includes non-performing and restructured loans.

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

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

(4) "RUS" is the Rural Utilities Service.

## Non-Performing and Restructured Loans

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

| (dollar amounts in thousands)          | February 28, 2010 |                            | May 31, 2009      |                            |
|--|-------------------|----------------------------|-------------------|----------------------------|
|  | Loans Outstanding | Unadvanced Commitments (1) | Loans Outstanding | Unadvanced Commitments (1) |
| Non-performing and restructured loans: |                   |                            |                   |                            |
| Non-performing loans (2):              |                   |                            |                   |                            |
| RTFC:                                  |                   |                            |                   |                            |
| Long-term fixed-rate loans             | \$ 8,960}         | \$ -}                      | \$ 8,960          | \$ -                       |
| Long-term variable-rate loans          | 457,418}          | -}                         | 457,504           | -                          |
| Short-term loans                       | 57,471}           | -}                         | 57,294            | -                          |
| Total non-performing loans             | \$ 523,849}       | \$ -}                      | \$ 523,758        | \$ -                       |
| Restructured loans (2):                |                   |                            |                   |                            |
| CFC:                                   |                   |                            |                   |                            |
| Long-term fixed-rate loans (3)         | \$ 41,633}        | \$ -}                      | \$ 41,907         | \$ -                       |
| Long-term variable-rate loans (3)      | 469,505}          | 140,755}                   | 490,827           | 186,673                    |
| Short-term loans                       | -}                | 12,500}                    | -                 | 12,500                     |
| CFC total restructured loans           | 511,138}          | 153,255}                   | 532,734           | 199,173                    |
| RTFC:                                  |                   |                            |                   |                            |
| Long-term fixed-rate loans             | 3,446}            | -}                         | 4,853             | -                          |
| Long-term variable rate loans          | 854}              | -}                         | -                 | -                          |
| Total restructured loans               | \$ 515,438}       | \$ 153,255}                | \$ 537,587        | \$ 199,173                 |

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

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

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

## Loan Loss Allowance

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

Activity in the loan loss allowance account is summarized below:

| (dollar amounts in thousands)              | As of and for the three<br>months<br>ended February 28, |            | As of and for the nine<br>months<br>ended February 28, |            |
|--|---|------------|--|------------|
|  | 2010  | 2009       | 2010   | 2009       |
| Balance at beginning of period             | \$608,458 }   | \$ 648,946 | \$622,960 }  | \$ 514,906 |
| Provision for (recovery of)<br>loan losses | 10,000 }  | (10,415)   | (4,594)  | 126,577    |
| Charge-offs                                | (23)  | (55)       | (79)   | (3,173)    |
| Recoveries                                 | 63 }  | 107        | 211 }  | 273        |
| Balance at end of period                   | \$618,498 }   | \$ 638,583 | \$618,498 }  | \$ 638,583 |
| As a percentage of total loans outstanding | 3.18%   | 3.17%      | 3.18%  | 3.17%      |

#### Loan Security

Except when providing short-term loans, we typically lend to our members on a senior secured basis. Long-term loans are typically secured on parity with other secured lenders (primarily the Rural Utilities Service), if any, by all assets and revenues of the borrower with exceptions typical in utility mortgages. Short-term loans are generally unsecured lines of credit. In addition to the collateral received, our member borrowers are also required to set rates charged to their customers to achieve certain financial ratios as required by loan covenants.



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

| (dollar amounts in thousands) | February 28, 2010     |           |                      |           | May 31, 2009         |           |                     |           |
|-------------------------------|-----------------------|-----------|----------------------|-----------|----------------------|-----------|---------------------|-----------|
| <b>Total by loan type:</b>    | Secured               | %         | Unsecured            | %         | Secured              | %         | Unsecured           | %         |
| Long-term fixed-rate loans    | \$ 14,757,501}        | 96%       | \$ 605,656}          | 4%        | \$ 14,044,469        | 96%       | \$ 557,896          | 4%        |
| Long-term variable-rate loans | 2,105,713}            | 96        | 96,241}              | 4         | 2,835,451            | 87        | 408,265             | 13        |
| Loans guaranteed by RUS (1)   | 238,423}              | 100       | -}                   | -         | 243,997              | 100       | -                   | -         |
| Short-term loans              | 274,198}              | 17        | 1,380,204}           | 83        | 233,179              | 11        | 1,864,950           | 89        |
| <b>Total loans</b>            | <b>\$ 17,375,835}</b> | <b>89</b> | <b>\$ 2,082,101}</b> | <b>11</b> | <b>\$ 17,357,096</b> | <b>86</b> | <b>\$ 2,831,111</b> | <b>14</b> |
| <b>Total by segment:</b>      |                       |           |                      |           |                      |           |                     |           |
| CFC                           | \$ 15,632,134}        | 90%       | \$ 1,767,587}        | 10%       | \$ 15,562,761        | 86%       | \$ 2,528,572        | 14%       |
| RTFC                          | 1,451,385}            | 85        | 251,255}             | 15        | 1,443,395            | 86        | 236,759             | 14        |
| NCSC                          | 292,316}              | 82        | 63,259}              | 18        | 350,940              | 84        | 65,780              | 16        |
| <b>Total loans</b>            | <b>\$ 17,375,835}</b> | <b>89</b> | <b>\$ 2,082,101}</b> | <b>11</b> | <b>\$ 17,357,096</b> | <b>86</b> | <b>\$ 2,831,111</b> | <b>14</b> |

(1) "RUS" refers to the Rural Utilities Service.

#### Pledging of Loans and Loans on Deposit

The following table summarizes our collateral pledged to secure our collateral trust bonds, Clean Renewable Energy Bonds and notes payable to the Federal Agricultural Mortgage Corporation (see Note 6, Long-Term Debt) and the amount of the corresponding debt outstanding:

| (dollar amounts in thousands)                                | February 28,<br>2010 | May 31,<br>2009     |
|--|----------------------|---------------------|
| <b>Collateral trust bonds:</b>                               |                      |                     |
| 2007 indenture   |                      |                     |
| Distribution system mortgage notes                           | \$ 3,969,589}        | \$ 4,176,760        |
| Collateral trust bonds outstanding                           | 3,500,000}           | 3,000,000           |
| 1994 indenture   |                      |                     |
| Distribution system mortgage notes                           | \$ 2,182,175}        | \$ 2,308,713        |
| RUS guaranteed loans qualifying as permitted investments (1) | 208,203}             | 211,337             |
| <b>Total pledged collateral</b>                              | <b>\$ 2,390,378}</b> | <b>\$ 2,520,050</b> |
| Collateral trust bonds outstanding                           | 1,985,000}           | 2,190,000           |
| 1972 indenture   |                      |                     |
| Cash   | \$ 2,032}            | \$ 2,032            |
| Collateral trust bonds outstanding                           | 1,736}               | 1,736               |
| <b>Federal Agricultural Mortgage Corporation:</b>            |                      |                     |
| Utility system notes   | \$ 2,193,683}        | \$ 1,488,929        |
| Notes payable  | 1,675,000}           | 1,200,000           |

Clean Renewable Energy Bonds:

|                            |    |         |    |   |
|----------------------------|----|---------|----|---|
| Utility system notes       | \$ | 34,548} | \$ | - |
| Cash                       |    | 12,864} |    | - |
| Total pledged collateral   | \$ | 47,412} |    | - |
| Clean Renewable            |    |         |    |   |
| Energy Bonds notes payable |    | 27,101} |    | - |

(1) "RUS" refers to the Rural Utilities Service

The following table shows the collateral on deposit for the notes payable to the Federal Financing Bank of the United States Treasury as part of the Rural Economic Development Loan and Grant ("REDLG") program (see Note 6, Long-Term Debt) and the amount of the corresponding debt outstanding:

|  | February<br>28,<br>2010 | May 31,<br>2009 |
|--|-------------------------|-----------------|
| (dollar amounts in thousands)            |                         |                 |
| Utility system mortgage notes on deposit | \$ 3,684,080}           | \$3,770,983     |
| REDLG notes payable                      | 3,000,000}              | 3,000,000       |

The \$3 billion of notes payable to the Federal Financing Bank at February 28, 2010 and May 31, 2009 contain a rating trigger related to our senior secured credit ratings from Standard & Poor's Corporation, Moody's Investors Service and Fitch Ratings. A rating trigger event exists if our senior secured debt does not have at least two of the following ratings: (i) A- or higher from Standard & Poor's Corporation, (ii) A3 or higher from Moody's Investors Service, (iii) A- or higher from Fitch Ratings and

(iv) an equivalent rating from a successor rating agency to any of the above rating agencies. If our senior secured credit ratings fall below the levels listed above, the mortgage notes on deposit at that time, which totaled \$3,684 million at February 28, 2010, would be pledged as collateral rather than held on deposit. At February 28, 2010 and May 31, 2009, our senior secured debt ratings were above the rating trigger threshold.

A total of \$2 billion of these notes payable to the Federal Financing Bank at February 28, 2010 and May 31, 2009 have a second trigger requiring that a director on the CFC board satisfies the requirements of a financial expert as defined by Section 407 of the Sarbanes-Oxley Act of 2002. A financial expert triggering event will occur if the financial expert position remains vacant for more than 90 consecutive days. If we do not satisfy the financial expert requirement, the mortgage notes on deposit at that time, which totaled \$2,473 million at February 28, 2010, would be pledged as collateral rather than held on deposit. The financial expert position on CFC's board of directors has been filled since March 2007.

#### (4) Foreclosed Assets

Assets received in satisfaction of loan receivables are initially recorded at fair value when received and are subsequently evaluated periodically for impairment. These assets are classified on the consolidated balance sheets as foreclosed assets, net. These assets do not meet the criteria to be classified as held for sale at February 28, 2010 and May 31, 2009.

The activity for foreclosed assets is summarized below:

| (dollar amounts in thousands)             | As of and for<br>the<br>three months<br>ended<br>February 28,<br>2010 | As of and for<br>the nine<br>months ended<br>February 28,<br>2010 |
|---|---|---|
| Beginning balance                         | \$ 47,579}  | \$ 48,721}  |
| Results of operations                     | 338}  | 946}  |
| Net cash provided by<br>foreclosed assets | (1,000)   | (1,000)   |
| Market adjustment                         | (988)   | (2,738)   |
| Ending balance                            | \$ 45,929}  | \$ 45,929}  |

The balance of foreclosed assets includes two land development loans and limited partnership interests in certain real estate developments for all periods presented. The collateral for both land development loans includes developed lots and land, raw land, and underground mineral rights. The change in natural gas prices influences the fair value of those mineral rights each quarter.

During the nine months ended February 28, 2010, the value of the collateral decreased by \$3 million due to the continued troubled commercial real estate market offset by the increase in natural gas prices that increased the value of the mineral rights. At February 28, 2010, both land development loans were impaired and on non-accrual status.

#### (5) Short-Term Debt and Credit Arrangements

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

| (dollar amounts in thousands) | February 28, | May 31, |
|-------------------------------|--------------|---------|
|-------------------------------|--------------|---------|

|   | 2010           | 2009         |
|---|----------------|--------------|
| Short-term debt:  |                |              |
| Commercial paper sold through dealers, net of discounts | \$ 607,661 }   | \$ 594,533   |
| Commercial paper sold directly to members, at par       | 967,391 }      | 934,897      |
| Commercial paper sold directly to non-members, at par   | 39,328 }       | 12,502       |
| Total commercial paper                                  | 1,614,380 }    | 1,541,932    |
| Daily liquidity fund sold directly to members           | 343,059 }      | 291,341      |
| Term loan   | - }            | 200,000      |
| Bank bid notes  | 30,000 }       | 255,000      |
| Subtotal short-term debt                                | 1,987,439 }    | 2,288,273    |
| Long-term debt maturing within one year:                |                |              |
| Medium-term notes sold through dealers                  | 688,769 }      | 1,674,760    |
| Medium-term notes sold to members                       | 468,706 }      | 502,396      |
| Secured collateral trust bonds                          | 911,390 }      | 209,985      |
| Secured notes payable                                   | 189,607 }      | 187,800      |
| Unsecured notes payable                                 | 4,647 }        | 4,650        |
| Total long-term debt maturing within one year           | 2,263,119 }    | 2,579,591    |
| Total short-term debt                                   | \$ 4,250,558 } | \$ 4,867,864 |

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

#### Revolving Credit Agreements

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

| (dollar amounts in thousands) | February 28, 2010 | May 31, 2009 | Termination Date | Facility fee per year (1) |
|-------------------------------|-------------------|--------------|------------------|---------------------------|
| Five-year agreement           | \$ 1,049,000      | \$ 1,125,000 | March 16, 2012   | 6 basis points            |
| Five-year agreement           | 967,313           | 1,025,000    | March 22, 2011   | 6 basis points            |
| 364-day agreement             | 1,000,000         | 1,000,000    | March 12, 2010   | 12.5 basis points         |
| Total                         | \$ 3,016,313      | \$ 3,150,000 |                  |                           |

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

At February 28, 2010 and May 31, 2009, we were in compliance with all covenants and conditions under our revolving credit agreements and there were no borrowings outstanding under these agreements.

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

|  | Requirement | Actual<br>February 28, 2010 | Actual<br>May 31, 2009 |
|--|-------------|-----------------------------|------------------------|
| Minimum average adjusted TIER over the six most recent fiscal quarters | 1.025       | 1.15                        | 1.18                   |
| Minimum adjusted TIER at fiscal year end (1)                           | 1.05        | NA                          | 1.10                   |
| Maximum ratio of senior debt to total equity                           | 10.00       | 6.24                        | 6.90                   |

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

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

On March 10, 2010, we replaced the \$1,000 million 364-day revolving credit agreement in effect on March 13, 2009 with a new \$1,300 million three-year agreement that expires on March 8, 2013. The facility fee for the new three-year facility is 25 basis points per year. The facility fee is determined by pricing matrices in the agreement and is payable quarterly. We have the right to choose between a (i) Eurodollar rate plus an applicable margin to be determined by pricing matrices in the agreement or (ii) a base rate calculated based on the greater of prime rate, the federal funds

effective rate plus 2 percent or the one-month LIBOR rate plus 2 percent, plus an applicable margin to be determined by pricing matrices in the agreement.

We may request letters of credit for up to \$100 million under the three-year revolving credit agreement. We also have the right, subject to certain terms and conditions, to increase the aggregate amount of the commitments under the three-year revolving credit agreement by up to \$250 million either by increasing the commitment of one or more existing lenders or by adding one or more new lenders, provided that no existing lender's commitment is increased without the consent of the lender and the administrative agent. Effective March 15, 2010, we exercised our right to increase the aggregate amount of the commitment under the three-year revolving credit agreement by \$35 million to a total of \$1,335 million. The total committed credit available under our three current facilities was \$3,351 million at March 15, 2010.

## (6) Long-Term Debt

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

| (dollar amounts in thousands)          | February 28,<br>2010 | May 31,<br>2009 |
|--|----------------------|-----------------|
| Unsecured long-term debt:              |                      |                 |
| Medium-term notes sold through dealers | \$ 3,016,396}        | \$ 3,469,580    |
| Medium-term notes sold to members      | 145,372}             | 220,613         |
| Subtotal                               | 3,161,768}           | 3,690,193       |
| Unamortized discount                   | (2,578)              | (3,120)         |
| Total unsecured medium-term notes      | 3,159,190}           | 3,687,073       |
| Unsecured notes payable                | 3,050,297}           | 3,053,705       |
| Unamortized discount                   | (1,528)              | (1,694)         |
| Total unsecured notes payable          | 3,048,769}           | 3,052,011       |
| Total unsecured long-term debt         | 6,207,959}           | 6,739,084       |
| Secured long-term debt:                |                      |                 |
| Collateral trust bonds                 | 4,575,000}           | 4,981,736       |
| Unamortized discount                   | (12,646)             | (12,965)        |
| Total secured collateral trust bonds   | 4,562,354}           | 4,968,771       |
| Secured notes payable                  | 1,512,494}           | 1,012,200       |
| Total secured long-term debt           | 6,074,848}           | 5,980,971       |
| Total long-term debt                   | \$ 12,282,807}       | \$ 12,720,055   |

Medium-term notes represent our unsecured obligations. 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 3, Loans and Commitments, for additional information on the collateral pledged to secure our collateral trust bonds. See Note 5, Short-Term Debt and Credit Arrangements for the portion of long-term debt maturing within one year.

## Unsecured Notes Payable

At February 28, 2010 and May 31, 2009, we had unsecured notes payable totaling \$3 billion outstanding under a bond purchase agreement with the Federal Financing Bank and a bond guarantee agreement with the Rural Utilities Service as part of the funding mechanism for the Rural Economic Development Loan and Grant program. As part of the Rural Economic Development Loan and Grant program, we pay the Rural Utilities Service a fee of 30 basis points per year on the total amount borrowed. At February 28, 2010, the \$3 billion of unsecured notes payable issued as part of the Rural Economic Development Loan and Grant program require us to place mortgage notes on deposit in an amount at least equal to the principal balance of the notes outstanding. See Note 3, Loans and Commitments, for additional information on the mortgage notes held on deposit and the triggering events that result in these mortgage notes becoming pledged as collateral.

## Secured Notes Payable

Details about our note purchase agreements and outstanding notes payable with the Federal Agricultural Mortgage Corporation are shown below.

| (dollar amounts in thousands) |                     | Amount Outstanding |                   |              |
|-------------------------------|---------------------|--------------------|-------------------|--------------|
| Note Purchase Agreement       | Final Maturity Date | Amount Available   | February 28, 2010 | May 31, 2009 |

|                       |                      |             |             |             |
|-----------------------|----------------------|-------------|-------------|-------------|
| December 2008 (1) (2) | December 31,<br>2015 | \$ 500,000  | \$ 350,000  | \$ 500,000  |
| February 2009         | February 29,<br>2016 | 500,000     | 500,000     | 300,000     |
| March 2009 (1)        | April 1, 2014        | 400,000     | 400,000     | 400,000     |
| May 2009              | December 31,<br>2016 | 1,000,000   | 425,000     | -           |
| Total                 |                      | \$2,400,000 | \$1,675,000 | \$1,200,000 |

(1) Includes \$100 million and \$87.8 million of secured notes payable under this program that were classified as short-term debt at February 28, 2010 and May 31, 2009, respectively, under the December 2008 and March 2009 note purchase agreements, respectively.

(2) In December 2009, we exercised the call option on a \$150 million 4.95 percent note under this agreement at par.

All of the agreements with the Federal Agricultural Mortgage Corporation are revolving credit facilities that allow us to borrow, repay and re-borrow funds at any time through maturity or from time to time as market conditions permit; provided that the principal amount at any time outstanding under each of the note purchase agreements is not more than the total available under each agreement. All of the agreements require us to pledge eligible distribution system or power supply system loans as collateral in an amount at least equal to the total principal amount of notes outstanding under the agreement. See Note 3, Loans and Commitments, for additional information on the collateral pledged to secure notes payable under this program. These agreements also require us to purchase the Federal Agricultural Mortgage Corporation Series C cumulative,



redeemable, non-voting preferred stock in an amount sufficient to maintain a balance at all times that is at least equal to 4 percent of the principal amount of the notes outstanding under the agreements. See Note 2, Investments in Equity Securities, for additional information about the preferred stock that we purchased.

The secured notes payable also includes a secured private placement related to Clean Renewable Energy Bonds totaling \$27 million, with \$2 million of that total classified as short-term debt.

(7) Subordinated Deferrable Debt

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

|                               | February<br>28,<br>2010 | May 31,<br>2009 |
|-------------------------------|-------------------------|-----------------|
| (dollar amounts in thousands) |                         |                 |
| NRN 6.75% due 2043            | \$ 125,000              | \$ 125,000      |
| NRC 6.10% due 2044            | 88,201                  | 88,201          |
| NRU 5.95% due 2045            | 98,239                  | 98,239          |
| Total                         | \$ 311,440              | \$ 311,440      |

All subordinated deferrable debt is callable at par at any time.

(8) Derivative Financial Instruments

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

Generally, our derivative instruments do not qualify for hedge accounting under the accounting standards for derivative financial instruments. Consistent with the accounting standards for derivative financial instruments, we record derivative instruments on the consolidated balance sheet as either an asset or liability measured at fair value. Changes in the fair value of derivative instruments along with realized gains and losses from cash settlements are recognized in the derivative gains (losses) line item of the consolidated statement of operations unless specific hedge accounting criteria are met. At February 28, 2010 and May 31, 2009, we did not have any derivative instruments that were accounted for using hedge accounting.

Interest Rate Swaps

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

|                               | Notional Amounts Outstanding |                 |
|-------------------------------|------------------------------|-----------------|
|                               | February 28,<br>2010         | May 31,<br>2009 |
| (dollar amounts in thousands) |                              |                 |
| Pay fixed-receive variable    | \$ 5,626,147}                | \$6,506,603     |
| Pay variable-receive fixed    | 5,551,440}                   | 5,323,239       |
| Total interest rate swaps     | \$ 11,177,587}               | \$ 11,829,842   |

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

|                               | Three months ended<br>February 28, |      | Nine months ended<br>February 28, |      |
|-------------------------------|------------------------------------|------|-----------------------------------|------|
| (dollar amounts in thousands) | 2010                               | 2009 | 2010                              | 2009 |

## Statement of operations:

Agreements that do not qualify for hedge  
accounting

|                             |            |           |             |             |
|-----------------------------|------------|-----------|-------------|-------------|
| Derivative cash settlements | \$ (5,636) | \$104,012 | \$ (19,836) | \$ 116,946  |
| Derivative forward value    | 28,207}    | (53,046)  | 24,935}     | (203,457)   |
| Derivative gains (losses)   | \$ 22,571} | \$ 50,966 | \$ 5,099}   | \$ (86,511) |

Cash settlements includes periodic amounts that were paid and received related to our interest rate swaps, as well as amounts accrued from the prior settlement date. As a result of the termination of \$583 million in notional amount of interest rate swaps during the third quarter of fiscal year 2009, we recorded a \$97 million charge to the derivative forward value to reduce the derivative asset and received a payment of \$97 million identified above as derivative cash settlements, resulting in no net impact on the derivative gain (loss) line on the consolidated statement of operations.

We recorded a transition adjustment of \$62 million as other comprehensive loss when we implemented the accounting standards for derivative financial instruments in 2001. This amount will amortize to income through April 2029 in the derivative gain (loss) line of the statement of operations.

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

#### Rating Triggers

Some of our interest rate swaps have credit risk-related contingent features referred to as rating triggers. Rating triggers are not separate financial instruments and are not required to be accounted for separately as derivatives. At February 28, 2010, the following derivative instruments had rating triggers based on our senior unsecured credit ratings from Moody's Investors Service or Standard & Poor's Corporation falling to a level specified in the agreement and grouped into the categories below. In calculating the payments and collections required upon termination, we netted the agreements for each counterparty, as allowed by the underlying master agreements. At February 28, 2010, our senior unsecured credit rating from Moody's Investors Service and Standard & Poor's Corporation was A2 and A, respectively. At February 28, 2010, Moody's Investors Service had our ratings on stable outlook and Standard & Poor's Corporation had our ratings on a negative outlook.

|                                   | Notional<br>Amount | Required<br>Company<br>Payment | Amount<br>Company<br>Would<br>Collect | Net<br>Total |
|-----------------------------------|--------------------|--------------------------------|---------------------------------------|--------------|
| (dollar amounts in thousands)     |                    |                                |                                       |              |
| Rating Level:                     |                    |                                |                                       |              |
| Mutual rating trigger if ratings: |                    |                                |                                       |              |
| fall to Baa1/BBB+ (1)             | \$ 1,368,450}      | \$ (593)                       | \$ 9,914}                             | \$ 9,321     |
| fall below Baa1/BBB+ (1)          | 6,725,437}         | (88,322)                       | 24,274}                               | (64,048)     |
| Total                             | \$ 8,093,887}      | \$ (88,915)                    | \$ 34,188                             | \$ (54,727)  |

(1) Stated senior unsecured credit ratings are for Moody's Investors Service and Standard & Poor's Corporation, respectively. Under these rating triggers, if the credit rating for either counterparty falls to the level specified in the agreement, the other counterparty may, but is not obligated to, terminate the agreement. If either counterparty terminates the agreement, a net payment may be due from one counterparty to the other based on the fair value, excluding credit risk, of the underlying derivative instrument.

In addition to the rating triggers listed above, at February 28, 2010, we had a total notional amount of \$845 million of derivative instruments with one counterparty that would require the pledging of collateral totaling \$24 million (the fair value of such derivative instruments excluding credit risk) if our senior unsecured ratings from Moody's Investors Service were to fall below Baa2 or if the rating from Standard & Poor's Corporation were to fall below BBB. The aggregate fair value of all interest rate swaps with rating triggers that were in a net liability position at February 28, 2010 was \$110 million.

#### (9) Equity

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

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

Noncontrolling interest represents 100 percent of RTFC and NCSC equity as the members of RTFC and NCSC own or control 100 percent of the interest in their respective companies. On June 1, 2009, we implemented new accounting standards for noncontrolling interests in consolidated financial statements and as a result, total equity includes the noncontrolling interest at February 28, 2010 of \$11 million. In accordance with the retrospective presentation and disclosure requirements, noncontrolling interest on the consolidated balance sheet at May 31, 2009 was reclassified from liabilities to equity attributable to noncontrolling interests, increasing the total of consolidated equity by \$10 million. Additionally, the net income attributable to the noncontrolling interest totaling \$0.2 million and \$3.1 million for the three and nine month periods ended February 28, 2009, respectively, has been included in net income reported on the consolidated statement of operations to conform with the February 28, 2010 presentation. The change in presentation for noncontrolling interests is reflected in our footnote disclosures for all periods presented in this Form 10-Q where applicable.

At May 31, 2009, based on the consolidation accounting standards in effect at that time, consolidated equity was required to absorb the \$6 million equity deficit of NCSC rather than being reflected in minority interest. The loss absorbed by consolidated equity was caused by the decline in the fair value of the NCSC derivatives and therefore does not represent a loss that was funded by us. Under prior accounting standards, NCSC future earnings would have been used to offset the equity deficit absorbed by consolidated equity. Based on the provisions of the new standards, the application of the NCSC future earnings to offset the unfunded loss reported in consolidated equity at February 28, 2010 is not permitted. As a result of these new standards, the \$6 million unfunded loss absorbed at May 31, 2009 will be reported as part of consolidated retained equity for as long as NCSC is in business. Additionally, the reported noncontrolling interest will be \$6 million greater than the total equity reported on the separate RTFC and NCSC financial statements.

Equity includes the following components:

| (dollar amounts in thousands)  | February<br>28,<br>2010 | May 31,<br>2009 |
|--|-------------------------|-----------------|
| Membership fees  | \$ 992}                 | \$ 990          |
| Education fund   | 829}                    | 1,592           |
| Members' capital reserve   | 187,098}                | 187,098         |
| Allocated net income   | 379,434}                | 420,834         |
| Unallocated net income (loss) (1)  | 63,247}                 | (6,198)         |
| Total members' equity  | 631,600}                | 604,316         |
| Prior years cumulative derivative forward<br>value and foreign currency<br>adjustments | (103,493)               | 44,056          |
| Year-to-date derivative forward value loss (2)   | 23,587}                 | (147,549)       |
| Total CFC retained equity  | 551,694}                | 500,823         |
| Accumulated other comprehensive income   | 7,772}                  | 8,115           |
| Total CFC equity   | 559,466}                | 508,938         |
| Noncontrolling<br>interest   | 10,850}                 | 10,162          |
| Total equity   | \$ 570,316}             | \$ 519,100      |

(1) Excludes derivative forward value.

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

#### (10) Guarantees

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

The following table summarizes total guarantees by type and segment:

| (dollar amounts in thousands) | February<br>28,<br>2010 | May 31,<br>2009 |
|-------------------------------|-------------------------|-----------------|
| Total by type:                |                         |                 |
| Long-term tax-exempt bonds    | \$ 603,830}             | \$ 644,540      |

|   |               |              |
|---|---------------|--------------|
| Indemnifications of tax benefit transfers | 72,514}       | 81,574       |
| Letters of credit                         | 402,243}      | 450,659      |
| Other guarantees                          | 119,701}      | 98,682       |
| Total                                     | \$ 1,198,288} | \$ 1,275,455 |

## Total by segment:

|                         |               |              |
|-------------------------|---------------|--------------|
| CFC:                    |               |              |
| Distribution            | \$ 230,185}   | \$ 264,084   |
| Power supply            | 893,458}      | 945,624      |
| Statewide and associate | 22,060}       | 23,625       |
| CFC total               | 1,145,703}    | 1,233,333    |
| RTFC                    | 637}          | 500          |
| NCSC                    | 51,948}       | 41,622       |
| Total                   | \$ 1,198,288} | \$ 1,275,455 |

The maturities for the long-term tax-exempt bonds and the related guarantees run through calendar year 2042. Amounts in the table represent the outstanding principal amount of the guaranteed bonds. At February 28, 2010, our maximum potential exposure for the \$1 million of fixed-rate tax-exempt bonds is \$1 million, representing principal and interest. CFC is unable to determine the maximum amount of interest that it could be required to pay related to the remaining adjustable and floating-rate

bonds. See below for further information about this type of guarantee. Many of these bonds have a call provision that in the event of a default would allow us to trigger the call provision. This would limit our exposure to future interest payments on these bonds. Our maximum potential exposure is secured by a mortgage lien on all of the system's assets and future revenues. If the debt is accelerated because of a determination that the interest thereon is not tax-exempt, the system's obligation to reimburse us for any guarantee payments will be treated as a long-term loan.

The maturities for the indemnification of tax benefit transfers run through calendar year 2015. The amounts shown represent our maximum potential exposure for guaranteed indemnity payments. A member's obligation to reimburse CFC 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.

The maturities for letters of credit run through calendar year 2024. Additionally, letters of credit totaling \$3 million at February 28, 2010 have a term of one year and automatically extend for a period of one year unless we cancel the agreement within 120 days of maturity (in which case, the beneficiary may draw on the letter of credit). The amounts shown in the table above represent CFC's maximum potential exposure, of which \$180 million is secured, at February 28, 2010. When taking into consideration reimbursement obligation agreements that we have in place with other lenders, our maximum potential exposure related to \$31 million of letters of credit would be reduced to \$9 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 with us. In addition to the letters of credit listed in the table, under master letter of credit facilities, we may be required to issue up to an additional \$498 million in letters of credit to third parties for the benefit of our members at February 28, 2010. At May 31, 2009, this amount was \$440 million.

The maturities for other guarantees run through calendar year 2025. The maximum potential exposure for these guarantees is \$121 million, all of which is unsecured.

At February 28, 2010 and May 31, 2009, we had a total of \$342 million and \$347 million of guarantees, representing 29 percent and 27 percent of total guarantees, respectively, under which our right of recovery from our members was not secured.

#### Long-term Tax-Exempt Bonds

We guarantee debt issued in connection with the construction or acquisition of pollution control, solid waste disposal, industrial development and electric distribution facilities, classified as long-term tax-exempt bonds in the table above. We unconditionally guarantee to the holders or to trustees for the benefit of holders of these bonds the full principal, interest, and in most cases, premium, if any, on each bond when due. In the event of default by a member system for non-payment of debt service, we are obligated to pay any required amounts under our guarantees, which will prevent the acceleration of the bond issue. The member system is required to repay, on demand, any amount advanced by us with interest, pursuant to the documents evidencing the member system's reimbursement obligation.

Of the amounts shown in the table above, \$603 million and \$643 million as of February 28, 2010 and May 31, 2009, respectively, are adjustable or floating/fixed-rate bonds that may be converted to a fixed rate as specified in the indenture for each bond offering. During the variable-rate period (including at the time of conversion to a fixed rate), we have, in return for a fee, unconditionally agreed to purchase bonds tendered or put for redemption if the remarketing agents have not previously sold such bonds to other investors.

#### Guarantee Liability

At February 28, 2010 and May 31, 2009, we recorded a guarantee liability of \$26 million and \$30 million, respectively, which represents the contingent and non-contingent exposures related to guarantees and liquidity obligations associated with members' debt. The contingent guarantee liability at February 28, 2010 and May 31, 2009 was \$9 million and \$12 million, respectively, based on management's estimate of exposure to losses within the guarantee portfolio. We use factors such as internal risk rating, remaining term of guarantee, corporate bond default probabilities and estimated recovery rates in estimating our contingent exposure. The remaining balance of the total guarantee liability of \$17 million and \$18 million at February 28, 2010 and May 31, 2009, respectively, relates to our non-contingent obligation to stand ready to perform over the term of our guarantees and liquidity obligations that we have entered into or modified since January 1, 2003. The non-contingent obligation is estimated based on guarantee and liquidity fees collectible over the life of the guarantee. The fees are deferred and amortized using the straight-line method into interest income over the term of the guarantees.



Activity in the guarantee liability account is summarized below:

| (dollar amounts in thousands)                   | As of and for the three months<br>ended February 28, |           | As of and for the nine<br>months<br>ended February 28, |           |
|---|--|-----------|--|-----------|
|   | 2010   | 2009      | 2010   | 2009      |
| Beginning balance                               | \$ 25,113 }  | \$ 32,824 | \$ 29,672 }  | \$ 15,034 |
| Net change in non-contingent liability          | 127 }  | 652       | (1,216)  | 13,461    |
| Provision for (recovery of) guarantee liability | 451 }  | 338       | (2,765)  | 5,319     |
| Ending balance                                  | \$ 25,691 }  | \$ 33,814 | \$ 25,691 }  | \$ 33,814 |
| Liability as a percentage of total guarantees   | 2.14%  | 2.66%     | 2.14 %   | 2.66%     |

#### (11) Fair Value Measurement

Assets and liabilities measured at fair value on either a recurring or nonrecurring basis on the consolidated balance sheets at February 28, 2010 and May 31, 2009 consist of derivative instruments, foreclosed assets, and collateral-dependent non-performing loans. Additionally, assets measured at fair value included investments in common stock at February 28, 2010.

##### Assets and Liabilities Measured at Fair Value on a Recurring Basis

At February 28, 2010, our investments in equity securities includes investments in the Federal Agricultural Mortgage Corporation Series A common stock that is recorded in the consolidated balance sheets at fair value. We calculate fair value based on the quoted price on the stock exchange where the stock is traded. That stock exchange is an active market based on the volume of shares transacted. Fair values for these securities are classified as a Level 1 valuation.

The following table presents our assets and liabilities that are measured at fair value on a recurring basis at February 28, 2010:

| (dollar amounts in thousands) | Level 1 | Level 2      | Level 3 |
|-------------------------------|---------|--------------|---------|
| Derivative assets             | \$ - }  | \$ 373,814 } | \$ - }  |
| Derivative liabilities        | - }     | 461,030 }    | - }     |
| Investments in common stock   | 642 }   | - }          | - }     |

##### Assets and Liabilities Measured at Fair Value on a Nonrecurring Basis

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

Our foreclosed assets are initially recorded at the fair value of the underlying assets. Foreclosed assets are evaluated periodically for impairment by performing a fair value analysis based on estimated future cash flows or in some instances, an assessment of the fair value of the asset or business, which may be provided by a third party consultant. Estimates of future cash flows are subjective and are considered to be a significant input in the valuation. A review for significant changes in the key assumptions and estimates of the fair value analysis is performed on a quarterly basis.

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

instances, the valuation is considered to be a nonrecurring item.

Assets measured at fair value on a nonrecurring basis at February 28, 2010 were classified as Level 3 within the fair value hierarchy. The following table provides the carrying value of the related individual assets at February 28, 2010 and the total losses for the three and nine months ended February 28, 2010.

| (dollar amounts in thousands)                     | Level 3<br>Fair Value | Total losses                                  |  |
|---|-----------------------|---|--|
|   |                       | Three months<br>ended<br>February 28,<br>2010 | Nine months<br>ended<br>February 28,<br>2010 |
| Foreclosed assets, net                            | \$ 45,929}            | \$ (988)                                      | \$ (2,738)                                   |
| Non-performing loans, net of<br>specific reserves | 154,717}              | (17,304)                                      | (19,163)                                     |

(12) Fair Value of Financial Instrument

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

The estimated market values have not been updated since February 28, 2010; therefore, current estimates of fair value may differ significantly from the amounts presented. With the exception of redeeming subordinated deferrable debt under early redemption provisions, terminating derivative instruments under early termination provisions and allowing borrowers to prepay their loans, we have held and intend to hold all financial instruments to maturity. Below is a summary of significant methodologies used in estimating fair value amounts at February 28, 2010 and May 31, 2009.

Cash and Cash Equivalents

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

Restricted Cash

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

Investments in Equity Securities

At February 28, 2010, our investments in equity securities includes investments in the Federal Agricultural Mortgage Corporation Series A common stock acquired during the fiscal year that is recorded in the consolidated balance sheets at fair value. We calculate fair value based on the quoted price on the stock exchange where the stock is traded. That stock exchange is an active market based on the volume of shares transacted.

The carrying value of the Federal Agricultural Mortgage Corporation Series B-1 preferred stock held at May 31, 2009 and Series C preferred stock held at February 28, 2010 and May 31, 2009 is equal to cost, which approximates fair value. Our investments in Series B-1 preferred stock were callable at par and fair value was estimated at cost based upon dealer quotes. The fair value for the Series C preferred stock is estimated at cost because we continue to enter into new transactions with the issuer at the same terms and the stock is callable at par. The preferred stock securities do not meet the definition of marketable securities.

Loans to Members, Net

As part of receiving a loan from us, our members have additional requirements and rights that are not typical of other financial institutions, such as the right to receive a patronage capital allocation, the general requirement to purchase subordinated certificates or member capital securities to meet their capital contribution requirements as a condition of obtaining additional credit from us, the option to select fixed rates from one year to maturity with the fixed rate resetting or repricing at the end of each selected rate term, the ability to convert from a fixed rate to another fixed rate or the variable rate at any time and certain interest rate discounts that are specific to the borrower's activity with us. These features make it difficult to find market data for similar loans. Therefore, we must use other methods to estimate the fair value. Fair values are estimated by discounting the future cash flows using the current rates at which we would make similar loans to new borrowers for the same remaining maturities. The maturity date used in the fair value calculation of loans with a fixed rate for a selected rate term is the next repricing date since these borrowers must reprice their loans at various times throughout the life of the loan at the then current market rate. Loans with different risk characteristics, specifically non-performing and restructured loans, are valued by using collateral valuations or by adjusting cash flows for credit risk and discounting those cash flows using the current rates at which

similar loans would be made by us to borrowers for the same remaining maturities.

See Note 11, Fair Value Measurement, for more details about how we calculate the fair value of certain non-performing loans. Credit risk for the remainder of the loan portfolio is estimated based on the associated reserve in our allowance for loan losses. Variable-rate loans are valued at cost, which approximates fair value since we can reset rates every 15 days.

#### Debt Service Reserve Funds

Debt service reserve funds represent cash and/or investments on deposit with the bond trustee for tax-exempt bonds that we guarantee. Carrying value is considered to be equal to fair value.

#### Short-Term Debt

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

#### Long-Term Debt

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

#### Subordinated Deferrable Debt

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

#### Members' Subordinated Certificates

Members' subordinated certificates include membership subordinated certificates issued to our members as a condition of membership, loan and guarantee subordinated certificates as a condition of obtaining loan funds or guarantees and member capital securities issued as voluntary investments by our members. All members' subordinated certificates are non-transferable other than among members. As there is no ready market from which to obtain fair value quotes for membership, loan, and guarantee subordinated certificates, it is impracticable to estimate fair value and such certificates are therefore valued at par. There is also no ready market from which to obtain fair value quotes for member capital securities. Fair value for member capital securities is based on the discounted cash flows using the coupon interest rate on the last business day of the quarter.

#### Derivative Instruments

We record derivative instruments in the consolidated balance sheets as either an asset or liability measured at fair value. Because there is not an active secondary market for the types of interest rate swap derivative instruments we use, we obtain market quotes from the interest rate swap counterparties to adjust all swaps to fair value on a quarterly basis. The market quotes are based on the expected future cash flow and estimated yield curves. We adjust the market values received from the counterparties using credit default swap levels for us and the counterparties. The credit default swap levels represent the credit risk premium required by a market participant based on the available information related to us and the counterparty.

#### Commitments

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

#### Guarantees

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

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

| (dollar amounts in thousands)         | February 28, 2010 |             | May 31, 2009   |            |
|---------------------------------------|-------------------|-------------|----------------|------------|
|                                       | Carrying Value    | Fair Value  | Carrying Value | Fair Value |
| <b>Assets:</b>                        |                   |             |                |            |
| Cash and cash equivalents             | \$ 380,291}       | \$ 380,291} | \$ 504,999     | \$ 504,999 |
| Restricted cash                       | 16,173}           | 16,173}     | 8,207          | 8,207      |
| Investments in equity securities      | 58,220}           | 58,220}     | 47,000         | 47,000     |
| Loans to members, net                 | 18,843,287}       | 19,041,268} | 19,569,349     | 18,766,573 |
| Debt service reserve funds            | 45,662}           | 45,662}     | 46,662         | 46,662     |
| Interest rate exchange agreements     | 373,814}          | 373,814}    | 381,356        | 381,356    |
| <b>Liabilities:</b>                   |                   |             |                |            |
| Short-term debt                       | 4,250,558}        | 4,282,890}  | 4,867,864      | 4,885,919  |
| Long-term debt                        | 12,282,807}       | 13,524,668} | 12,720,055     | 13,160,498 |
| Guarantee liability                   | 25,691}           | 28,840}     | 29,672         | 33,181     |
| Interest rate exchange agreements     | 461,030}          | 461,030}    | 493,002        | 493,002    |
| Subordinated deferrable debt          | 311,440}          | 313,892}    | 311,440        | 274,759    |
| Members' subordinated certificates    | 1,828,461}        | 1,990,607}  | 1,740,054      | 1,740,054  |
| <b>Off-balance sheet instruments:</b> |                   |             |                |            |
| Commitments                           | -}                | -}          | -              | -          |

### (13) Restructured/Non-performing Loans and Contingencies

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

| (dollar amounts in thousands) | February      |              |
|-------------------------------|---------------|--------------|
|                               | 28, 2010      | May 31, 2009 |
| Non-performing loans          | \$ 523,849}   | \$ 523,758   |
| Restructured loans            | 515,438}      | 537,587      |
| Total                         | \$ 1,039,287} | \$ 1,061,345 |

(a) At February 28, 2010 and May 31, 2009, all loans classified as non-performing were on a non-accrual status with respect to the recognition of interest income. At February 28, 2010 and May 31, 2009, \$470 million and \$491 million, respectively, of restructured loans were on non-accrual status with respect to the recognition of interest income. Approximately \$1 million and \$2 million, respectively, of interest income was accrued on restructured loans during the three and nine months ended February 28, 2010. For the three and nine months ended February 28, 2009, approximately \$1 million and \$3 million, respectively, of interest income was accrued on restructured loans.

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

| Three months ended | Nine months ended |
|--------------------|-------------------|
|--------------------|-------------------|

| (dollar amounts in thousands) | February 28, |           | February 28, |           |
|-------------------------------|--------------|-----------|--------------|-----------|
|                               | 2010         | 2009      | 2010         | 2009      |
| Non-performing loans          | \$ 7,117}    | \$ 7,484  | \$ 21,790}   | \$ 22,335 |
| Restructured loans            | 5,862}       | 6,538     | 17,853}      | 20,135    |
| Total                         | \$ 12,979}   | \$ 14,022 | \$ 39,643}   | \$ 42,470 |

(b) We classified \$1,035 million and \$1,056 million of loans as impaired at February 28, 2010 and May 31, 2009, respectively. We reserved \$412 million and \$414 million of the loan loss allowance for such impaired loans at February 28, 2010 and May 31, 2009, respectively. The amount included in the loan loss allowance for such loans was based on a comparison of the present value of the expected future cash flows associated with the loan discounted at the effective interest rate at the time of impairment and/or the estimated fair value of the collateral securing the loan to the recorded investment in the loan. Impaired loans may be on accrual or non-accrual status with respect to the recognition of interest income based on a review of the terms of the restructure agreement and borrower performance. We accrued a total of \$1 million and \$2 million of interest income on impaired loans for the three and nine months ended February 28, 2010. We accrued a total of \$1 million and \$3 million of interest income on impaired loans for the three and nine months ended February 28, 2009. The average recorded investment in impaired loans for the nine months ended February 28, 2010 and 2009 was \$1,042 million and \$1,050 million, respectively.

We update impairment calculations on a quarterly basis. Since a borrower's effective interest rate on the loan at the time of impairment may include a variable-rate component, calculated impairment could vary with changes to our variable rate, independent of a borrower's underlying financial performance or condition. In addition, the calculated impairment for a



borrower will fluctuate based on changes to certain assumptions. Changes to assumptions include, but are not limited to the following:

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

(c) At February 28, 2010 and May 31, 2009, we had a total of \$470 million and \$491 million, respectively, of restructured loans outstanding to Denton County Electric Cooperative, d/b/a CoServ Electric ("CoServ"), a large electric distribution cooperative located in Denton County, Texas, that provides retail electric service to residential and business customers. All restructured loans have been on non-accrual status since January 1, 2001. In addition, a total of \$20 million was outstanding under the capital expenditure loan facility which was classified as a performing loan at both February 28, 2010 and May 31, 2009. Total loans to CoServ at February 28, 2010 and May 31, 2009 represented 2.4 percent of our total loans and guarantees outstanding.

Under the terms of a bankruptcy settlement from 2002, we restructured our loans to CoServ. CoServ is scheduled to make quarterly payments to CFC through December 2037. As part of the restructuring, CFC may be obligated to provide up to \$204 million of senior secured capital expenditure loans to CoServ for electric distribution infrastructure through December 2012. Under this facility, advances are limited to \$46 million per year. As of the date of this filing, there is \$138 million available under this loan facility. When CoServ requests capital expenditure loans from us, 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 us. To date, CoServ has made all payments required under the restructure agreement and capital expenditure loan facility. Under the terms of the restructure agreement, CoServ has the option to prepay the loan for the lesser of their outstanding balance or \$405 million plus an interest payment true up on or after December 13, 2008. To date, we have not received notice from CoServ that it intends to prepay the loan. CoServ and CFC have no claims related to any of the legal actions asserted before or during the bankruptcy proceedings. Our legal claim against CoServ is limited to CoServ's performance under the terms of the bankruptcy settlement.

Based on our analysis, we believe that we are adequately reserved for our exposure to CoServ at February 28, 2010.

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

At February 28, 2010 and May 31, 2009, RTFC had \$524 million in loans outstanding to ICC. All loans to ICC have been on non-accrual status since February 1, 2005. ICC has not made debt service payments to RTFC since June 2005.

RTFC is the primary secured lender to ICC. RTFC's collateral for the loans included:

- a series of mortgages, security agreements, financing statements, pledges and guarantees creating liens in favor of RTFC on substantially all of the assets and voting stock of ICC;
- a direct pledge of 100 percent of the voting stock of ICC's United States Virgin Islands local exchange carrier subsidiary, Virgin Islands Telephone Corporation d/b/a Innovative Telephone;
- secured guarantees, 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, and its parent, Innovative Communication Company LLC, a Delaware limited liability company; and

- a personal guaranty of the loans from ICC's indirect majority shareholder and former chairman, Jeffrey Prosser.

In February 2006, involuntary bankruptcy petitions were filed against:

- ICC's indirect majority shareholder and former chairman, Jeffrey Prosser;
  - ICC's immediate parent, Emerging Communications, Inc.; and
- Emerging Communications, Inc's parent, Innovative Communication Company LLC.

In April 2006, RTFC reached a settlement with the following individually:

- ICC;
- Virgin Islands Telephone Corporation;
- Innovative Communication Company LLC;
  - Emerging Communications, Inc.;
- the directors of each of the above-listed entities; and
  - Jeffrey Prosser.

Under the settlement, RTFC obtained entry of judgments in the District Court of the Virgin Islands against ICC for approximately \$525 million and Jeffrey Prosser for approximately \$100 million. RTFC also obtained dismissals with prejudice and releases of all counterclaims, affirmative defenses and other lawsuits alleging wrongful acts by RTFC, certain of its officers, and CFC, thereby resolving all the loan-related litigation in RTFC's favor. Regardless, Jeffrey Prosser and related parties continue to assert claims against CFC and certain of its officers and directors and other parties in various proceedings and forums. CFC therefore anticipates that it will continue to be engaged in defense of those assertions on many fronts, as well as pursuing claims of its own.

Innovative Communication Company LLC, Emerging Communications, Inc., ICC and Jeffrey Prosser each have bankruptcy proceedings pending in the United States District Court for the Virgin Islands, Bankruptcy Division. A Chapter 11 trustee has been appointed for the corporate estates; and a Chapter 7 trustee was appointed in Jeffrey Prosser's individual case. The Chapter 11 trustee of ICC has assumed ownership and control of ICC, including its subsidiaries.

On February 1, 2008, the bankruptcy court approved a motion of the Chapter 11 trustee of ICC to sell substantially all of ICC's assets, divided into three groups:

- Group 1 consisting of ICC assets and stock in ICC subsidiaries operating in the United States Virgin Islands, the British Virgin Islands and St. Maarten (the "Group 1 Assets");
- Group 2 consisting of stock in ICC subsidiaries operating in France and certain of its Caribbean territories (these assets were sold in December 2008); and
  - Group 3 consisting of the newspaper operations of ICC (these assets were sold in May 2008).

Certain ancillary assets have also been sold including aircraft, art and real estate. In each instance, the distribution of proceeds was approved by the bankruptcy court and resulted in a net recovery to us.

On March 13, 2009, RTFC and the Chapter 11 trustee entered into a Purchase Agreement as part of a \$250 million credit bid for the ICC Group 1 Assets. The Purchase Agreement is conditional upon the approval of the bankruptcy court and applicable regulators. On April 9, 2009, the U.S. bankruptcy court approved, on an interim basis, the sale of the ICC Group 1 Assets to RTFC, with RTFC reserving the right to assign its rights under the Purchase Agreement to CFC or its subsidiaries. CFC, together with certain of its subsidiaries, is in the process of obtaining the applicable regulatory approvals. In October 2009, the British Virgin Islands regulatory approval process was successfully completed, and in December 2009, FCC approval was granted. On January 13, 2010, the Netherlands Antilles granted unconditional consent for CFC to acquire the St. Maarten assets. CFC awaits approval from the Public Services Commission of the United States Virgin Islands. Once that approval is granted, the Chapter 11 trustee and CFC will request authorization from the U.S. bankruptcy court to consummate the transfer of ownership of the Group 1 Assets to designated subsidiaries of CFC.

In May 2009, RTFC acquired \$85 million of Virgin Islands Telephone Corporation d/b/a Innovative Telephone preferred stock and \$12.5 million of accrued and unpaid dividends relating to such shares for a total purchase price of \$30 million. We believe that the acquisition of the preferred shareholders interests at a discount has improved our estimated recovery from the collateral.

Based on our analysis, we believe that we are adequately reserved for our exposure to ICC at February 28, 2010.

(e) At February 28, 2010 and May 31, 2009, we had a total of \$42 million in restructured loans outstanding to Pioneer Electric Cooperative, Inc. ("Pioneer"), an electric distribution cooperative located in Greenville, Alabama. Pioneer was current with respect to all debt service payments at February 28, 2010 and all loans to Pioneer remain on accrual status. We are the principal creditor to Pioneer.

Based on our analysis, we believe that we are adequately reserved for our exposure to Pioneer at February 28, 2010.

## (14) Segment Information

Our consolidated financial statements include the financial results of CFC, 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 CFC segment includes the consolidation of entities controlled by CFC and created to hold foreclosed assets and facilitate loan securitization transactions and intercompany transaction elimination entries. The segment presentation for the three and nine months ended February 28, 2010 and 2009 reflect the operating results of each of the three companies as a separate segment.

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

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

The following table contains consolidated statements of operations for the nine months ended February 28, 2010, and consolidated balance sheet information at February 28, 2010.

| (dollar amounts in thousands)                     | CFC         | RTFC       | NCSC       | Consolidated |
|---|-------------|------------|------------|--------------|
| Statement of Operations:                          |             |            |            |              |
| Interest income                                   | \$ 716,904} | \$ 54,789} | \$ 19,202} | \$ 790,895}  |
| Interest expense                                  | (631,421)   | (51,062)   | (9,021)    | (691,504)    |
| Net interest income                               | 85,483}     | 3,727}     | 10,181}    | 99,391}      |
| Recovery of loan losses                           | 4,549}      | -}         | 45}        | 4,594}       |
| Net interest income after recovery of loan losses | 90,032}     | 3,727}     | 10,226}    | 103,985}     |
| Non-interest income:                              |             |            |            |              |
| Fee and other income                              | 12,331}     | 127}       | 1,020}     | 13,478}      |
| Settlement income                                 | 22,906}     | -}         | -}         | 22,906}      |
| Derivative gains (losses)                         | 10,492}     | -}         | (5,393)    | 5,099}       |
| Results of operations from foreclosed assets      | 946}        | -}         | -}         | 946}         |
| Total non-interest income                         | 46,675}     | 127}       | (4,373)    | 42,429}      |
| Non-interest expense:                             |             |            |            |              |
| General and administrative expenses               | (43,438)    | (4,598)    | (3,532)    | (51,568)     |
| Recovery of guarantee liability                   | 2,765}      | -}         | -}         | 2,765}       |
| Market adjustment of foreclosed assets            | (2,738)     | -}         | -}         | (2,738)      |
| Other expenses                                    | (264)       | -}         | (168)      | (432)        |
| Total non-interest expense                        | (43,675)    | (4,598)    | (3,700)    | (51,973)     |
| Income (loss) prior to income taxes               | 93,032}     | (744)      | 2,153}     | 94,441}      |
| Income tax expense                                | -}          | (13)       | (643)      | (656)        |
| Net income (loss)                                 | \$ 93,032}  | \$ (757)   | \$ 1,510}  | \$ 93,785}   |

Assets:

|                                 |                 |                |              |                 |
|---------------------------------|-----------------|----------------|--------------|-----------------|
| Total loans outstanding         | \$ 17,399,721 } | \$ 1,702,640 } | \$ 355,575 } | \$ 19,457,936 } |
| Deferred origination costs      | 3,849 }         | - }            | - }          | 3,849 }         |
| Less: Allowance for loan losses | (618,462)       | - }            | (36)         | (618,498)       |
| Loans to members, net           | 16,785,108 }    | 1,702,640 }    | 355,539 }    | 18,843,287 }    |
| Other assets                    | 1,047,055 }     | 176,405 }      | 42,807 }     | 1,266,267 }     |
| Total assets                    | \$ 17,832,163 } | \$ 1,879,045 } | \$ 398,346 } | \$ 20,109,554 } |

The following table contains consolidated statements of operations for the nine months ended February 28, 2009, and consolidated balance sheet information at February 28, 2009.

| (in thousands)   | CFC           | RTFC         | NCSC        | Consolidated  |
|--|---------------|--------------|-------------|---------------|
| <b>Statement of operations:</b>  |               |              |             |               |
| Interest income  | \$ 718,516    | \$ 57,598    | \$ 22,202   | \$ 798,316    |
| Interest expense   | (623,700)     | (54,101)     | (16,279)    | (694,080)     |
| Net interest income  | 94,816        | 3,497        | 5,923       | 104,236       |
| <br>(Provision for) recovery of loan losses                              | <br>(126,640) | <br>-        | <br>63      | <br>(126,577) |
| Net interest (loss) income after (provision for) recovery of loan losses | (31,824)      | 3,497        | 5,986       | (22,341)      |
| <br><b>Non-interest income:</b>  |               |              |             |               |
| Fee and other income   | 8,136         | 156          | 1,227       | 9,519         |
| Derivative losses  | (65,310)      | -            | (21,201)    | (86,511)      |
| Results of operations from foreclosed assets                             | 3,258         | -            | -           | 3,258         |
| Total non-interest income  | (53,916)      | 156          | (19,974)    | (73,734)      |
| <br><b>Non-interest expense:</b>   |               |              |             |               |
| General and administrative expenses                                      | )             | )            | (3,363)     | (46,153)      |
| Provision for guarantee liability  | (38,558)      | (4,232)      | -           | (5,319)       |
| Market adjustment on foreclosed assets                                   | (5,319)       | -}           | -           | (1,805)       |
| Other  | (1,805)       | -}           | (450)       | (670)         |
| Total non-interest expense   | (220)         | -}           | (3,813)     | (53,947)      |
| Loss prior to income taxes   | (45,902)      | (4,232)      | (3,813)     | (53,947)      |
| Income tax benefit   | -             | 220          | 6,757       | 6,977         |
| Net loss   | \$ (131,642)  | \$ (359)     | \$ (11,044) | \$ (143,045)  |
| <br><b>Assets:</b>   |               |              |             |               |
| Total loans outstanding  | \$ 18,053,972 | \$ 1,674,307 | \$ 440,599  | \$ 20,168,878 |
| Deferred origination costs   | 3,621         | -            | -           | 3,621         |
| Less: Allowance for loan losses  | (638,436)     | -            | (147)       | (638,583)     |
| Loans to members, net  | 17,419,157    | 1,674,307    | 440,452     | 19,533,916    |
| Other assets   | 1,208,536     | 181,293      | 23,172      | 1,413,001     |
| Total assets   | \$ 18,627,693 | \$ 1,855,600 | \$ 463,624  | \$ 20,946,917 |

The following table contains the consolidated statement of operations for the three months ended February 28, 2010 by segment.

| (dollar amounts in thousands)                                     | CFC         | RTFC       | NCSC      | Consolidated |
|---|-------------|------------|-----------|--------------|
| Statement of operations:  |             |            |           |              |
| Interest income   | \$ 232,328} | \$ 17,999} | \$ 6,192} | \$ 256,519}  |
| Interest expense  | (202,477)   | (16,714)   | (2,707)   | (221,898)    |
| Net interest income   | 29,851}     | 1,285}     | 3,485}    | 34,621}      |
| (Provision for) recovery of loan losses                           | (10,007)    | -}         | 7}        | (10,000)     |
| Net interest income after (provision for) recovery of loan losses | 19,844}     | 1,285}     | 3,492}    | 24,621}      |
| Non-interest income:  |             |            |           |              |
| Fee and other income  | 5,236}      | 50}        | 352}      | 5,638}       |
| Settlement income   | 22,906}     | -}         | -}        | 22,906}      |
| Derivative gains  | 21,182}     | -}         | 1,389}    | 22,571}      |
| Results of operations of foreclosed assets                        | 338}        | -}         | -}        | 338}         |
| Total non-interest income   | 49,662}     | 50}        | 1,741}    | 51,453}      |
| Non-interest expense:   |             |            |           |              |
| General and administrative expenses                               | (15,211)    | (1,587)    | (1,328)   | (18,126)     |
| Recovery of guarantee liability                                   | (451)       | -}         | -}        | (451)        |
| Market adjustment on foreclosed assets                            | (988)       | -}         | -}        | (988)        |
| Other   | (53)        | -}         | (58)      | (111)        |
| Total non-interest expense  | (16,703)    | (1,587)    | (1,386)   | (19,676)     |
| Income (loss) prior to income taxes                               | 52,803}     | (252)      | 3,847}    | 56,398}      |
| Income tax expense  | -}          | (5)        | (1,460)   | (1,465)      |
| Net income (loss)   | \$ 52,803}  | \$ (257)   | \$ 2,387} | \$ 54,933}   |

The following table contains the consolidated statement of operations for the three months ended February 28, 2009 by segment.

| (dollar amounts in thousands)                     | CFC        | RTFC      | NCSC     | Consolidated |
|---|------------|-----------|----------|--------------|
| Statement of operations:                          |            |           |          |              |
| Interest income                                   | \$ 242,404 | \$ 18,828 | \$ 7,221 | \$ 268,453   |
| Interest expense                                  | (216,812)  | (17,647)  | (5,285)  | (239,744)    |
| Net interest income                               | 25,592     | 1,181     | 1,936    | 28,709       |
| Recovery of loan losses                           | 10,391     | -         | 24       | 10,415       |
| Net interest income after recovery of loan losses | 35,983     | 1,181     | 1,960    | 39,124       |



|   |           |          |         |    |          |
|---|-----------|----------|---------|----|----------|
| Non-interest income:                          |           |          |         |    |          |
| Fee and other income                          | 2,530     | 38       | 632     |    | 3,200    |
| Derivative gains (losses)                     | 51,192    | -        | (226)   |    | 50,966   |
| Results of operations of<br>foreclosed assets | 801       | -        | -       |    | 801      |
| Total non-interest income                     | 54,523    | 38       | 406     |    | 54,967   |
| Non-interest expense:                         |           |          |         |    |          |
| General and administrative<br>expenses        | (13,746)  | (1,534)  | (1,186) |    | (16,466) |
| Provision for guarantee liability             | (338)     | -        | -       |    | (338)    |
| Market adjustment on<br>foreclosed assets     | (1,652)   | -        | -       |    | (1,652)  |
| Other   | (71)      | -        | (301)   |    | (372)    |
| Total non-interest expense                    | (15,807)  | (1,534)  | (1,487) |    | (18,828) |
| Income (loss) prior to income taxes           | 74,699    | (315)    | 879     |    | 75,263   |
| Income tax benefit (expense)                  | -         | 151      | (334)   |    | (183)    |
| Net income (loss)                             | \$ 74,699 | \$ (164) | \$ 545  | \$ | 75,080   |

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

Unless stated otherwise, references to "we," "our," or "us" relate to the consolidation of National Rural Utilities Cooperative Finance Corporation ("CFC"), Rural Telephone Finance Cooperative ("RTFC"), National Cooperative Services Corporation ("NCSC") and certain entities created and controlled by CFC to hold foreclosed assets and accommodate loan securitization transactions.

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

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

Throughout this management discussion and analysis, we will refer to our financial measures that are not in accordance with GAAP as "adjusted". In our Executive Summary, our discussion will focus on the key metrics that we use to evaluate our business, which are adjusted TIER and adjusted debt to equity ratio. The most closely related GAAP measures are TIER and debt to equity ratio. For the nine month period ended February 28, 2010, we reported a 1.14 TIER. At February 28, 2010, our debt to equity ratio was 34.26 to 1. We do not measure our performance or evaluate our business based on the GAAP measures and the financial covenants in our revolving credit agreements and debt indentures are based on our adjusted measures rather than the related GAAP measure. The main adjustments we make to calculate the non-GAAP measures compared to the related GAAP measures is to remove the impact of the unrealized derivative forward value and to include subordinated certificates and subordinated deferrable debt as equity. See Non-GAAP Financial Measures for further explanation of the adjustment we make to our financial results for our own analysis and covenant compliance and for a reconciliation to the related GAAP measure.

#### Executive Summary

Our primary objective as a cooperative is to provide attractively priced financial products to our rural electric and telecommunications members while maintaining sound financial results required for investment grade credit ratings on our debt instruments. Our goal is not to maximize profit on loans to members, but to balance charging our members low rates on loans and maintaining the financial performance required to access the capital markets on behalf of our members. Therefore, the rates we charge our borrowers reflect our adjusted interest expense plus a

spread to cover our operating expenses, a provision for loan losses and to provide earnings sufficient to preserve interest coverage to meet our financial objectives. Our key operating metrics are adjusted TIER and the adjusted debt to equity ratio. Our goal is to earn an annual minimum adjusted TIER of 1.10 and to operate with an adjusted debt to equity ratio within a range of 6.0 or less.

#### Results of Operations

For the nine month period ended February 28, 2010, we earned an adjusted TIER of 1.10. Our adjusted net income for this nine-month period included the recognition of a one-time gain of \$23 million from the proceeds of a settlement with CoBank, ACB, a government-sponsored enterprise, related to its accessing of proprietary information from our member "Extranet" without proper authority. The adjusted TIER for the period excluding the settlement proceeds was 1.06. The primary items that impacted our adjusted TIER during the nine months ended February 28, 2010 are listed below.

### Liquidity Management

Liquidity has been a primary concern of investors and the rating agencies since the financial crisis began in the fall of 2008. To help mitigate liquidity risks during the nine months ended February 28, 2010, we issued more term debt and relied less on lower-cost commercial paper, holding the commercial paper issuance capacity in reserve for liquidity purposes. During the nine months ended February 28, 2010, our average balance of commercial paper outstanding decreased by approximately 34 percent compared to the prior-year period. This change in the overall mix of funding to use more term debt was successful in mitigating liquidity risks, but resulted in our inability to fully realize the potential reduction to interest expense available through the commercial paper market in the current low interest rate environment. We expect to increase the use of commercial paper in our funding mix in the future as compared to the utilization over the past nine months.

### High Corporate Debt Spreads

In October 2008, we issued a \$1 billion collateral trust bond maturing in 2018 with a coupon of 10.375 percent. There were a number of factors that came together to influence us to issue this debt at a time when the markets were experiencing a significant disruption. We had maturing debt that had to be refinanced, we had to delay the planned private placement of debt with one of our financial partners due to financial difficulties that they were experiencing and we had increased demand for loan funds from our members. The interest expense on this bond has a negative impact on our adjusted TIER. During the nine months ended February 28, 2010, we have seen the spread over comparable treasuries on corporate bonds decrease significantly. In September 2009, we issued \$250 million of 2.625 percent collateral trust bonds with a three-year maturity at a spread of 125 basis points and \$250 million of 3.875 percent collateral trust bonds with a six-year maturity at a spread of 158 basis points. Corporate debt spreads have continued to tighten since that time.

### Non-Accrual Loans

During the nine months ended February 28, 2010, we had \$524 million of non-performing ICC loans on non-accrual status, which resulted in approximately \$22 million of foregone interest for that period. The pressure on adjusted net income and adjusted TIER from this non-accrual loan will be reduced significantly once we acquire the operating companies that comprise the collateral. At February 28, 2010, we also had a \$470 million restructured loan to CoServ on non-accrual status. We are not recognizing interest income on this loan, however, as long as it remains on non-accrual status we experience a reduction in the calculated impairment. CoServ is required to make quarterly payments totaling \$28 million to us each year. Currently, the application of the \$28 million of payments to reduce the principal balance over the next 12 months results in a reduction of \$21 million to the calculated impairment. In addition, CoServ's effective rate utilized to calculate impairment on the loans outstanding from us has a variable rate component. Based on CoServ's current loan balance at February 28, 2010, an increase or decrease of 25 basis points to our short-term and long-term variable interest rates results in an increase or decrease of approximately \$9 million, respectively, to the calculated impairment on loans irrespective of a change in the credit fundamentals for CoServ.

### Deterioration in Collateral Value for Impaired Loans

During the nine months ended February 28, 2009, we recorded a \$127 million loan loss provision primarily to reflect the estimated deterioration to the value of the operating companies comprising the collateral for one of our impaired loans. During the nine months ended February 28, 2010, we increased the specific reserve again for the same reason, however at a level significantly lower than in the prior year. Our adjusted TIER would have been 1.12 for the nine months ended February 28, 2010 without the deterioration to the estimated fair value of this collateral. At this time, it is not possible to determine how much of the deterioration in the estimated fair value of the collateral is due to the current effect of the economic recession and how much represents longer term issues with the infrastructure and operations of the companies that will require investment and the focus of management to resolve.

### Competition

Competition for our members' lending business has increased over the past year and has impacted our ability to grow or sustain loan volume. The economic recession has also contributed to a lower demand for loan funds from our members.

#### Financial Condition

##### Outstanding Loan Balances

Our outstanding loan balances decreased by \$730 million during the nine months ended February 28, 2010. The primary reasons for this decline were the anticipated repayments from power supply bridge loans with loan funds from the Rural Utilities Service, the general decline in construction of distribution infrastructure due to the economic downturn, the lower use of lines of credit from distribution members, and the sale of \$67 million in distribution loans to the Federal Agricultural Mortgage Corporation during the period. We advance loans to our power supply systems that requested funding from the

Rural Utilities Service to bridge the gap between the time the loan from the Rural Utilities Service is requested and the time it is funded. These CFC bridge loans will generally be outstanding for up to five years. We established a program with the Federal Agricultural Mortgage Corporation under which we facilitate a lower cost option for our members compared to our interest rates. All loans sold to the Federal Agricultural Mortgage Corporation are sold at par and we retain the servicing rights.

#### Adjusted Debt to Equity Ratio

Our adjusted debt to equity ratio at February 28, 2010 was 6.00, a reduction from 6.63 at May 31, 2009. We have taken a number of steps over the past two years to lower our adjusted debt to equity ratio. In addition, our decrease to loans outstanding at February 28, 2010 has also contributed to the decrease in the adjusted debt to equity ratio.

In November 2008, we began to offer member capital securities to our members and since that time, we have sold approximately \$400 million. Member capital securities are voluntary investments by members in our subordinated certificates with a 35-year maturity. The member capital securities were initially offered with an interest rate of 7.50 percent and on January 1, 2010, the rate for new member capital securities was lowered to 5.00 percent. Member capital securities have a call feature pursuant to which we have the option at any time after five years from the date of issuance to call the investments at 100 percent of the principal amount plus accrued interest. The member capital securities are subordinated to all other debt outstanding, and on par with all other forms of subordinated certificates. Member capital securities are classified as equity rather than debt in the adjusted debt to equity ratio.

In June 2009, our board of directors approved a change in the patronage capital retirement guidelines. We now retire 50 percent of the prior year's allocated patronage capital during the first quarter of the next fiscal year, which is down from 70 percent. We hold the remaining 50 percent for 25 years, which represents an extension of the prior hold period of 15 years. This change to the retirement guidelines is expected to significantly increase our retained equity over the next 10 years. The board of directors must approve the annual allocation and retirement of patronage capital and may adjust these to increase or decrease the amount allocated or retired.

#### Liquidity

The investing community and rating agencies placed a premium on liquidity after the financial crisis in the fall of 2008. As mentioned above, some of the actions we took to mitigate liquidity concerns have been successful, but resulted in higher interest expense than we could have otherwise achieved. During the nine months ended February 28, 2010, we kept commercial paper issuance capacity in reserve by issuing longer term debt. As a result, our average balance of commercial paper outstanding during the nine months ended February 28, 2010 is substantially lower than in the prior year. Commercial paper provides our lowest cost variable-rate funding.

We believe that we have sufficient sources of liquidity to meet all debt refinancing and member loan needs over the next 12 to 18 month period.

We have long-term debt maturing in the next 12 months totaling \$2,263 million at February 28, 2010. As presented in our sources and uses of liquidity chart on page 52, we believe that over the next six quarters, the repayments on our long-term loans will be approximately \$550 million greater than our long-term loan advances, which will partially reduce the need for liquidity over that period. At February 28, 2010, we have \$725 million of issuance authority under our note purchase agreements with the Federal Agricultural Mortgage Corporation. From February 2009 through November 2009, we issued a significant amount of retail notes. There has not been a need for us to obtain additional market funding since November 2009 and we have not posted retail notes for sale, however we believe that such market is available to us. We also qualify as a well-known seasoned issuer and have effective registration statements on file with the Securities and Exchange Commission to issue an unlimited amount of collateral trust bonds, medium-term notes and member capital securities.

In March 2010, we replaced our 364-day \$1 billion revolving credit agreement with a \$1.3 billion three-year revolving credit agreement. Subsequent to the renewal, also in March 2010, we increased our available credit under the facility by \$35 million to a total of \$1,335 million. This new facility, along with our two five-year revolving credit agreements, now provides us with \$3,351 million of liquidity. We use this liquidity as backup support for our commercial paper program.

## Results of Operations

Three and nine months ended February 28, 2010 versus February 28, 2009 results

The following table presents the results of operations for the three and nine months ended February 28, 2010 and 2009.

| (dollar amounts in thousands)  | For the three months ended February 28, |            |            | For the nine months ended February 28, |            |            |
|--|---|------------|------------|--|------------|------------|
|  | 2010                                    | 2009       | Change     | 2010                                   | 2009       | Change     |
| Interest income  | \$ 256,519}                             | \$ 268,453 | \$(11,934) | \$ 790,895}                            | \$ 798,316 | \$ (7,421) |
| Interest expense   | (221,898)                               | (239,744)  | 17,846}    | (691,504)                              | (694,080)  | 2,576}     |
| Net interest income  | 34,621}                                 | 28,709     | 5,912}     | 99,391}                                | 104,236    | (4,845)    |
| (Provision for) recovery of loan losses                                  | (10,000)                                | 10,415     | (20,415)   | 4,594}                                 | (126,577)  | 131,171}   |
| Net interest income (loss) after (provision for) recovery of loan losses | 24,621}                                 | 39,124     | (14,503)   | 103,985}                               | (22,341)   | 126,326}   |
| Non-interest income:   |   |            |            |  |            |            |
| Fee and other income   | 5,638}                                  | 3,200      | 2,438}     | 13,478}                                | 9,519      | 3,959}     |
| Settlement income  | 22,906}                                 | -          | 22,906}    | 22,906}                                | -          | 22,906}    |
| Derivative gains (losses)  | 22,571}                                 | 50,966     | (28,395)   | 5,099}                                 | (86,511)   | 91,610}    |
| Results of operations from foreclosed assets                             | 338}                                    | 801        | (463)      | 946}                                   | 3,258      | (2,312)    |
| Total non-interest income  | 51,453}                                 | 54,967     | (3,514)    | 42,429}                                | (73,734)   | 116,163}   |
| Non-interest expense:  |   |            |            |  |            |            |
| Salaries and employee benefits   | (9,286)                                 | (10,036)   | 750}       | (28,970)                               | (29,799)   | 829}       |
| Other general and administrative expenses                                | (8,840)                                 | (6,430)    | (2,410)    | (22,598)                               | (16,354)   | (6,244)    |
| (Provision for) recovery of guarantee liability                          | (451)                                   | (338)      | (113)      | 2,765}                                 | (5,319)    | 8,084}     |
| Market adjustment on foreclosed assets                                   | (988)                                   | (1,652)    | 664}       | (2,738)                                | (1,805)    | (933)      |
| Other  | (111)                                   | (372)      | 261}       | (432)                                  | (670)      | 238}       |
| Total non-interest expense   | (19,676)                                | (18,828)   | (848)      | (51,973)                               | (53,947)   | 1,974}     |
| Income (loss) prior to income taxes                                      | 56,398}                                 | 75,263     | (18,865)   | 94,441}                                | (150,022)  | 244,463}   |
| Income tax (expense) benefit   | (1,465)                                 | (183)      | (1,282)    | (656)                                  | 6,977      | (7,633)    |
| Net income (loss)  | 54,933}                                 | 75,080     | (20,147)   | 93,785}                                | (143,045)  | 236,830}   |
|  | (2,130)                                 | 159        | (2,289)    | (753)                                  | 3,138      | (3,891)    |



Less: Net (loss) income  
attributable to  
noncontrolling interest

|  |            |           |            |            |             |                |
|--|------------|-----------|------------|------------|-------------|----------------|
| Net income (loss)<br>attributable to CFC | \$ 52,803} | \$ 75,239 | \$(22,436) | \$ 93,032} | \$(139,907) | \$<br>232,939} |
|--|------------|-----------|------------|------------|-------------|----------------|

|                       |       |      |  |       |      |   |
|-----------------------|-------|------|--|-------|------|---|
| TIER (1)              | 1.25} | 1.31 |  | 1.14} | -    | ! |
| Adjusted TIER (1) (2) | 1.12} | 1.94 |  | 1.10} | 1.10 |   |

(1) For the nine months ended February 28, 2009, we reported a net loss of \$143 million and therefore, the TIER calculations for that period results in a value below 1.00.

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

#### Interest Income

The following tables break out the average yield on loans and the change to interest income due to changes in average loan volume versus changes to interest rates summarized by loan type.

#### Average balances and interest rates - Assets

|                                   | For the three months ended February 28, |                |                 |             |               |       |
|-----------------------------------|---|----------------|-----------------|-------------|---------------|-------|
|                                   | 2010                                    | 2009           | 2010            | 2009        | 2010          | 2009  |
| (dollar amounts in thousands)     |   |                |                 |             |               |       |
|                                   | Average volume                          |                | Interest income |             | Average yield |       |
| Long-term fixed-rate loans (1)    | \$ 15,558,058}                          | \$ 14,919,093} | \$ 224,201}     | \$ 220,791} | 5.84%         | 6.00% |
| Long-term variable-rate loans (1) | 1,884,054}                              | 2,567,066}     | 15,964}         | 27,035}     | 3.44          | 4.27  |
| Short-term loans (1)              | 1,570,264}                              | 2,007,714}     | 13,612}         | 18,208}     | 3.52          | 3.68  |
| Non-performing loans              | 523,850}                                | 495,062}       | -}              | -}          | -}            | -}    |
| Total loans                       | 19,536,226}                             | 19,988,935}    | 253,777}        | 266,034}    | 5.27          | 5.40  |
| Investments (2)                   | 606,755}                                | 513,988}       | 1,328}          | 990}        | 0.89          | 0.78  |
| Fee income                        | -}                                      | -}             | 1,414}          | 1,429}      | -}            | -}    |
| Total                             | \$ 20,142,981}                          | \$ 20,502,923} | \$ 256,519}     | \$ 268,453} | 5.16          | 5.31  |

## Average balances and interest rates - Assets

|                                   | For the nine months ended February 28, |                |                 |             |               |       |
|-----------------------------------|--|----------------|-----------------|-------------|---------------|-------|
|                                   | 2010                                   | 2009           | 2010            | 2009        | 2010          | 2009  |
| (dollar amounts in thousands)     | Average volume                         |                | Interest income |             | Average yield |       |
| Long-term fixed-rate loans (1)    | \$ 15,402,498}                         | \$ 15,123,380} | \$ 673,277}     | \$ 669,454} | 5.84%         | 5.92% |
| Long-term variable-rate loans (1) | 2,268,828}                             | 2,047,781}     | 64,215}         | 60,684}     | 3.78          | 3.96  |
| Short-term loans (1)              | 1,728,376}                             | 1,882,711}     | 44,288}         | 58,654}     | 3.43          | 4.17  |
| Non-performing loans              | 523,801}                               | 495,235}       | -}              | -}          | -}            | -}    |
| Total loans                       | 19,923,503}                            | 19,549,107}    | 781,780}        | 788,792}    | 5.25          | 5.39  |
| Investments (2)                   | 627,452}                               | 481,861}       | 4,314}          | 4,615}      | 0.92          | 1.28  |
| Fee income                        | -}                                     | -}             | 4,801}          | 4,909}      | -}            | -}    |
| Total                             | \$ 20,550,955}                         | \$ 20,030,968} | \$ 790,895}     | \$ 798,316} | 5.15          | 5.33  |

(1) Interest income on loans to members.

(2) Interest income on the investment of excess cash and equity securities.

## Analysis of changes in interest income

|   | For the three months ended<br>February 28, 2010 vs. 2009 |                  |            | For the nine months ended<br>February 28, 2010 vs. 2009 |                  |            |
|---|--|------------------|------------|---|------------------|------------|
|   | Change due to (3)  |                  |            | Change due to (3)                                       |                  |            |
| (dollar amounts in thousands)           | Average volume (1)                                       | Average rate (2) | Net change | Average volume (1)                                      | Average rate (2) | Net change |
| Increase (decrease) in interest income: |  |                  |            |   |                  |            |
| Long-term fixed-rate loans              | \$ 9,456}  | \$ (6,046)       | \$ 3,410   | \$ 12,355}  | \$ (8,532)       | \$ 3,823   |
| Long-term variable-rate loans           | (7,193)  | (3,878)          | (11,071)   | 6,551}  | (3,020)          | 3,531      |
| Short-term loans                        | (3,967)  | (629)            | (4,596)    | (4,808)   | (9,558)          | (14,366)   |
| Total interest income on loans (4)      | (6,025)  | (6,232)          | (12,257)   | 15,107}   | (22,119)         | (7,012)    |
| Investments                             | 179}   | 159}             | 338        | 1,394}  | (1,695)          | (301)      |
| Fee income                              | -}   | (15)             | (15)       | -}  | (108)            | (108)      |
| Total interest (4) income               | (4,713)  | (7,221)          | (11,934)   | 20,724}   | (28,145)         | (7,421)    |

(1) Calculated using the following formula: (current period average balance – prior-year period average balance) x prior-year period average rate.

(2) Calculated using the following formula: (current period average rate – prior-year period average rate) x current period average balance.

(3) The net change attributable to the combined impact of volume and rate has been allocated to each in proportion to the absolute dollar amounts of change.

(4) Changes due to average volume and average rate represent a calculated amount and are not intended to sum.

During the three and nine months ended February 28, 2010 compared to the same prior-year periods, interest income decreased 4 percent and 1 percent, respectively. The factors that impacted our interest income during the three and nine months ended February 28, 2010 are pressure from competition and the overall lower interest rate environment. Additionally, non-accrual loans reduced interest income for both the current and prior-year periods.

A portion of the reduction in income from the variable and fixed interest rates we charged on our loans during fiscal year 2010 is due to continued pressures from alternative sources of funding available to our members from the Rural Utilities Service and CoBank, ACB. The Rural Utilities Service had authority to provide loans and guarantees for electric purposes of up to \$6.6 billion for the fiscal year ending September 30, 2010, the same level as the prior two years. The Rural Utilities Service, as a government agency, generally provides loans with rates lower than all other competitors and may lend 100 percent of the amount required by a rural electric system. However, loans from the Rural Utilities Service are generally limited to long-term (35-year) financing for physical facilities. The Rural Utilities Service does not provide lines of credit, letters of credit, bridge loans or other financing options available from CFC. In addition, the Rural Utilities Service is currently unable to provide financing for certain base load generation facilities. CoBank, ACB is a government-sponsored enterprise and thus gains a benefit from an implied government guarantee, allowing it to access financing at a lower cost than organizations that do not have the implied government guarantee. While there has been increased competitive pressure, we were successful in keeping approximately 95% of the fixed-rate loans that had a scheduled repricing date during the nine months ended February 28, 2010. Our members have the opportunity to consider other interest rate options at repricing, including refinancing with another lender. Furthermore, we developed and continued to offer attractively priced options for our members, such as the program under which we will sell loans to the Federal Agricultural Mortgage Corporation at 100 percent of the principal amount while retaining the servicing rights. In addition, we expect to increase the use of commercial paper, which is our lowest cost funding, in our funding mix in the future as compared to the utilization over the past nine months.

At February 28, 2010, approximately 31 percent of the outstanding balance of our line of credit loans was priced at rates lower than our standard line of credit interest rates because of loan syndications and our need to competitively price these loans due to competition for the business. Of the line of credit loans priced lower than our standard rates at February 28, 2010, 52 percent were made as part of loan syndications where the pricing was agreed upon by all of the participating banks and is based on current market conditions.

Our non-performing and restructured loans on non-accrual status continue to impact interest income for both the current and prior-year periods. The effect of non-accrual loans on interest income is included in the rate variance in the table above.

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

| (dollar amounts in thousands) | Three months ended<br>February 28, |           | Nine months ended<br>February 28, |           |
|-------------------------------|------------------------------------|-----------|-----------------------------------|-----------|
|                               | 2010                               | 2009      | 2010                              | 2009      |
| Telecommunications            | \$ 7,117}                          | \$ 7,484  | \$ 21,790}                        | \$ 22,335 |
| Electric                      | 5,862}                             | 6,538     | 17,853}                           | 20,135    |
| Total                         | \$ 12,979}                         | \$ 14,022 | \$ 39,643}                        | \$ 42,470 |

The restructured loan to CoServ is on non-accrual status, however we benefit from a reduction to the calculated impairment due to the principal payments, which results in a reduction to the required loan loss provision or a recovery for the period. During the nine months ended February 28, 2010, CoServ made scheduled payments of \$21 million, all of which were applied as a reduction to the loan principal balance and resulted in a reduction of \$16 million to the calculated impairment.

Since, on average, 77 percent of our loan portfolio from February 28, 2009 to February 28, 2010 was comprised of loans that have a fixed rate of interest, we do not experience dramatic swings in our interest income as a result of changes to interest rates in the capital markets. We issue new loans with fixed rates based on our cost at the time of the advance. Our long-term variable interest rates at February 28, 2010 were 45 basis points lower for electric loans compared to the interest rates at February 28, 2009. However, since a high percentage of our loan portfolio is made up of long-term fixed rate loans, the average yield on the loan portfolio during the three and nine months ended February 28, 2010 only decreased by 13 basis points and 14 basis points compared to the prior-year periods, respectively. The long-term fixed interest rates we offered on electric loans at February 28, 2010 compared with February 28, 2009 decreased between 50 basis points and 205 basis points, depending on the loan term.

#### Interest Expense

The following tables break out the average cost of debt and the change to interest expense due to changes in average debt volume versus changes to interest rates summarized by debt type. We do not fund each individual loan borrowed by our members with specific debt. Rather we attempt to minimize cost and maximize efficiency by funding large aggregated amounts of loans. The following tables also break out the change to derivative cash settlements due to changes in the average notional amount of our derivative portfolio versus changes to the net difference between the average rate paid and the average rate received. Management calculates an adjusted interest expense, which includes all derivative cash settlements in interest expense. See Non-GAAP Financial Measures for further explanation of the adjustment we make in our financial analysis to include all derivative cash settlements in interest expense.

#### Average balances and interest rates - Liabilities

| For the three months ended February 28, |      |      |      |      |      |
|---|------|------|------|------|------|
| 2010                                    | 2009 | 2010 | 2009 | 2010 | 2009 |

| (dollar amounts<br>in thousands) | Average volume |               | Interest expense |              | Average cost |         |
|----------------------------------|----------------|---------------|------------------|--------------|--------------|---------|
| Commercial paper and<br>bank bid |                |               |                  |              |              |         |
| notes (1)                        | \$ 1,890,326}  | \$ 3,583,654  | \$ (1,114)       | \$ (13,424)  | (0.24)%      | (1.52)% |
| Medium-term notes (1)            | 4,321,808}     | 5,160,558     | (64,683)         | (80,503)     | (6.07)       | (6.33)  |
| Collateral trust                 | 5,600,755}     |               |                  | )            | (5.84)       | (6.25)  |
| bonds (1)                        |                | 5,198,768     | (80,618)         | (80,111)     |              |         |
| Subordinated deferrable          | 301,922}       |               |                  |              | (6.60)       | (6.61)  |
| debt (1)                         |                | 301,846       | (4,916)          | (4,916)      |              |         |
| Subordinated                     | 1,774,984}     |               |                  | )            | (4.58)       | (3.85)  |
| certificates (1)                 |                | 1,420,421     | (20,064)         | (13,475)     |              |         |
| Long-term                        | 4,711,074}     |               |                  | )            | (3.92)       | (4.31)  |
| private debt (1)                 |                | 3,869,997     | (45,588)         | (41,146)     |              |         |
| Total debt                       | 18,600,869}    | 19,535,244    | (216,983)        | (233,575)    | (4.73)       | (4.85)  |
| Debt issuance                    | -}             |               |                  | )            | -            | -       |
| costs (2)                        |                | -             | (2,676)          | (2,692)      |              |         |
| Fee expense (3)                  | -}             | -             | (2,239)          | (3,477)      | -            | -       |
| Total                            | \$ 18,600,869} | \$ 19,535,244 | \$ (221,898)     | \$ (239,744) | (4.84)       | (4.98)  |
| Derivative cash                  | \$ 11,128,340} | \$ 12,358,960 | \$ (5,636)       | \$           |              |         |
| settlements (4)                  |                |               |                  | 104,012      | (0.21)%      | 3.41%   |
| Adjusted interest                | 18,600,870}    |               | (227,534)        | )            |              |         |
| expense (5)                      |                | 19,535,244    |                  | (135,732)    | (4.96)       | (2.82)  |

| (dollar amounts in thousands)    | For the nine months ended February 28, |               |                  |              |              |         |
|----------------------------------|--|---------------|------------------|--------------|--------------|---------|
|                                  | 2010                                   | 2009          | 2010             | 2009         | 2010         | 2009    |
| Commercial paper and bank bid    | Average volume                         |               | Interest expense |              | Average cost |         |
| notes (1)                        | \$ 2,199,082}                          | \$ 3,333,546  | \$ (6,300)       | \$ (53,500)  | (0.38)%      | (2.15)% |
| Medium-term notes (1)            | 4,767,964}                             | 5,162,762     | (215,180)        | (242,016)    | (6.03)       | (6.27)  |
| Collateral trust bonds (1)       | 5,461,966}                             | 5,250,372     | (240,796)        | (211,066)    | (5.89)       | (5.37)  |
| Subordinated deferrable debt (1) | 301,904}                               | 301,830       | (14,747)         | (14,747)     | (6.53)       | (6.53)  |
| Subordinated certificates (1)    | 1,743,758}                             | 1,382,558     | (58,871)         | (38,723)     | (4.51)       | (3.74)  |
| Long-term private debt (1)       | 4,666,798}                             | 3,450,158     | (139,142)        | (119,501)    | (3.99)       | (4.63)  |
| Total debt                       | 19,141,472}                            | 18,881,226    | (675,036)        | (679,553)    | (4.72)       | (4.81)  |
| Debt issuance costs (2)          | -}                                     | -             | (8,281)          | (7,218)      | -            | -       |
| Fee expense (3)                  | -}                                     | -             | (8,187)          | (7,309)      | -            | -       |
| Total                            | \$ 19,141,472}                         | \$ 18,881,226 | \$ (691,504)     | \$ (694,080) | (4.83)       | (4.91)  |
| Derivative cash settlements (4)  | \$ 11,488,463}                         | \$ 13,039,310 | \$ (19,836)      | \$ 116,946   | (0.23)%      | 1.20%   |
| Adjusted interest expense (5)    | 19,141,472}                            | 18,881,226    | (711,340)        | (577,134)    | (4.97)       | (4.09)  |

(1) Represents interest expense and the amortization of discounts on debt.

(2) Includes amortization of all deferred charges related to debt issuances, principally underwriter's fees, legal fees, printing costs and comfort letter fees. Amortization is calculated on the effective interest method. Also includes issuance costs related to dealer commercial paper, which are recognized as incurred.

(3) Includes various fees related to funding activities, including fees paid to banks participating in our revolving credit agreements. Fees are recognized as incurred or amortized on a straight-line basis over the life of the respective agreement.

(4) For derivative cash settlements, average volume represents the average notional amount of derivative contracts outstanding and the average cost represents the net difference between the average rate paid and the average rate received for cash settlements during the period.

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

#### Analysis of changes in interest expense

| (dollar amounts in thousands) | For the three months ended<br>February 28, 2010 vs. 2009 |                     |               | For the nine months ended<br>February 28, 2010 vs. 2009 |                     |               |
|-------------------------------|--|---------------------|---------------|---|---------------------|---------------|
|                               | Change due to (3)  |                     |               | Change due to (3)                                       |                     |               |
|                               | Average<br>volume<br>(1)                                 | Average<br>rate (2) | Net<br>change | Average<br>volume<br>(1)                                | Average<br>rate (2) | Net<br>change |

(Increase) decrease in interest expense:

|                                     |            |            |             |            |             |             |
|-------------------------------------|------------|------------|-------------|------------|-------------|-------------|
| Commercial paper and bank bid notes | 6,343}     | 5,967}     | 12,310      | 18,207}    | \$ 28,993}  | \$ 47,200   |
| Medium-term notes                   | \$ 13,084} | \$ 2,736}  | \$ 15,820   | \$ 18,507} | 8,329}      | 26,836      |
| Collateral trust bonds              | (6,194)    | 5,687}     | (507)       | (8,506)    | (21,224)    | (29,730)    |
| Subordinated deferrable debt        | (1)        | 1}         | -           | (4)        | 4}          | -           |
| Subordinated certificates           | (3,364)    | (3,225)    | (6,589)     | (10,117)   | (10,031)    | (20,148)    |
| Long-term private debt              | (8,942)    | 4,500}     | (4,442)     | (42,140)   | 22,499}     | (19,641)    |
| Total interest expense on debt (4)  | 11,172}    | 5,420}     | 16,592      | (9,366)    | 13,883}     | 4,517       |
| Debt issuance costs                 | -          | 16}        | 16          | -          | (1,063)     | (1,063)     |
| Fee expense                         | -          | 1,238}     | 1,238       | -          | (878)       | (878)       |
| Total interest expense (4)          | 11,467}    | 6,379}     | 17,846      | (9,567)    | 12,143}     | 2,576       |
| Derivative cash settlements (5)     | \$(10,357) | \$(99,291) | \$(109,648) | \$(13,909) | \$(122,873) | \$(136,782) |
| Adjusted interest expense (6)       | 6,492}     | (98,294)   | (91,802)    | (7,955)    | (126,251)   | (134,206)   |

(1) Calculated using the following formula: (current period average balance – prior-year period average balance) x prior-year period average rate.

(2) Calculated using the following formula: (current period average rate – prior-year period average rate) x current period average balance.

(3) The net change attributable to the combined impact of volume and rate has been allocated to each in proportion to the absolute dollar amounts of change.

(4) Changes due to average volume and average rate represent a calculated amount and are not intended to sum.

(5) For derivative cash settlements, variance due to average volume represents the change in derivative cash settlements from the change in average notional amount of derivative contracts outstanding. Variance due to average rate represents the change in derivative cash settlements due to the net difference between the average rate paid and the average rate received for interest rate swaps during the period.

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

During the three and nine months ended February 28, 2010, interest expense decreased 7 percent and less than 1 percent, respectively, compared with the prior-year period. The largest factors contributing to these decreases were the reduction in both the average volume and average interest rates on our commercial paper and medium-term notes during the three and nine months ended February 28, 2010 compared with the same prior-year period.

The lower interest rate environment for variable-rate debt in the capital markets significantly decreased the average interest rate on commercial paper issued during the three and nine months ended February 28, 2010 compared with the prior-year period. Although commercial paper is our lowest cost funding, we increased our term debt issuance during fiscal year 2010 to keep more commercial paper issuance capacity in reserve to help mitigate liquidity risk which tempered the reduction to interest expense we could have achieved by issuing more commercial paper during the period.

The average volume of medium-term notes decreased for the three and nine months ended February 28, 2010 because of the maturity of \$1,495 million of dealer medium-term notes in the first quarter of fiscal year 2010. Approximately \$2 billion of medium-term notes that matured during the period were primarily refinanced with collateral trust bond issuances totaling \$500 million, notes issued to the Federal Agricultural Mortgage Corporation totaling \$625 million and the issuance of \$472 million of new member and retail medium-term notes. The weighted average rate for medium-term notes decreased due to the 73 percent increase in retail notes from February 28, 2009 to February 28, 2010 that were issued at a lower interest rate relative to other medium-term notes.

The weighted average rate for long-term private placement debt decreased primarily due to the \$775 million increase in notes issued to Federal Agricultural Mortgage Corporation from February 28, 2009 to February 28, 2010 with a lower interest rate compared with other private placement debt in place, primarily Rural Economic Development Loan and Grant funding.

Partially offsetting these decreases in interest expense was the higher average interest rate on collateral trust bonds and subordinated certificates during the nine months ended February 28, 2010 compared to the prior-year period. We have a full nine months of higher interest expense during the current fiscal year-to-date period from the 10.375 percent \$1 billion collateral trust bonds issued in October 2008 and the 7.50 percent member capital securities, which we started issuing in November 2008. Both 10.375 percent and 7.50 percent represent a significantly higher cost than our other sources of funding.

The adjusted interest expense of \$228 million and \$711 million for the three and nine months ended February 28, 2010, respectively, which includes all derivative cash settlements, represented an increase of \$92 million and \$134 million compared with the prior-year period. The adjusted interest expense was lower during the three and nine months ended February 28, 2009 primarily due to the termination of swaps during the third quarter of fiscal year 2009 that resulted in a \$97 million gain recognized as a cash settlement. This change in derivative cash settlements was partially offset by the changes to interest expense noted above. See Non-GAAP Financial Measures for further explanation of the adjustment we make in our financial analysis to include all derivative cash settlements in interest expense.

#### Net Interest Income

The following tables represent a summary of the effect on the net interest income from changes in the components of the total interest income and total interest expense described above. The tables show the total average yield on loans and the change to total interest income due to changes in average loan volume versus changes to interest rates. The tables also show the total average cost on debt and the change to total interest expense and net interest income due to changes in average debt volume versus changes to interest rates summarized by debt type. See Non-GAAP Financial Measures for further explanation of the adjustment we make in our financial analysis to include all derivative cash settlements in interest expense.

#### Average interest rates – Assets and Liabilities

| For the three months ended February 28, |      |      |      |
|---|------|------|------|
| 2010                                    | 2009 | 2010 | 2009 |



| (dollar amounts in thousands)                       | Interest income/expense |            | Average yield/cost |        |
|---|-------------------------|------------|--------------------|--------|
| Total interest income                               | \$ 256,519}             | \$ 268,453 | 5.16%              | 5.31%  |
| Total interest expense                              | (221,898)               | (239,744)  | (4.84)             | (4.98) |
| Net interest income/Net yield                       | \$ 34,621}              | \$ 28,709  | 0.32%              | 0.33%  |
| Adjusted net interest income/Adjusted net yield (1) | 28,985}                 | 132,721    | 0.20               | 2.49   |

For the nine months ended February 28,

| (dollar amounts in thousands)                       | 2010                    | 2009        | 2010               | 2009   |
|---|-------------------------|-------------|--------------------|--------|
|   | Interest income/expense |             | Average yield/cost |        |
| Total interest income                               | \$ 790,895}             | \$ 798,316} | 5.15%              | 5.33%  |
| Total interest expense                              | (691,504)               | (694,080)   | (4.83)             | (4.91) |
| Net interest income/Net yield                       | \$ 99,391}              | \$ 104,236} | 0.32%              | 0.42%  |
| Adjusted net interest income/Adjusted net yield (1) | 79,555}                 | 221,182}    | 0.18               | 1.24   |

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

## Analysis of changes in net interest income

| (dollar amounts in thousands)              | For the three months ended<br>February 28, 2010 vs. 2009 |                     |               | For the nine months ended<br>February 28, 2010 vs. 2009 |                     |               |
|--|--|---------------------|---------------|---|---------------------|---------------|
|  | Change due to (3)  |                     |               | Change due to (3)                                       |                     |               |
|  | Average<br>volume<br>(1)                                 | Average<br>rate (2) | Net<br>change | Average<br>volume<br>(1)                                | Average<br>rate (2) | Net<br>change |
| Increase (decrease) in net interest income | \$ 6,754}  | \$ (842)            | \$ 5,912      | \$ 11,157}  | \$ (16,002)         | \$ (4,845)    |

(1) Calculated using the following formula: (current period average balance – prior-year period average balance) x prior-year period average rate.

(2) Calculated using the following formula: (current period average rate – prior-year period average rate) x current period average balance.

(3) The net change attributable to the combined impact of volume and rate has been allocated to each in proportion to the absolute dollar amounts of change.

The \$6 million increase in net interest income for the three months ended February 28, 2010 compared with the prior-year period was due to lower average debt outstanding of \$934 million or 5 percent as compared to the decrease in the average loan volume of \$453 million or 2 percent.

The \$5 million decrease in net interest income for the nine months ended February 28, 2010 compared with the prior-year period was due primarily to the following factors described in more detail above:

- the \$260 million or 1 percent increase in the average debt volume due to the \$374 million or 2 percent increase in average loan volume and the prefunding of maturing debt,
- the 14 basis point decline in the yield of our loan portfolio due primarily to lower interest rates earned on long-term fixed and variable-rate loans, offset by
  - the 9 basis point decrease in the overall cost of debt.

The adjusted net interest income, which includes all derivative cash settlements, for the three and nine months ended February 28, 2010 was \$29 million and \$80 million, respectively, a decrease of \$104 million and \$142 million from the prior-year periods, respectively, primarily due to cash settlements. The adjusted net interest income during the three and nine months ended February 28, 2009 was impacted by the termination of swaps during the third quarter of fiscal year 2009 that resulted in a \$97 million gain recognized as a cash settlement. See Non-GAAP Financial Measures for further explanation of the adjustment we make in our financial analysis to include all derivative cash settlements in determining our adjusted interest expense which, in turn, affects adjusted net interest income.

#### Recovery of/Provision for Loan Losses

During the three months ended February 28, 2010, there was a loan loss provision of \$10 million compared to a recovery of \$10 million for the prior-year period. During the nine months ended February 28, 2010, there was a loan loss recovery of \$5 million compared to a provision of \$127 million for the prior-year period. For the three months ended February 28, 2010, the \$10 million provision for loan losses was primarily due to the increase to the reserve for one of our impaired loans due to an estimation of the deterioration in the collateral securing this impaired loan, which was partly offset by a decrease to the reserve of another of our impaired loans due to payments received on this loan. The recovery of loan losses during the nine months ended February 28, 2010 was primarily due to the decrease to the reserve for impaired loans and the decrease in exposure in the general portfolio, which was partially offset by an increase to the exposure for high risk loans during the period. The reserve for impaired loans decreased due to payments received and the net decrease in our variable interest rates, which was partially offset by the deterioration in

the collateral securing impaired loans.

The loan loss provision of \$127 million for the nine months ended February 28, 2009 was primarily due to a reduction in the estimated fair value of the collateral supporting our exposure to one of our impaired borrowers. The fair value of the collateral was negatively affected by the limited access to, and high cost of, capital to support acquisitions of assets similar to the collateral supporting our impaired loans, which resulted in a compression of the earning multiple that potential buyers are willing to pay for such assets. In addition, the current economic conditions caused consumers and businesses to reduce spending, which resulted in, at least for the short-term, reductions in the estimated earnings for companies in general. The combination of these two factors resulted in a decrease to the market value of companies similar to the collateral supporting our impaired loans.

#### Non-interest Income

Non-interest income decreased by \$4 million and increased by \$116 million for the three and nine months ended February 28, 2010, respectively, compared with the prior-year periods primarily due to the \$28 million decrease and \$92 million increase in derivative gains, respectively, as well as one-time settlement income of \$23 million recorded during the three months ended February 28, 2010.

The derivative forward value in the derivative gains (losses) increased during both the three and nine months ended February 28, 2010 compared to the prior year period due to the shift in the composition of our derivative portfolio. At February 28, 2010, 50 percent of our interest rate swaps were pay fixed-receive variable versus 56 percent at February 28, 2009. At February 28, 2010 it is anticipated that variable interest rates will increase sooner and at a faster pace than at February 28, 2009, which has increased the estimated forward value of our derivative portfolio.

Non-interest income for the three and nine months ended February 28, 2010 was also impacted by the \$23 million one-time settlement payment from CoBank, ACB, a government-sponsored enterprise that lends to agribusinesses and rural utilities throughout the United States. On February 25, 2010, CoBank, ACB agreed to a settlement relating to our discovery that for a period of years, CoBank, ACB employees improperly accessed confidential and proprietary information from our password-protected, web-based "Extranet." The settlement includes a monetary payment of \$23 million to us as well as non-monetary commitments, including an agreement not to engage in the challenged conduct in the future. The settlement income, classified as non-interest income on the statement of operations, is net of legal and other related expenses.

#### Non-interest Expense

Non-interest expense decreased by \$2 million for the nine months ended February 28, 2010 compared with the prior-year period primarily due to the change in the guarantee liability partially offset by the increase in general and administrative expenses.

We recorded a \$3 million recovery of guarantee liability for the nine months ended February 28, 2010 compared with a \$5 million provision during the same prior-year period. Guarantees decreased by \$77 million over the nine months ended February 28, 2010, partially due to the early redemption of a \$20 million tax-exempt bond guarantee.

During the nine months ended February 28, 2010, we experienced an increase in legal fees and other expenses related to our effort to obtain the regulatory approvals necessary to close the acquisition of the operating companies that comprise the collateral for our ICC loan exposure.

#### Net Income (Loss)

The change in the items described above resulted in net income of \$55 million for the three months ended February 28, 2010, compared to \$75 million for the prior-year period. The adjusted net income, which excludes the effect of the derivative forward value, was \$27 million, compared to \$128 million for the prior-year period. See Non-GAAP Financial Measures for further explanation of the adjustments we make in our financial analysis to net income.

The change in the items described above resulted in net income of \$94 million for the nine months ended February 28, 2010, compared to net loss of \$143 million for the prior-year period. The adjusted net income, which excludes the effect of the derivative forward value, was \$69 million, compared to an adjusted net income of \$60 million for the prior-year period.

#### Noncontrolling Interest

Noncontrolling interest represents \$0.3 million of net loss for RTFC and \$2.4 million of net income for NCSC for the three months ended February 28, 2010. Noncontrolling interest for the three months ended February 28, 2009 represents \$0.2 million of RTFC net loss and \$0.3 million of NCSC's \$0.5 million net income for the period.

Noncontrolling interest for the nine months ended February 28, 2010 represents \$0.7 million of net loss for RTFC and \$1.5 million of net income for NCSC. For the nine months ended February 28, 2009, noncontrolling interest represents \$0.4 million of the RTFC net loss and \$2.9 million of the \$11 million NCSC net loss, respectively. NCSC's net loss for the nine months ended February 28, 2009 exceeded its equity balance by \$8.1 million. Under prior accounting standards, CFC was required to absorb the \$8.1 million excess NCSC loss. Based on the provisions of

new accounting standards applied prospectively starting June 1, 2009, the noncontrolling interest is required to absorb the full amount of its losses, even if the losses exceed its equity balance.

The decrease in the loss attributable to the noncontrolling interest was primarily due to the decrease in the derivative forward value loss recorded at NCSC for the three and nine months ended February 28, 2010 compared to the prior-year periods.

## Ratio of Earnings to Fixed Charges

The following table provides the calculation of the ratio of earnings to fixed charges. The fixed charge coverage ratio includes capitalized interest in total fixed charges which is not included in our TIER calculation. See Results of Operations for a discussion of TIER and adjustments that we make to the TIER calculation.

| (dollar amounts in thousands)  | Three months ended<br>February 28, |           | Nine months ended<br>February 28, |             |
|--|------------------------------------|-----------|-----------------------------------|-------------|
|  | 2010                               | 2009      | 2010                              | 2009        |
| Income (loss) prior to cumulative effect of                                  |                                    |           |                                   |             |
| change in accounting principle   | \$ 54,933}                         | \$ 75,080 | \$ 93,785}                        | \$(143,045) |
| Add: fixed charges   | 221,922}                           | 239,808   | 691,587}                          | 694,196     |
| Less: interest capitalized   | (24)                               | (64)      | (83)                              | (116)       |
| Earnings available for fixed charges   | \$ 276,831}                        | \$314,824 | \$ 785,289}                       | \$ 551,035  |
| Total fixed charges:   |                                    |           |                                   |             |
| Interest on all debt (including amortization of discount and issuance costs) | \$ 221,898}                        | \$239,744 | \$ 691,504}                       | \$ 694,080  |
| Interest capitalized   | 24}                                | 64        | 83}                               | 116         |
| Total fixed charges  | \$ 221,922}                        | \$239,808 | \$ 691,587}                       | \$ 694,196  |
| Ratio of earnings to fixed charges (1)                                       | 1.25                               | 1.31      | 1.14                              | -           |

(1) For the nine months ended February 28, 2009, earnings were insufficient to cover fixed charges by \$143 million.

## Financial Condition

## Loan and Guarantee Portfolio Assessment

## Loan Programs

We are a cost-plus lender that offers long-term fixed and variable-rate loans and short-term variable-rate loans. Borrowers choose between a variable interest rate or a fixed interest rate for periods of one to 35 years. When a selected fixed interest rate term expires, the borrower may select another fixed-rate term or the variable rate.

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

| (dollar amounts in thousands) | February 28, 2010 |      | May 31, 2009  |      | Increase/<br>(Decrease) |
|-------------------------------|-------------------|------|---------------|------|-------------------------|
| Loans by type:                |                   |      |               |      |                         |
| Long-term loans (1):          |                   |      |               |      |                         |
| Long-term fixed rate loans    | \$ 15,570,305}    | 80%  | \$ 14,812,550 | 74%  | \$ 757,755}             |
| Long-term variable rate loans | 2,233,229}        | 11   | 3,277,528     | 16   | (1,044,299)             |
| Total long-term loans         | 17,803,534}       | 91   | 18,090,078    | 90   | (286,544)               |
| Short-term loans (2)          | 1,654,402}        | 9    | 2,098,129     | 10   | (443,727)               |
| Total loans                   | \$ 19,457,936}    | 100% | \$ 20,188,207 | 100% | \$ (730,271)            |

| (dollar amounts in thousands) | February 28, 2010 |      | May 31, 2009  |      | Increase/<br>(Decrease) |
|-------------------------------|-------------------|------|---------------|------|-------------------------|
| Loans by segment:             |                   |      |               |      |                         |
| CFC:                          |                   |      |               |      |                         |
| Distribution                  | \$ 13,523,257}    | 69%  | \$ 13,730,511 | 68%  | \$ (207,254)            |
| Power supply                  | 3,792,196}        | 19   | 4,268,244     | 21   | (476,048)               |
| Statewide and<br>associate    | 84,268}           | 1    | 92,578        | 1    | (8,310)                 |
| CFC total                     | 17,399,721}       | 89   | 18,091,333    | 90   | (691,612)               |
| RTFC                          | 1,702,640}        | 9    | 1,680,154     | 8    | 22,486}                 |
| NCSC                          | 355,575}          | 2    | 416,720       | 2    | (61,145)                |
| Total                         | \$ 19,457,936}    | 100% | \$ 20,188,207 | 100% | \$ (730,271)            |

(1) Includes loans classified as restructured and non-performing and loans guaranteed by the Rural Utilities Service.

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

Our loans outstanding decreased by \$730 million or 4 percent for the nine months ended February 28, 2010. The primary reasons for this decline are anticipated repayments from power supply bridge loans with loan funds from the Rural Utilities Service, the general decline in construction of distribution infrastructure due to the economic downturn, the lower use of lines of credit from distribution members, and the sale of \$67 million in distribution loans to the Federal Agricultural Mortgage Corporation during the period. We currently expect our loans outstanding to remain stable over the remainder of fiscal year 2010.

During the nine months ended February 28, 2010, the percentage of long-term fixed-rate loans increased from 74 percent to 80 percent primarily due to loan conversions. Loans converting from a variable rate to a fixed rate for the nine months ended February 28, 2010 totaled \$1,086 million, which was partially offset by loans that converted from a fixed rate to a variable rate totaling \$303 million. The significant shift in variable-rate loans converting to fixed rates was the result of the decrease of our long-term fixed rates offered during the nine months ended February 28, 2010 of between 130 and 195 basis points for electric loans and between 185 and 250 basis points for telecommunications loans, depending on the type and maturity of the loan. In addition, the possibility that interest rates could rise as the economy improves fueled the shift from variable to fixed rates. For the nine months ended February 28, 2009, loans converting from a fixed rate to variable rate totaled \$775 million, which was partially offset by \$169 million of loans that converted from a variable rate to a fixed rate.

The following table summarizes loans and guarantees outstanding by segment:

| (dollar amounts in thousands)     | February 28, 2010 |            | May 31, 2009  |            | Increase/<br>(Decrease) |
|-----------------------------------|-------------------|------------|---------------|------------|-------------------------|
|                                   | Amount            | % of Total | Amount        | % of Total |                         |
| CFC:                              |                   |            |               |            |                         |
| Distribution                      | \$ 13,753,442}    | 67%        | \$ 13,994,595 | 65%        | \$ (241,153)            |
| Power supply                      | 4,685,654}        | 22         | 5,213,868     | 24         | (528,214)               |
| Statewide and associate CFC total | 106,328}          | 1          | 116,203       | 1          | (9,875)                 |
| RTFC                              | 1,703,277}        | 8          | 1,680,654     | 8          | 22,623}                 |
| NCSC                              | 407,523}          | 2          | 458,342       | 2          | (50,819)                |
| Total                             | \$ 20,656,224}    | 100%       | \$ 21,463,662 | 100%       | \$ (807,438)            |

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

| (dollar amounts in thousands)       | February 28, 2010 |            | May 31, 2009 |            | Increase/<br>(Decrease) |
|-------------------------------------|-------------------|------------|--------------|------------|-------------------------|
|                                     | Amount            | % of Total | Amount       | % of Total |                         |
| Rural local exchange carriers       | \$ 1,494,803}     | 88%        | \$ 1,476,402 | 88%        | \$ 18,401}              |
| Cable television providers          | 151,406}          | 9          | 152,326      | 9          | (920)                   |
| Fiber optic network providers       | 6,884}            | -          | 8,126        | 1          | (1,242)                 |
| Competitive local exchange carriers | 33,810}           | 2          | 37,294       | 2          | (3,484)                 |
| Wireless providers                  | 13,374}           | 1          | 3,924        | -          | 9,450}                  |
| Other                               | 3,000}            | -          | 2,582        | -          | 418}                    |
| Total                               | \$ 1,703,277}     | 100%       | \$ 1,680,654 | 100%       | \$ 22,623}              |

#### Credit Concentration

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



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

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

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

Our members are located throughout the United States and its territories, including 49 states, the District of Columbia and two U.S. territories. At February 28, 2010 and May 31, 2009, loans outstanding to members in any one state or territory did not exceed 16 percent and 17 percent, respectively, of total loans outstanding.

At February 28, 2010 and May 31, 2009, the total exposure outstanding to any one borrower or controlled group did not exceed 2.5 percent and 2.4 percent, respectively, of total loans and guarantees outstanding. At February 28, 2010 and May 31, 2009, the

ten largest borrowers included four distribution systems, five power supply systems and one telecommunications system. The following table shows the exposure to the ten largest borrowers as a percentage of total exposure by type and by segment:

| (dollar amounts in thousands)                  | February 28, 2010 |            | May 31, 2009 |            | Increase/<br>(Decrease) |
|--|-------------------|------------|--------------|------------|-------------------------|
|  | Amount            | % of Total | Amount       | % of Total |                         |
| Total by type:                                 |                   |            |              |            |                         |
| Loans  | \$ 3,554,254}     | 17%        | \$ 3,686,956 | 17%        | \$ (132,702)            |
| Guarantees                                     | 275,314}          | 2          | 363,883      | 2          | (88,569)                |
| Total credit exposure to ten largest borrowers | \$ 3,829,568}     | 19%        | \$ 4,050,839 | 19%        | \$ (221,271)            |
| Total by segment:                              |                   |            |              |            |                         |
| CFC  | \$ 3,281,969}     | 16%        | \$ 3,497,331 | 16%        | \$ (215,362)            |
| RTFC   | 523,849}          | 3          | 523,758      | 3          | 91}                     |
| NCSC   | 23,750}           | -          | 29,750       | -          | (6,000)                 |
| Total credit exposure to ten largest borrowers | \$ 3,829,568}     | 19%        | \$ 4,050,839 | 19%        | \$ (221,271)            |

#### Security Provisions

Except when providing short-term loans, we typically lend to our members on a senior secured basis. Long-term loans are typically secured on parity with other secured lenders (primarily the Rural Utilities Service), if any, by all assets and revenues of the borrower with exceptions typical in utility mortgages. Short-term loans are generally unsecured lines of credit. Guarantee reimbursement obligations are typically secured on parity with other secured creditors by all assets and revenues of the borrower or by the underlying financed asset. In addition to the collateral received, borrowers are also required to set rates charged to customers to achieve certain financial ratios.

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

| (dollar amounts in thousands)   | February 28, 2010 |            | May 31, 2009 |            | Increase/<br>(Decrease) |
|---------------------------------|-------------------|------------|--------------|------------|-------------------------|
|                                 | Amount            | % of Total | Amount       | % of Total |                         |
| Total by type:                  |                   |            |              |            |                         |
| Loans                           | \$ 2,082,101}     | 10%        | \$ 2,831,111 | 13%        | \$ (749,010)            |
| Guarantees                      | 341,715}          | 2          | 347,325      | 2          | (5,610)                 |
| Total unsecured credit exposure | \$ 2,423,816}     | 12%        | \$ 3,178,436 | 15%        | \$ (754,620)            |
| Total by segment:               |                   |            |              |            |                         |
| CFC                             | \$ 2,108,665}     | 10%        | \$ 2,875,396 | 14%        | \$ (766,731)            |
| RTFC                            | 251,892}          | 2          | 237,259      | 1          | 14,633}                 |
| NCSC                            | 63,259}           | -          | 65,781       | -          | (2,522)                 |
| Total unsecured credit exposure | \$ 2,423,816}     | 12%        | \$ 3,178,436 | 15%        | \$ (754,620)            |

#### Pledging of Loans and Loans on Deposit

We are required to pledge collateral equal to at least 100 percent of the outstanding balance of debt issued under the collateral trust bond indentures and the revolving debt issuance agreements with the Federal Agricultural Mortgage Corporation. In addition, we are required to maintain collateral on deposit equal to at least 100 percent of the outstanding balance of debt under the Rural Economic Development Loan and Grant program.

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

| (dollar amounts in thousands)  | February 28,<br>2010 | May 31,<br>2009 |
|--|----------------------|-----------------|
| Total loans to members   | \$ 19,457,936}       | \$ 20,188,207   |
| Less: Total secured debt or debt requiring collateral on deposit (1) | (10,187,101)         | (9,390,000)     |
| Less: Excess collateral pledged or on deposit (2)                    | (2,085,177)          | (2,566,723)     |
| Unencumbered loans   | \$ 7,185,658}        | \$ 8,231,484    |

Unencumbered loans as a percentage of total loans

|     |     |
|-----|-----|
| 37% | 41% |
|-----|-----|

(1) Excludes debt secured by cash collateral only.

(2) Excludes cash collateral pledged to secure debt. Unless and until there is an event of default, we can withdraw excess collateral as long as there is 100 percent coverage of the secured debt. If there is an event of default under most of our indentures, we can only withdraw this excess collateral if we substitute cash of equal value.

## Non-performing and Restructured Loans

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

| (dollar amounts in thousands)                   | February<br>28,<br>2010 | May 31,<br>2009  |
|---|-------------------------|------------------|
| Non-performing loans (1)                        | \$ 523,849              | \$ 523,758       |
| Percent of loans outstanding                    | 2.69%                   | 2.59%            |
| Percent of loans and guarantees outstanding     | 2.54                    | 2.44             |
| <br>Restructured loans                          | <br>\$ 515,438          | <br>\$ 537,587   |
| Percent of loans outstanding                    | 2.65%                   | 2.66%            |
| Percent of loans and guarantees outstanding     | 2.50                    | 2.50             |
| <br>Total non-performing and restructured loans | <br>\$ 1,039,287        | <br>\$ 1,061,345 |
| Percent of loans outstanding                    | 5.34%                   | 5.25%            |
| Percent of loans and guarantees outstanding     | 5.04                    | 4.94             |
| <br>Total non-accrual loans                     | <br>\$ 993,354          | <br>\$ 1,014,585 |
| Percent of loans outstanding                    | 5.11%                   | 5.03%            |
| Percent of loans and guarantees outstanding     | 4.81                    | 4.73             |

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

At February 28, 2010 and May 31, 2009, all loans classified as restructured were performing according to the restructure agreements. A total of \$45 million and \$47 million of restructured loans at February 28, 2010 and May 31, 2009, respectively, have been on accrual status since the time of the loan restructuring. There has been no principal written off on these loans. Approximately \$1 million of interest income was accrued on restructured loans during the three months ended February 28, 2010 and 2009. Approximately \$2 million and \$3 million of interest income was accrued on restructured loans during the nine months ended February 28, 2010 and 2009, respectively.

At February 28, 2010 and May 31, 2009, \$470 million and \$491 million, respectively, of the loans on non-accrual status were performing as required under the loan agreement with the borrower. During the nine months ended February 28, 2010, this borrower made scheduled payments of \$21 million, all of which were applied as a reduction to the loan principal balance and resulted in a reduction of \$16 million to the calculated impairment. There has been no principal written off on the exposure to this borrower.

At February 28, 2010 and May 31, 2009, non-performing loans consist of loans to ICC totaling \$524 million. All loans to ICC have been on non-accrual status since February 1, 2005. ICC has not made debt service payments to us since June 2005. RTFC is the primary secured lender to ICC.

In February 2006, involuntary bankruptcy petitions were filed against:

- ICC's indirect majority shareholder and former chairman, Jeffrey Prosser;
  - ICC's immediate parent, Emerging Communications, Inc.; and
- Emerging Communications, Inc.'s parent, Innovative Communication Company LLC.

In April 2006, RTFC reached a settlement with the following individually:

- ICC;
- Virgin Islands Telephone Corporation;
- Innovative Communication Company LLC;
  - Emerging Communications, Inc.;
- the directors of each of the above-listed entities; and
  - Jeffrey Prosser.

Under the settlement, RTFC obtained entry of judgments in the District Court of the Virgin Islands against ICC for approximately \$525 million and Jeffrey Prosser for approximately \$100 million. RTFC also obtained dismissals with prejudice and releases of all counterclaims, affirmative defenses and other lawsuits alleging wrongful acts by RTFC, certain of its officers, and CFC thereby resolving all the loan-related litigation in RTFC's favor. Regardless, Jeffrey Prosser and related parties continue to assert claims against CFC and certain of its officers and directors and other parties in various proceedings and forums. CFC therefore anticipates that it will continue to be engaged in defense of those assertions on many fronts, as well as pursuing claims of its own.

Innovative Communication Company LLC, Emerging Communications, Inc., ICC and Jeffrey Prosser each have bankruptcy proceedings pending in the United States District Court for the Virgin Islands, Bankruptcy Division. A Chapter 11 trustee has been appointed for the corporate estates; and a Chapter 7 trustee was appointed in Jeffrey Prosser's individual case. The Chapter 11 trustee of ICC has assumed ownership and control of ICC, including its subsidiaries.

On February 1, 2008, the bankruptcy court approved a motion of the Chapter 11 trustee of ICC to sell substantially all of ICC's assets, divided into three groups:

- Group 1 consisting of ICC assets and stock in ICC subsidiaries operating in the United States Virgin Islands, the British Virgin Islands and St. Maarten (the "Group 1 Assets");
- Group 2 consisting of stock in ICC subsidiaries operating in France and certain of its Caribbean territories (these assets were sold in December 2008); and
- Group 3 consisting of the newspaper operations of ICC (these assets were sold in May 2008).

Certain ancillary assets have also been sold including aircraft, art and real estate. In each instance, the distribution of proceeds was approved by the bankruptcy court and resulted in a net recovery to us.

On March 13, 2009, RTFC and the Chapter 11 trustee entered into a Purchase Agreement as part of a \$250 million credit bid for the ICC Group 1 Assets. The Purchase Agreement is conditional upon the approval of the bankruptcy court and applicable regulators. On April 9, 2009, the U.S. bankruptcy court approved, on an interim basis, the sale of the ICC Group 1 Assets to RTFC, with RTFC reserving the right to assign its rights under the Purchase Agreement to CFC or its subsidiaries. CFC, together with certain of its subsidiaries, is in the process of obtaining the applicable regulatory approvals. In October 2009, the British Virgin Islands regulatory approval process was successfully completed, and in December 2009, FCC approval was granted. On January 13, 2010, the Netherlands Antilles granted unconditional consent for CFC to acquire the St. Maarten assets. CFC awaits approval from the Public Services Commission of the United States Virgin Islands. Once that approval is granted, the Chapter 11 trustee and CFC will request authorization from the U.S. bankruptcy court to consummate the transfer of ownership of the Group 1 Assets to designated subsidiaries of CFC.

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

Based on our analysis, we believe that we have adequately reserved for our exposure to ICC at February 28, 2010.

At February 28, 2010 and May 31, 2009, restructured loans totaled \$515 million and \$538 million, respectively. A total of \$470 million and \$491 million of restructured loans were on non-accrual status at February 28, 2010 and May 31, 2009, respectively. When agreements are executed to change the original terms of a loan, generally a change to the originally scheduled cash flows, we classify the loan as restructured unless the new terms are deemed to be market terms. We make a determination about the accrual of interest income for these loans on a loan-by-loan basis. The initial decision is based on the terms of the restructure agreement and the anticipated performance of the borrower over the term of the agreement. We will periodically review the decision whether or not to accrue interest income on restructured loans based on the borrower's past performance and current financial condition.

At February 28, 2010 and May 31, 2009, restructured loans outstanding to Denton County Electric Cooperative, d/b/a CoServ Electric ("CoServ") were \$470 million and \$491 million, respectively. All restructured CoServ loans have been on non-accrual status since January 1, 2001. In addition, \$20 million were outstanding under the capital expenditure loan facility classified as a performing loan at February 28, 2010 and May 31, 2009. Total loans to CoServ at February 28, 2010 and May 31, 2009 represented in each case 2.4 percent of our total loans and guarantees

outstanding.

Under the terms of a bankruptcy settlement from 2002, we restructured the loans to CoServ. CoServ is scheduled to make quarterly payments to us through December 2037. As part of the restructuring, we may be obligated to provide up to \$204 million of senior secured capital expenditure loans to CoServ for electric distribution infrastructure through December 2012. Under the facility, advances are limited to \$46 million per year. As of the date of this filing, there is \$138 million available under this loan facility. When CoServ requests capital expenditure loans under this facility, these loans are made at the standard terms offered to all borrowers and require debt service payments in addition to the quarterly payments that CoServ is required to make on the restructured loan. To date, CoServ has made all payments required under the restructure agreement and capital expenditure loan facility. Under the terms of the restructure agreement, CoServ has the option to prepay the loan for the lesser of their outstanding balance or \$405 million plus an interest payment true up on or after December 13, 2008. To date, we have not received notice from CoServ that it intends to prepay the loan.

Based on our analysis, we believe that we have adequately reserved for our exposure to CoServ at February 28, 2010.

At February 28, 2010 and May 31, 2009, we had a total of \$42 million in restructured loans outstanding to Pioneer Electric Cooperative, Inc. ("Pioneer"). Pioneer is current with respect to all debt service payments at February 28, 2010 and all loans to Pioneer remain on accrual status. We are the principal creditor to Pioneer.

Based on our analysis, we believe that we have adequately reserved for our exposure to Pioneer at February 28, 2010.

#### Allowance for Loan Losses

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

Management makes recommendations to our board of directors regarding charge-offs of loan balances. In making its recommendation to charge-off all or a portion of a loan balance, management considers various factors including cash flows and the collateral securing the loan. Since our inception in 1969, charge-offs totaled \$218 million and recoveries totaled \$35 million for a total net charge-off of \$183 million. Management believes that the allowance for loan losses is adequate to cover estimated probable portfolio losses.

Activity in the allowance for loan losses is summarized below:

|   | As of and<br>for the three<br>months ended<br>February 28, |            | As of and<br>for the nine<br>months ended<br>February 28, |            | As of and<br>for the<br>year<br>ended<br>May 31,<br>2009 |
|---|--|------------|---|------------|--|
| (dollar amounts in thousands)           | 2010   | 2009       | 2010  | 2009       |  |
| Beginning balance                       | \$ 608,458}  | \$ 648,946 | \$ 622,960}   | \$ 514,906 | \$ 514,906   |
| Provision for (recovery of) loan losses | 10,000}  | (10,415)   | (4,594)   | 126,577    | 113,699  |
| Net recoveries (charge-offs)            | 40}  | 52         | 132}  | (2,900)    | (5,645)  |
| Ending balance                          | \$ 618,498}  | \$ 638,583 | \$ 618,498}   | \$ 638,583 | \$ 622,960   |
| Loan loss allowance by segment:         |  |            |   |            |  |
| CFC                                     | \$ 618,462}  | \$ 638,436 | \$ 618,462}   | \$ 638,436 | \$ 622,851   |
| NCSC                                    | 36}  | 147        | 36}   | 147        | 109  |
| Total                                   | \$ 618,498}  | \$ 638,583 | \$ 618,498}   | \$ 638,583 | \$ 622,960   |

|   |  |  |         |         |         |
|---|--|--|---------|---------|---------|
| As a percentage of total loans outstanding (1)                |  |  | 3.18%   | 3.17%   | 3.09%   |
| As a percentage of total non-performing loans outstanding (1) |  |  | 118.07% | 128.15% | 118.94% |
| As a percentage of total restructured loans outstanding (1)   |  |  | 119.99% | 117.18% | 115.88% |
| As a percentage of total loans on non-accrual (1)             |  |  | 62.26%  | 64.10%  | 61.40%  |
| (1) As of February 28, 2010 and 2009.                         |  |  |         |         |         |



Our loan loss allowance decreased \$4 million from May 31, 2009 to February 28, 2010. See Recovery of/Provision for Loan Losses in the Results of Operations for more details about the loan loss recovery/provision for the current period.

We agreed to indemnify RTFC and NCSC for loan losses, with the exception of the NCSC consumer loans that are covered by the NCSC loan loss allowance. Therefore, there is no loan loss allowance required at RTFC and \$0.04 million loan loss allowance required at NCSC to cover the exposure for consumer loans of \$0.2 million.

#### Loan Impairment

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

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

As events related to the borrower take place and economic conditions and our assumptions change, the impairment calculations will change. The loan loss allowance specifically reserved to cover the calculated impairments is adjusted on a quarterly basis based on the most current information available. At February 28, 2010 and May 31, 2009, impaired loans totaled \$1,035 million and \$1,056 million, respectively. At February 28, 2010 and May 31, 2009, we specifically reserved a total of \$412 million and \$414 million, respectively, to cover impaired loans.

#### Liabilities and Equity

##### Outstanding Debt

The following table breaks out our debt outstanding:

| (dollar amounts in thousands)        | February 28,<br>2010 | May 31,<br>2009 | Increase/<br>(Decrease) |
|--------------------------------------|----------------------|-----------------|-------------------------|
| Commercial paper (1)                 | \$ 1,957,439}        | \$ 1,833,273    | \$ 124,166}             |
| Bank bid notes                       | 30,000}              | 255,000         | (225,000)               |
| Term loan                            | -}                   | 200,000         | (200,000)               |
| Collateral trust bonds               | 5,473,744}           | 5,178,756       | 294,988}                |
| Notes payable                        | 4,755,517}           | 4,256,661       | 498,856}                |
| Medium-term notes                    | 4,316,665}           | 5,864,229       | (1,547,564)             |
| Subordinated deferrable debt         | 311,440}             | 311,440         | -}                      |
| Membership certificates              | 643,148}             | 642,960         | 188}                    |
| Loan certificates                    | 663,946}             | 692,806         | (28,860)                |
| Guarantee certificates               | 123,517}             | 126,193         | (2,675)                 |
| Member capital securities            | 397,850}             | 278,095         | 119,755}                |
| Total debt outstanding               | \$ 18,673,266}       | \$ 19,639,413   | \$ (966,146)            |
| Percentage of fixed-rate debt (2)    | 82%                  | 87%             |                         |
| Percentage of variable-rate debt (3) | 18                   | 13              |                         |
| Percentage of long-term debt         | 77                   | 75              |                         |
| Percentage of short-term debt        | 23                   | 25              |                         |

(1) Includes \$343 million and \$291 million related to the daily liquidity fund at February 28, 2010 and May 31, 2009, respectively.

(2) Includes variable-rate debt that has been swapped to a fixed rate less any fixed-rate debt that has been swapped to a variable rate.

(3) The rate on commercial paper notes does not change once the note has been issued. However, the rates on new commercial paper notes change daily and commercial paper notes generally have maturities of less than 90 days. Therefore, commercial paper notes are classified as variable-rate debt. Also includes fixed-rate debt that has been swapped to a variable rate less any variable-rate debt that has been swapped to a fixed rate.

The following table provides additional information on the debt instruments we offer and related credit ratings at February 28, 2010.

| Debt Instrument      | Maturity Range | Rate Options          | Market            | Security  | Credit Rating<br>(1) |
|----------------------|----------------|-----------------------|-------------------|-----------|----------------------|
| Daily liquidity fund | Demand note    | Rate may change daily | Members           | Unsecured | NA                   |
| Bank bid notes       | Up to 3 months | Fixed rate            | Bank institutions | Unsecured | NA                   |
|                      | 1 to 270 days  | Fixed rate            |                   | Unsecured | P1, A1, F2           |

|                                  |                                 |                        |                                    |               |              |
|----------------------------------|---------------------------------|------------------------|------------------------------------|---------------|--------------|
| Commercial paper                 |                                 |                        | Public capital markets and members |               |              |
| Collateral trust bonds           | Range from 2 years to 30 years  | Fixed or variable rate | Public capital markets             | Secured (2)   | A1, A+, A    |
| Medium-term notes                | Range from 9 months to 30 years | Fixed or variable rate | Public capital markets and members | Unsecured     | A2, A, A-    |
| Notes payable                    | Range from 1 year to 30 years   | Fixed or variable rate | Private placement                  | Varies (3)    | Varies (3)   |
| Subordinated deferrable debt (4) | Up to 39 yrs                    | Fixed or variable rate | Public capital markets             | Unsecured (5) | A3, BBB, BBB |
| Subordinated certificates        | Up to 100 years (6)             | Varies                 | Members                            | Unsecured (7) | NA           |

(1) Based on ratings defined by Moody's Investors Service, Standard & Poor's Corporation and Fitch Ratings, respectively.

(2) Secured by the pledge of permitted investments and eligible mortgage notes from distribution system borrowers, in an amount at least equal to the outstanding principal amount of collateral trust bonds.

(3) At February 28, 2010, notes payable primarily represent unsecured notes payable issued under the Rural Economic Development Loan and Grant program and secured notes payable to the Federal Agricultural Mortgage Corporation. We must obtain credit ratings on certain senior secured debt from two rating agencies on an annual basis. The most recent credit ratings obtained on the Federal Agricultural Mortgage Corporation notes were A+ from Standard & Poor's Corporation and A from Fitch Ratings. Unsecured guaranteed notes payable issued under the Rural Economic Development Loan and Grant program do not have a credit rating. However, we must obtain one credit rating on an annual basis for the Rural Economic Development Loan and Grant notes payable without regard to the bond guarantee agreement with the Rural Utilities Service. The most recent credit rating obtained on the Rural Economic Development Loan and Grant notes payable without regard to the bond guarantee agreement with the Rural Utilities Service was A by Standard and Poor's Corporation. We are required to maintain collateral on deposit equal to at least 100 percent of the outstanding balance of debt under the Rural Economic Development Loan and Grant program.

(4) We have the right at any time and from time to time during the term of the subordinated deferrable debt to suspend interest payments for a period not exceeding 20 consecutive quarters. We have the right to call the subordinated deferrable debt any time after five years, at par. To date, we have not exercised our option to suspend interest payments.

(5) Subordinate and junior in right of payment to senior debt and the debt obligations we guarantee, but senior to subordinated certificates.

(6) Membership subordinated certificates generally mature 100 years from issuance. Loan and guarantee subordinated certificates have the same maturity as the related long-term loan. Some certificates may also amortize annually based on the outstanding loan balance. Member capital securities mature 35 years from issuance.

(7) Subordinate and junior in right of payment to senior and subordinated debt and debt obligations we guarantee.

Total debt outstanding decreased by \$966 million at February 28, 2010 as compared with May 31, 2009 primarily due to the \$730 million decrease to loans outstanding and the use of \$125 million in cash to pay down debt. During the nine months ended February 28, 2010, there was a shift in the type of funding used to obtain the lowest interest rates available in the market. Approximately \$2 billion of medium-term notes that matured during the period were primarily refinanced with collateral trust bond issuances totaling \$500 million, notes issued to the Federal Agricultural Mortgage Corporation totaling \$625 million and the issuance of \$472 million of new member and retail medium-term notes.

Our members also continue to support the member capital securities program with the purchase of \$398 million of securities as of February 28, 2010, an increase of \$120 million from May 31, 2009. Effective January 1, 2010, the fixed interest rate earned on our member capital securities changed from 7.5 percent for purchases on or before December 31, 2009 to 5 percent for purchases after that date.

#### Equity

The following table breaks out our equity balances:

| (dollar amounts in thousands)   | February<br>28,<br>2010 | May 31,<br>2009 | Increase/<br>(Decrease) |
|---|-------------------------|-----------------|-------------------------|
| Membership fees   | \$ 992}                 | \$ 990          | \$ 2}                   |
| Education fund  | 829}                    | 1,592           | (763)                   |
| Members' capital reserve  | 187,098}                | 187,098         | -}                      |
| Allocated net income  | 379,434}                | 420,834         | (41,400)                |
| Unallocated net income (loss) (1)   | 63,247}                 | (6,198)         | 69,445}                 |
| Total members' equity   | 631,600}                | 604,316         | 27,284                  |
| Prior years cumulative derivative forward value<br>and foreign currency adjustments | (103,493)               | 44,056          | (147,549)               |
| Year-to-date derivative forward value gain<br>(loss) (2)                            | 23,587}                 | (147,549)       | 171,136}                |
| Total CFC retained equity   | 551,694}                | 500,823         | 50,871                  |
| Accumulated other comprehensive income  | 7,772}                  | 8,115           | (343)                   |
| Total CFC equity  | 559,466}                | 508,938         | 50,528}                 |
| Noncontrolling interest   | 10,850}                 | 10,162          | 688}                    |
| Total equity  | \$ 570,316}             | \$ 519,100      | \$ 51,216}              |

(1) Excludes derivative forward value.

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

At February 28, 2010, total equity increased by \$51 million from May 31, 2009 primarily due to the net income of \$94 million offset by the board authorized patronage capital retirement of \$41 million.

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

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

Noncontrolling interest represents 100 percent of RTFC and NCSC equity as the members of RTFC and NCSC own or control 100 percent of the interest in their respective companies. On June 1, 2009, CFC implemented new accounting standards for noncontrolling interests in consolidated financial statements and as a result, total equity includes the noncontrolling interest at February 28, 2010 of \$11 million. Additionally, noncontrolling interest totaling \$10 million was reclassified from liabilities to equity at May 31, 2009 due to the retrospective presentation and disclosure requirements of the new accounting standards.

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

#### Contractual Obligations

The following table summarizes our long-term contractual obligations at February 28, 2010 and the scheduled reductions by fiscal year.

| (dollar amounts in millions)               | 2010   | 2011     | 2012     | 2013     | 2014     | More than 5<br>years | Total     |
|--|--------|----------|----------|----------|----------|----------------------|-----------|
| Long-term debt due in less than one year   | \$ 273 | \$ 1,990 | \$ -     | \$ -     | \$ -     | \$ -                 | \$ 2,263  |
| Long-term debt                             | -      | 252      | 2,023    | 649      | 2,080    | 7,279                | 12,283    |
| Subordinated deferrable debt               | -      | -        | -        | -        | -        | 311                  | 311       |
| Members' subordinated certificates (1)     | 1      | 13       | 30       | 39       | 18       | 1,486                | 1,587     |
| Operating leases (2)                       | 1      | 4        | 1        | -        | -        | -                    | 6         |
| Contractual interest on long-term debt (3) | 236    | 809      | 744      | 641      | 573      | 7,580                | 10,583    |
| Total contractual obligations              | \$ 511 | \$ 3,068 | \$ 2,798 | \$ 1,329 | \$ 2,671 | \$ 16,656            | \$ 27,033 |

(1) Excludes loan subordinated certificates totaling \$241 million that amortize annually based on the outstanding balance of the related loan. There are many items that affect the amortization of a loan, such as loan conversions, loan repricing at the end of an interest rate term and prepayments, therefore an amortization schedule cannot be maintained for these certificates. Over the past three years, annual amortization on these certificates has averaged \$28 million. In fiscal year 2009, amortization represented 8 percent of amortizing loan subordinated certificates outstanding.

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

(3) Represents the interest obligation on our debt based on terms and conditions at February 28, 2010.

#### Off-Balance Sheet Obligations

##### Guarantees

The following table breaks out our guarantees outstanding by type and by segment:

| (dollar amounts in thousands) | February<br>28,<br>2010 | May 31,<br>2009 | Increase/<br>(Decrease) |
|-------------------------------|-------------------------|-----------------|-------------------------|
| Total by type:                |                         |                 |                         |

|   |               |              |             |
|---|---------------|--------------|-------------|
| Long-term tax-exempt bonds                | \$ 603,830}   | \$ 644,540   | \$ (40,710) |
| Indemnifications of tax benefit transfers | 72,514}       | 81,574       | (9,060)     |
| Letters of credit                         | 402,243}      | 450,659      | (48,416)    |
| Other guarantees                          | 119,701}      | 98,682       | 21,019}     |
| Total                                     | \$ 1,198,288} | \$ 1,275,455 | \$ (77,167) |
| Total by segment:                         |               |              |             |
| CFC                                       | \$ 1,145,703} | \$ 1,233,333 | \$ (87,630) |
| RTFC                                      | 637}          | 500          | 137}        |
| NCSC                                      | 51,948}       | 41,622       | 10,326}     |
| Total                                     | \$ 1,198,288} | \$ 1,275,455 | \$ (77,167) |

We guarantee certain contractual obligations of our members so that they may obtain various forms of financing. With the exception of letters of credit, the underlying obligations may not be accelerated due to a payment default by the member so long as we perform under our guarantee. We use the same credit policies and monitoring procedures in providing guarantees as we do for loans and commitments. At February 28, 2010 and May 31, 2009, 71 percent and 73 percent, respectively, of total guarantees were secured by a mortgage lien on substantially all of the system's assets and future revenues.

The decrease in total guarantees during the nine months ended February 28, 2010 is primarily due to letters of credit that expired during the period, the early redemption of a \$20 million tax-exempt bond guarantee and normal amortization. At February 28, 2010 and May 31, 2009, we had recorded a guarantee liability totaling \$26 million and \$30 million, respectively, which represents the contingent and non-contingent exposure related to guarantees and liquidity obligations associated with members' debt.

The following table summarizes the off-balance sheet obligations at February 28, 2010 and the related notional principal amortization and maturities by fiscal year.

| (dollar amounts in thousands) | Outstanding Balance | Principal Amortization and Maturities of Guaranteed Obligations |           |          |           |          | Remaining Years |
|-------------------------------|---------------------|---|-----------|----------|-----------|----------|-----------------|
|                               |                     | 2010  | 2011      | 2012     | 2013      | 2014     |                 |
| Guarantees (1)                | \$1,198,288         | \$102,746   | \$346,436 | \$67,166 | \$114,388 | \$39,519 | \$528,033       |

(1) On a total of \$603 million of tax-exempt bonds, we have unconditionally agreed to purchase bonds tendered or called for redemption at any time if the remarketing agents have not sold such bonds to other purchasers.

### Contingent Off-Balance Sheet Obligations

#### Unadvanced Loan Commitments

At February 28, 2010, our unadvanced loan commitments totaled \$13,698 million, an increase of \$147 million over the \$13,551 million unadvanced at May 31, 2009. These are unadvanced commitments because we approved and executed loan contracts, but the funds have not been advanced. For most long-term advances of unadvanced commitments, we confirm based on our credit underwriting policy that there have been no material adverse changes in the borrower's financial statement condition since we approved the loan.

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

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

Approximately \$3 billion of long-term commitments are scheduled to expire if not advanced over the next three years.

Our line of credit loans generally contain material adverse change clauses. The majority of the short-term unadvanced commitments provide working capital liquidity to our borrowers; therefore, we do not anticipate funding most of these commitments. Approximately 61 percent and 59 percent of the unadvanced commitments at February 28, 2010 and May 31, 2009, respectively, were for short-term line of credit loans.

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

### Ratio Analysis

#### Leverage Ratio

The leverage ratio is calculated by dividing the sum of total liabilities and guarantees outstanding by total equity. We adopted the new accounting standards for noncontrolling interests on June 1, 2009 and have reflected the changes in presentation and disclosure of noncontrolling interest in our consolidated financial statements for all periods presented in this Form 10-Q. The leverage ratio for May 31, 2009 was adjusted accordingly. Based on this formula, the leverage ratio at February 28, 2010 was 36.36, a decrease from 41.88 at May 31, 2009. The decrease in the leverage ratio is due to a decrease of \$924 million in total liabilities, a decrease of \$77 million in guarantees and an increase of \$51 million in total equity as discussed under the Liabilities and Equity section and the Off-Balance Sheet Obligations section of Financial Condition.



For covenant compliance on our revolving credit agreements and for internal management purposes, the leverage ratio calculation is adjusted to exclude derivative liabilities, debt used to fund loans guaranteed by the Rural Utilities Service, subordinated deferrable debt and subordinated certificates from liabilities, uses members' equity rather than total equity and adds subordinated deferrable debt, subordinated certificates and minority interest to calculate adjusted equity. Due to the recent adoption of new accounting standards on noncontrolling interests, minority interest is reported as equity on the consolidated balance sheets as of February 28, 2010 and May 31, 2009. As a result, it is not necessary to adjust equity to include minority interest.

At February 28, 2010 and May 31, 2009, the adjusted leverage ratio was 6.44 and 7.11, respectively. See Non-GAAP Financial Measures for further explanation and a reconciliation of the adjustments we make in our leverage ratio calculation. The decrease in the adjusted leverage ratio is due to a decrease of \$975 million in adjusted liabilities, an increase of \$115 million in adjusted equity and a decrease of \$77 million to guarantees as discussed under the Liabilities and Equity section and the Off-Balance Sheet Obligations section of Financial Condition. In addition to the adjustments made to the leverage ratio in the Non-GAAP Financial Measures section, guarantees to member systems that have certain investment grade ratings

from Moody's Investors Service and Standard & Poor's Corporation are excluded from the calculation of the leverage ratio under the terms of the revolving credit agreements.

#### Debt to Equity Ratio

The debt to equity ratio is calculated by dividing the sum of total liabilities outstanding by total equity. We adopted the new accounting standards for noncontrolling interests on June 1, 2009 and have reflected the changes in presentation and disclosure of noncontrolling interest in our consolidated financial statements for all periods presented in this Form 10-Q. The debt to equity ratio for May 31, 2009 was adjusted accordingly. The debt to equity ratio, based on this formula at February 28, 2010 was 34.26, a decrease from 39.42 at May 31, 2009. The decrease in the debt to equity ratio is due to the decrease of \$924 million in total liabilities and an increase of \$51 million in total equity as discussed under the Liabilities and Equity section of Financial Condition.

For internal management purposes, the debt to equity ratio calculation is adjusted to exclude derivative liabilities, debt used to fund loans guaranteed by the Rural Utilities Service, subordinated deferrable debt and subordinated certificates from liabilities, uses members' equity rather than total equity and adds subordinated deferrable debt and subordinated certificates to determine adjusted equity. At February 28, 2010 and May 31, 2009, the adjusted debt to equity ratio was 6.00 and 6.63, respectively. See Non-GAAP Financial Measures for further explanation and a reconciliation of the adjustments made to the debt to equity ratio calculation. The decrease in the adjusted debt to equity ratio is due to a decrease of \$975 million in adjusted liabilities and an increase of \$115 million in adjusted equity.

#### Credit Ratings

Our long- and short-term debt and guarantees are rated by three of the major credit rating agencies registered with the SEC, Moody's Investors Service, Standard & Poor's Corporation and Fitch Ratings. The following table presents our credit ratings at February 28, 2010.

|                              | Moody's Investors<br>Service | Standard & Poor's<br>Corporation | Fitch Ratings |
|------------------------------|------------------------------|----------------------------------|---------------|
| Direct:                      |                              |                                  |               |
| Senior secured debt          | A1                           | A+                               | A             |
| Senior unsecured debt        | A2                           | A                                | A-            |
| Subordinated deferrable debt | A3                           | BBB                              | BBB           |
| Commercial paper             | P1                           | A1                               | F2            |

We provide guarantees of our members' debt obligations. Generally, the debt we have guaranteed has a rating equal to our senior unsecured debt ratings listed above from each of the three rating agencies.

The ratings listed above are defined by each of the respective rating agencies, are not recommendations to buy, sell or hold securities and can be revised or withdrawn at any time by the rating organizations.

At February 28, 2010 and through the date of this filing, Moody's Investors Service and Fitch Ratings had our ratings on stable outlook and Standard & Poor's Corporation had our ratings on a negative outlook. On July 24, 2009, Fitch Ratings announced downgrades, with a stable outlook, on all of our secured and unsecured debt, which are reflected in the chart above. On August 24, 2009, Standard & Poor's Corporation affirmed our ratings and changed our outlook from stable to negative.

On November 24, 2009, Moody's Investors Service affirmed our ratings and the stable outlook and downgraded our pooled bonds guarantees to correspond to our senior unsecured debt rating of A2.

On March 26, 2010, Fitch Ratings affirmed our long-term ratings and the stable outlook and upgraded our short-term rating to F1 from F2.

### Liquidity and Capital Resources

The following section discusses our expected sources and uses of liquidity. At February 28, 2010, we expect that our current sources of liquidity will allow us to issue the debt required to fund our operations over the next 12 to 18 months.

The table below shows the projected sources and uses of cash by quarter through August 2011. In analyzing our projected liquidity position, we track the key items identified in the chart below. The long-term debt maturities represent the scheduled maturities of our outstanding term debt for the period presented. The long-term loan advances represent our current best estimate of the member demand for our loans, the amount and the timing of which are subject to change. The long-term loan amortization and prepayments represent the scheduled long-term loan amortization for the outstanding loans

at February 28, 2010, as well as our current estimate for the prepayment of long-term loans. The estimate of the amount and timing of long-term loan prepayments is subject to change. We assumed a minimum attainable level of member medium-term notes and retail note investments based on our recent historical trend. We assumed the issuance of other long-term debt, including collateral trust bonds and private placement of term debt, to maintain matched funding within our fixed rate loan portfolio and to allow our revolving lines of credit to provide 100% backup liquidity for our outstanding commercial paper. The commercial paper repayments in the table below do not represent scheduled maturities, but rather the assumed use of excess cash to pay down the commercial paper balance. We assumed the issuance or repayment of commercial paper to maintain excess liquidity within a range of \$350 million to \$450 million.

| (dollar amount in millions) | Projected Uses of Liquidity |                                 |                         |                         | Projected Sources of Liquidity                            |                      |                   |                            | Total sources of liquidity | Cumulative excess sources over us of liquidity \$ |
|-----------------------------|-----------------------------|---------------------------------|-------------------------|-------------------------|---|----------------------|-------------------|----------------------------|----------------------------|---|
|                             | Long-term debt maturities   | Debt repayment-commercial paper | Long-term loan advances | Total uses of liquidity | Long-term loan amortization & Commercial paper prepayment | Other long-term debt | Medium-term notes | Total sources of liquidity |                            |   |
| 3Q10                        |                             |                                 |                         |                         |   |                      |                   |                            |                            |   |
| 4Q10                        | \$ 274                      | \$ -                            | \$ 400                  | \$ 674                  | \$ 375  | \$ 250               | \$ -              | \$ 90                      | \$ 715                     |   |
| 1Q11                        | 708                         | -                               | 252                     | 960                     | 525   | 325                  | -                 | 90                         | 940                        |   |
| 2Q11                        | 836                         | -                               | 220                     | 1,056                   | 260   | 100                  | 600               | 90                         | 1,050                      |   |
| 3Q11                        | 442                         | -                               | 335                     | 777                     | 420   | -                    | 250               | 90                         | 760                        |   |
| 4Q11                        | 252                         | -                               | 200                     | 452                     | 265   | -                    | 125               | 90                         | 480                        |   |
| 1Q12                        | 167                         | -                               | 210                     | 377                     | 320   | -                    | -                 | 90                         | 410                        |   |
| Totals                      | \$ 2,679                    | \$ -                            | \$ 1,617                | \$ 4,296                | \$ 2,165  | \$ 675               | \$ 975            | \$ 540                     | \$ 4,355                   |   |

The above chart represents our best estimate of the funding requirements and how we expect to manage such funding requirements through August 31, 2011. These estimates will change on a quarterly basis based on many factors. We currently do not anticipate significant growth in the loan portfolio, thus our liquidity focus will be on refinancing maturing debt.

#### Sources of Liquidity

##### Capital Market Debt Issuance

As a well-known seasoned issuer, we have the following effective shelf registration statements on file with the Securities and Exchange Commission for the issuance of debt:

- Unlimited amount of collateral trust bonds until October 2010;
- Unlimited amount of medium-term notes, member capital securities, and subordinated deferrable debt until November 2011; and
- Daily liquidity fund until April 2010 for a total of \$20 billion with a \$3 billion limitation on the aggregate principal amount outstanding at any time. We plan to file a new registration statement for the daily liquidity fund in April 2010.

In September 2009, we issued \$250 million of 2.625 percent collateral trust bonds with a three-year maturity at a spread over comparable treasuries of 125 basis points and \$250 million of 3.875 percent collateral trust bonds with a six-year maturity at a spread over comparable treasuries of 158 basis points. Corporate debt spreads have continued to tighten since that time. As of February 28, 2010, a total of \$398 million of member capital securities had been sold.

In addition, we have a commercial paper program to sell commercial paper to investors in the capital markets. We limit the amount of commercial paper that can be sold to the amount of backup liquidity available under our revolving

credit agreements.

We also have authorization from our board of directors to issue in the European market up to \$1 billion of commercial paper and \$4 billion of medium-term notes, as well as \$2 billion of medium-term notes in the Australian market. At February 28, 2010, there was no debt outstanding under our European or Australian programs.

52

---

### Private Debt Issuance

We have access to liquidity from private debt issuances through note purchase agreements with the Federal Agricultural Mortgage Corporation. During the nine months ended February 28, 2010, we issued the following debt totaling \$625 million to the Federal Agricultural Mortgage Corporation:

- In June 2009, the remaining \$200 million available under our February 2009 note purchase agreement with the Federal Agricultural Mortgage Corporation was advanced in the form of variable-rate five-year notes at a blended spread over three-month LIBOR of 124.1 basis points.
- In August 2009, we issued a \$50 million three-year note at a blended spread over three-month LIBOR of 91 basis points.
- In August 2009, we also issued a \$200 million three-year note at a fixed rate of 2.91 percent and a \$175 million five-year note at a fixed rate of 4.06 percent.

When the Federal Agricultural Mortgage Corporation communicates favorable pricing indications and investor interest to us, we may elect to issue all or a portion of the \$725 million that remains unadvanced at February 28, 2010 under the May 2009 note purchase agreement with the Federal Agricultural Mortgage Corporation. In December 2009, we exercised the call option on a \$150 million 4.95 percent note with the Federal Agricultural Mortgage Corporation. All of the agreements with the Federal Agricultural Mortgage Corporation are revolving credit facilities that allow us to borrow, repay and re-borrow funds at any time through maturity or from time to time as market conditions permit; provided that the principal amount at any time outstanding under each of the note purchase agreements is not more than the total amount available under each of the agreements.

### Member Loan Repayments

Repayments on long-term loans are scheduled to be \$1,580 million over the next 12 months. Scheduled repayments include loan amortization based on current expectations.

### Member Loan Interest Payments

During the nine months ended February 28, 2010, interest income on the loan portfolio was \$782 million, representing an average yield of 5.25 percent as compared with 5.39 percent for the nine months ended February 28, 2009. For the past three fiscal years, interest income on the loan portfolio has averaged \$1,039 million. At February 28, 2010, 80 percent of the total loans outstanding had a fixed rate of interest and 20 percent of loans outstanding had a variable rate of interest. At February 28, 2010, 5 percent of loans outstanding were on non-accrual status.

### Bank Revolving Credit Facility

The following is a summary of our revolving credit agreements:

| (dollar amounts in thousands) | February<br>28, 2010 | May 31,<br>2009 | Termination<br>Date | Facility fee<br>per<br>year (1) |
|-------------------------------|----------------------|-----------------|---------------------|---------------------------------|
| Five-year agreement (2)       | \$ 1,049,000         | \$ 1,125,000    | March 16,<br>2012   | 6 basis points                  |
| Five-year agreement (2)       | 967,313              | 1,025,000       | March 22,<br>2011   | 6 basis points                  |
| 364-day agreement             | 1,000,000            | 1,000,000       | March 12,<br>2010   | 12.5 basis<br>points            |
| Total                         | \$ 3,016,313         | \$ 3,150,000    |                     |                                 |

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

(2) Amounts as of February 28, 2010 exclude Lehman Brothers Bank, FSB's portion of the credit facility totaling \$134 million allocated as follows: \$76 million under the five-year facility maturing 2012, and \$58 million under the

five-year facility maturing in 2011. These amounts were assigned to NCSC in September 2009 by Lehman Brothers Bank, FSB and are eliminated in consolidation.

At February 28, 2010 and May 31, 2009, we were in compliance with all covenants and conditions under our revolving credit agreements and there were no borrowings outstanding under these agreements.

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

|  | Requirement | February 28,<br>2010 | Actual<br>May 31, 2009 |
|--|-------------|----------------------|------------------------|
| Minimum average adjusted TIER over the six most recent fiscal quarters | 1.025       | 1.15                 | 1.18                   |
| Minimum adjusted TIER at fiscal year end (1)                           | 1.05        | NA                   | 1.10                   |
| Maximum ratio of senior debt to total equity                           | 10.00       | 6.24                 | 6.90                   |

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

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

On March 10, 2010, we replaced the \$1,000 million 364-day revolving credit agreement put in place on March 13, 2009 with a new \$1,300 million three-year agreement that expires on March 8, 2013. The facility fee for the new three-year facility is 25 basis points per year. The facility fee is determined by pricing matrices in the agreement and is payable quarterly. We have the right to choose between a (i) Eurodollar rate plus an applicable margin to be determined by pricing matrices in the agreement or (ii) a base rate calculated based on the greater of prime rate, the federal funds effective rate plus 2 percent or the one-month LIBOR rate plus 2 percent, plus an applicable margin to be determined by pricing matrices in the agreement.

We may request letters of credit for up to \$100 million under the three-year revolving credit agreement. We also have the right, subject to certain terms and conditions, to increase the aggregate amount of the commitments under the three-year revolving credit agreement by up to \$250 million either by increasing the commitment of one or more existing lenders or by adding one or more new lenders, provided that no existing lender's commitment is increased without the consent of the lender and the administrative agent. Effective March 15, 2010, we exercised our right to increase the aggregate amount of the commitment under the three-year revolving credit agreement by \$35 million to a total of \$1,335 million. The total committed credit available under our three current facilities was \$3,351 million at March 15, 2010.

#### Member Investments

At February 28, 2010 and May 31, 2009, members funded 21.9 percent and 20.5 percent, respectively, of total assets. Below is a table showing the components of our member investments:

| (dollar amounts in thousands)                            | February 28, 2010 |                   | May 31, 2009 |                   | Increase/<br>(Decrease) |
|--|-------------------|-------------------|--------------|-------------------|-------------------------|
|  | Amount            | % of<br>Total (1) | Amount       | % of<br>Total (1) |                         |
| Commercial paper (2)                                     | \$ 1,310,450}     | 67%               | \$ 1,226,238 | 67 %              | \$ 84,212}              |
| Medium-term notes  | 614,078}          | 14                | 723,009      | 12                | (108,931)               |
| Members' subordinated certificates                       | 1,828,461}        | 100               | 1,740,054    | 100               | 88,407}                 |
| Members' equity (3)                                      | 631,600}          | 100               | 604,316      | 100               | 27,284}                 |
| Noncontrolling interest (4)                              | 10,850}           | 100               | 10,162       | 100               | 688}                    |
| Total  | \$ 4,395,439}     |                   | \$ 4,303,779 |                   | \$ 91,660}              |
| Percentage of total assets                               | 21.9}%            |                   | 20.5%        |                   |                         |
| Percentage of total assets less<br>derivative assets (3) | 22.3}             |                   | 20.9         |                   |                         |

(1) Represents the percentage of each line item outstanding to our members.

(2) Includes \$343 million and \$291 million related to the daily liquidity fund at February 28, 2010 and May 31, 2009, respectively.

(3) See the Liabilities and Equity section of Financial Condition for a breakout of members' equity.

(4) Represents RTFC and NCSC equity since RTFC and NCSC members are members of the consolidated entity.

Member commercial paper investments have averaged \$1,168 million outstanding since January 1, 2007. Commercial paper issued through dealers and bank bid notes totaled \$638 million and represented 3 percent of total debt outstanding at February 28, 2010. We intend to maintain the balance of dealer commercial paper and bank bid notes at 15 percent or less of total debt outstanding during the rest of fiscal year 2010 and fiscal year 2011. We view member commercial paper investments as a more stable source of funding than investor-purchased commercial paper.

#### Uses of Liquidity

##### Loan Advances

Loan advances are either from new loans approved to members or from the unadvanced portion of loans that were previously approved. At February 28, 2010, we had unadvanced loan commitments totaling \$13,698 million. We do



not expect to advance the full amount of the unadvanced commitments. Unadvanced commitments generally expire within five years of the first advance on a loan and the majority of short-term unadvanced commitments are used as backup liquidity for member operations. Approximately \$3 billion of long-term commitments are scheduled to expire if not advanced over the next three years. Approximately 61 percent of the outstanding commitments at February 28, 2010 were for short-term or line of credit loans. We expect to fund long-term loan advances totaling \$1,207 million over the next 12 months either from new loans approved to members or from unadvanced commitments.

#### Interest Expense on Debt

For the nine months ended February 28, 2010, interest expense on debt was \$675 million, representing 4.72 percent of the average debt volume. The interest expense on debt represented 4.81 percent of the average debt volume for the nine months ended February 28, 2009. For the past three fiscal years, interest expense on debt has averaged \$935 million. At February 28, 2010, a total of 82 percent of outstanding debt had a fixed interest rate and 18 percent had a variable interest rate.

### Principal Repayments on Long-term Debt

The principal amount of medium-term notes, collateral trust bonds, long-term notes payable, subordinated deferrable debt and membership subordinated certificates maturing in each of the five fiscal years following February 28, 2010 and thereafter is as follows:

| (dollar amounts in thousands) | Amount<br>Maturing<br>(1) |
|-------------------------------|---------------------------|
| May 31, 2010                  | \$ 273,792                |
| May 31, 2011                  | 2,255,201                 |
| May 31, 2012                  | 2,053,670                 |
| May 31, 2013                  | 687,506                   |
| May 31, 2014                  | 2,098,101                 |
| Thereafter                    | 9,076,246                 |
| Total                         | \$16,444,516              |

(1) Excludes loan subordinated certificates totaling \$241 million that amortize annually based on the outstanding balance of the related loan. There are many items that affect the amortization of a loan, such as loan conversions, loan repricing at the end of an interest rate term and prepayments, therefore an amortization schedule cannot be maintained for these certificates. Over the past three years, annual amortization on these certificates has averaged \$28 million. In fiscal year 2009, amortization represented 8 percent of amortizing loan subordinated certificates outstanding.

### Patronage Capital Retirements

We have made annual retirements of our allocated patronage capital in 29 of the last 30 years. In July 2009, the CFC board of directors approved the allocation of \$83 million from fiscal year 2009 net earnings to CFC's members. CFC made cash payments of \$41 million to its members in September 2009 as retirement of 50 percent of allocated net earnings from the prior year as approved by the board of directors. The remaining portion of allocated net earnings will be retained by CFC for 25 years under new guidelines that started in June 2009.

### Market Risk

Our primary market risks are interest rate risk, counterparty risk as a result of entering into derivative financial instruments, and liquidity risk.

### Interest Rate Risk

The interest rate risk exposure is related to the funding of the fixed-rate loan portfolio. We do not match fund the majority of our fixed-rate loans with a specific debt issuance at the time the loans are advanced. We aggregate fixed-rate loans until the volume reaches a level that will allow an economically efficient issuance of debt to fund fixed-rate loans. We allow borrowers flexibility when choosing the period a fixed interest rate will be in effect. Long-term loans typically have maturities of up to 35 years. Borrowers may select fixed interest rates for periods of one year through the life of the loan. Each time borrowers select a rate, that rate is at our then-current market for that type of loan.

### Matched Funding Policy

To monitor and mitigate interest rate risk in the funding of fixed-rate loans, we perform a monthly interest rate gap analysis, a comparison of fixed-rate assets repricing or maturing by year to fixed-rate liabilities and members' equity maturing by year (see table below). The interest rate risk is deemed minimal on variable-rate loans, since the loans may be repriced either monthly or semi-monthly to reflect the cost of the debt used to fund the loans. At February 28, 2010 and May 31, 2009, 20 percent and 27 percent, respectively, of loans carried variable interest rates.

Our funding objective is to manage the matched funding of fixed-rate asset and liability repricing terms within a range of three percent of total assets excluding derivative assets. At February 28, 2010, we had \$15,566 million of fixed-rate assets amortizing or repricing, funded by \$12,839 million of fixed-rate liabilities maturing during the next 30 years and \$2,144 million of members' equity and members' subordinated certificates, a portion of which does not have a scheduled maturity. The difference of \$583 million, or less than three percent of total assets and total assets excluding derivative assets, represents the fixed-rate assets maturing during the next 30 years in excess of the fixed-rate debt and equity.

The following table shows the scheduled amortization and repricing of fixed-rate assets and liabilities outstanding at February 28, 2010.

| Interest Rate Gap Analysis<br>(Fixed-rate Assets/Liabilities)<br>As of February 28, 2010 |                                |                                       |                                       |                                       |                                       |                           |           |
|--|--------------------------------|---------------------------------------|---------------------------------------|---------------------------------------|---------------------------------------|---------------------------|-----------|
| (dollar amounts in millions)   | May 31,<br>2010<br>or<br>prior | June 1,<br>2010 to<br>May 31,<br>2012 | June 1,<br>2012 to<br>May 31,<br>2014 | June 1,<br>2014 to<br>May 31,<br>2019 | June 1,<br>2019 to<br>May 31,<br>2029 | Beyond<br>June 1,<br>2029 | Total     |
| Assets amortization and repricing  | \$ 413                         | \$ 4,907                              | \$ 2,964                              | \$ 3,709                              | \$ 2,527                              | \$ 1,046                  | \$ 15,566 |
| Liabilities and members' equity:   |                                |                                       |                                       |                                       |                                       |                           |           |
| Long-term debt   | \$ 63                          | \$ 4,874                              | \$ 2,451                              | \$ 3,946                              | \$ 673                                | \$ 832                    | \$ 12,839 |
| Subordinated certificates  | 5                              | 72                                    | 39                                    | 63                                    | 1,208                                 | 279                       | 1,666     |
| Members' equity (1)  | -                              | -                                     | -                                     | 15                                    | 206                                   | 257                       | 478       |
| Total liabilities and members' equity  | \$ 68                          | \$ 4,946                              | \$ 2,490                              | \$ 4,024                              | \$ 2,087                              | \$ 1,368                  | \$ 14,983 |
| Gap (2)  | \$ 345                         | \$ (39)                               | \$ 474                                | \$ (315)                              | \$ 440                                | \$ (322)                  | \$ 583    |
| Cumulative gap   | 345                            | 306                                   | 780                                   | 465                                   | 905                                   | 583                       |           |
| Cumulative gap as a % of total assets  | 1.72%                          | 1.52%                                 | 3.88%                                 | 2.31%                                 | 4.50%                                 | 2.90%                     |           |
| Cumulative gap as a % of adjusted total assets (3)                                       | 1.75                           | 1.55                                  | 3.95                                  | 2.36                                  | 4.59                                  | 2.95                      |           |

(1) Includes the portion of the loan loss allowance and subordinated deferrable debt allocated to fund fixed-rate assets. See Non-GAAP Financial Measures for further explanation of why we use members' equity in our analysis of the funding of our loan portfolio.

(2) Assets less liabilities and members' equity.

(3) Adjusted total assets represent total assets in the consolidated balance sheet less derivative assets.

At February 28, 2010, we are funding \$583 million of fixed-rate loans with lower cost variable-rate debt, specifically commercial paper, and therefore earning a higher margin on those assets. We fund these fixed-rate loans with short-term debt, primarily commercial paper, until we have enough for an efficient entrance into the capital markets with a fixed-rate bond. We also have the option to issue pay fixed/receive variable interest rate exchange agreements. Our current position of funding fixed-rate loans with short-term debt presents a higher liquidity risk of being able to roll over the short-term debt until we issue term debt to fund the fixed-rate loans through the term of the fixed rate selected by the borrower. Factors that mitigate this risk include our maintenance of back up liquidity through revolving credit agreements with domestic and foreign banks and a large volume of scheduled principal repayments received on an annual basis.

#### Derivative Financial Instruments

We are neither a dealer nor a trader in derivative financial instruments. We use interest rate, cross currency and cross currency interest rate swaps to manage our interest rate and foreign currency risk. These interest rate swaps are used when they provide a lower cost of funding or minimize interest rate risk as part of our overall interest rate matching

strategy. We enter into interest rate swaps only with counterparties that participate in our revolving credit agreements. We have not entered into derivative financial instruments for trading purposes in the past and do not anticipate doing so in the future. At February 28, 2010 and May 31, 2009, there were no foreign currency derivative instruments outstanding.

#### Counterparty Risk

We are exposed to counterparty risk related to the performance of the parties with which we have entered into derivative instruments. To mitigate this risk, we only enter into these agreements with financial institutions with investment grade ratings. At February 28, 2010 and May 31, 2009, we were a party to derivative instruments with notional amounts totaling \$11,178 million and \$11,830 million, respectively. At February 28, 2010 and May 31, 2009, the highest concentration of total notional exposure to any one counterparty was 12 percent and 11 percent, respectively, of total derivative instruments. At the time counterparties are selected to participate in our exchange agreements, the counterparty must be a participant in one of our revolving credit agreements. In addition, the derivative instruments executed per counterparty is based on key characteristics such as the following: notional concentration, credit risk exposure, tenor, bid success rate, total credit commitment, and credit ratings. At the date of this filing, our derivative instrument counterparties had credit ratings ranging from AAA to BBB as assigned by Standard & Poor's Corporation and Aaa to Baal as assigned by Moody's Investor Service. Based on the fair market value of our derivative instruments at February 28, 2010, there were nine counterparties that would be required to make a payment to us totaling \$60 million if all of our derivative instruments were terminated on that day. The largest amount owed to us by a single counterparty was \$15 million, or 25 percent of the total exposure to us at February 28, 2010.

### Rating Triggers

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

At February 28, 2010, the following derivative instruments had rating triggers based on our senior unsecured credit ratings from Moody's Investors Service or Standard & Poor's Corporation falling to a level specified in the agreement and grouped into the categories below. In calculating the payments and collections required upon termination, we netted the agreements for each counterparty, as allowed by the underlying master agreements. See table on page 51 for CFC's senior unsecured credit ratings and ratings outlook as of February 28, 2010.

| (dollar amounts in thousands)     | Notional Amount | Required Company Payment | Amount Company Would Collect | Net Total   |
|-----------------------------------|-----------------|--------------------------|------------------------------|-------------|
| Mutual rating trigger if ratings: |                 |                          |                              |             |
| fall to Baa1/BBB+ (1)             | \$ 1,368,450}   | \$ (593)                 | \$ 9,914}                    | \$ 9,321}   |
| fall below Baa1/BBB+ (1)          | 6,725,437}      | (88,322)                 | 24,274}                      | (64,048)    |
| Total                             | \$ 8,093,887}   | \$ (88,915)              | \$ 34,188}                   | \$ (54,727) |

(1) Stated senior unsecured credit ratings are for Moody's Investors Service and Standard & Poor's Corporation, respectively. Under these rating triggers, if the credit rating for either counterparty falls to the level specified in the agreement, the other counterparty may, but is not obligated to, terminate the agreement. If either counterparty terminates the agreement, a net payment may be due from one counterparty to the other based on the fair value, excluding credit risk, of the underlying derivative instrument.

In addition to the rating triggers listed above, at February 28, 2010, we had a total notional amount of \$845 million of derivative instruments with one counterparty that would require the pledging of collateral totaling \$24 million (the fair value of such derivative instruments excluding credit risk) if our senior unsecured ratings from Moody's Investors Service were to fall below Baa2 or if the rating from Standard & Poor's Corporation were to fall below BBB.

The aggregate fair value of all interest rate swaps with rating triggers that were in a net liability position at February 28, 2010 was \$110 million.

### Liquidity Risk

We face liquidity risk in funding our loan portfolio and refinancing our maturing obligations. We offer long-term loans with maturities of up to 35 years and line of credit loans that are generally required to be paid down annually. On long-term loans, we offer a variety of interest rate options including the ability to fix the interest rate for terms of one year through maturity. We fund the loan portfolio with a variety of debt instruments and our members' equity. We typically do not match fund each of our loans with a debt instrument of similar final maturity. Debt instruments such as membership subordinated certificates and loan and guarantee subordinated certificates have maturities that vary from the term of the associated loan or guarantee to 100 years, member capital securities have maturities of 35 years and subordinated deferrable debt has been issued with maturities of up to 49 years. We may issue collateral trust bonds and medium-term notes for periods of up to 30 years, but typically issue such debt instruments with maturities of 2, 3, 5, 7 and 10 years.

At February 28, 2010, we had \$1,987 million of commercial paper, daily liquidity fund, and bank bid notes scheduled to mature during the next 12 months. Based on past history, we expect to continue to maintain member investments in commercial paper at approximately the current level of \$967 million at February 28, 2010. We expect that we have the market access to increase dealer commercial paper and bank bid notes from the balance at February 28, 2010 of

\$0.6 million to approximately \$1,500 million to \$2,000 million, if required, while limiting the balance to 15 percent or less of total debt outstanding. At February 28, 2010, 15 percent of total debt outstanding was \$2.8 million.

Dealer and member commercial paper is also limited to the amount of our available lines of credit that provide 100 percent backup liquidity. At February 28, 2010, we had \$3,016 million in available lines of credit with financial institutions. Subsequent to the end of the quarter, we increased the total of our revolving credit agreements to \$3,351 million at March 15, 2010. We expect to be in compliance with the covenants under our revolving credit agreements, therefore we could draw on these facilities to repay any amount of dealer or member commercial paper that cannot be rolled over in the event of market disruptions.

At February 28, 2010, we had long-term debt maturing in the next 12 months totaling \$2,263 million. In addition to our access to the dealer and member commercial paper markets as discussed above, our ability to refinance our long-term obligations is supported by the following:

- Based on past history, we expect to maintain the ability to roll over our medium-term notes sold through dealers (including retail notes) of \$689 million and medium-term notes sold to members of \$469 million if we need this funding in the future.
- We experienced a significant increase in demand for our retail notes since February 28, 2009 and expect that we should be able to access the retail note market at least at the current level, if required. The total balance of retail notes outstanding has increased \$458 million over the past 12 months to \$1,085 million at February 28, 2010.
- We expect to maintain the ability to obtain funding through the capital markets, as indicated by our \$500 million issuance of collateral trust bonds in September 2009.
- We had \$725 million available under revolving note purchase agreements with the Federal Agricultural Mortgage Corporation at February 28, 2010, subject to market conditions. Secured notes payable to the Federal Agricultural Mortgage Corporation of \$188 million scheduled to mature in the next 12 months were issued under these revolving credit facilities with the Federal Agricultural Mortgage Corporation and allow us to borrow, repay and re-borrow funds as market conditions permit.

We face liquidity risk in the funding of our loan portfolio based on member demand for new loans, although we expect loans outstanding to decrease slightly during the rest of fiscal year 2010. We will face liquidity risk in the renewal of our \$967 million five-year revolving credit agreement maturing in March 2011 if we are unable to renew at current commitment levels, which would reduce the amount of commercial paper funding we could obtain in the future.

At February 28, 2010, we were the guarantor and liquidity provider for \$603 million of tax-exempt bonds issued for our member cooperatives. During the nine months ended February 28, 2010, we were not required to purchase any tax-exempt bonds pursuant to our obligation as liquidity provider.

At February 28, 2010, we expect that our \$380 million of cash on hand and our current sources of liquidity will allow us to issue the debt required to fund our operations over the next 12 to 18 months.

For additional information about the risks related to our business, see Part II, Item 1A. Risk Factors in this Form 10-Q.

#### Non-GAAP Financial Measures

We make certain adjustments to financial measures in assessing our financial performance that are not in accordance with GAAP. These non-GAAP adjustments fall primarily into two categories: (1) adjustments related to the calculation of the TIER ratio, and (2) adjustments related to the calculation of leverage and debt to equity ratios. These adjustments reflect management's perspective on our operations, and in several cases, adjustments used to measure covenant compliance under our revolving credit agreements, and therefore we believe these are useful financial measures for investors. We refer to our non-GAAP financial measures as "adjusted" throughout this document.

#### Adjustments to Net Income and the Calculation of the TIER Ratio

The following table provides a reconciliation between interest expense, net interest income, income prior to income taxes and net income and these financial measures adjusted to exclude the effect of derivatives for the three and nine months ended February 28, 2010 and February 28, 2009. Refer to Non-GAAP Financial Measures in Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operations, in our Form 10-K/A for the



year ended May 31, 2009 for an explanation of why these adjustments to net income and the calculation of the TIER ratio reflect management's perspective on our operations and why we believe these are useful financial measures for investors.

Due to the adoption of new accounting standards for noncontrolling interests on June 1, 2009, minority interest net income is included in total net income on the consolidated statement of operations for the three and nine months ended February 28, 2010 and 2009. As a result, it is not necessary to adjust net income to include minority interest net income as it was in prior periods. As required, we reflected changes in the presentation and disclosure of noncontrolling interest in our consolidated financial statements, including the adjusted net income and adjusted TIER calculations, for all periods presented, including the three and nine months ended February 28, 2009.

| (dollar amounts in thousands)  | Three months ended<br>February 28, |              | Nine months ended<br>February 28, |              |
|--|------------------------------------|--------------|-----------------------------------|--------------|
|  | 2010                               | 2009         | 2010                              | 2009         |
| Interest expense   | \$(221,898)                        | \$ (239,744) | \$(691,504)                       | \$ (694,080) |
| Derivative cash settlements  | (5,636)                            | 104,012      | (19,836)                          | 116,946      |
| Adjusted interest expense  | \$(227,534)                        | \$ (135,732) | \$(711,340)                       | \$ (577,134) |
| Net interest income  | \$ 34,621}                         | \$ 28,709    | \$ 99,391}                        | \$ 104,236   |
| Derivative cash settlements  | (5,636)                            | 104,012      | (19,836)                          | 116,946      |
| Adjusted net interest income   | \$ 28,985}                         | \$ 132,721   | \$ 79,555}                        | \$ 221,182   |
| Income (loss) prior to income taxes  | \$ 56,398}                         | \$ 75,263    | \$ 94,441}                        | \$ (150,022) |
| Derivative forward value   | (28,207)                           | 53,046       | (24,935)                          | 203,457      |
| Adjusted income prior to income taxes  | \$ 28,191}                         | \$ 128,309   | \$ 69,506}                        | \$ 53,435    |
| Net income (loss) prior to cumulative effect of change in accounting principle | \$ 54,933}                         | \$ 75,080    | \$ 93,785}                        | \$ (143,045) |
| Derivative forward value   | (28,207)                           | 53,046       | (24,935)                          | 203,457      |
| Adjusted net income  | \$ 26,726}                         | \$ 128,126   | \$ 68,850}                        | \$ 60,412    |

TIER using GAAP financial measures is calculated as follows:

$$\text{TIER} = \frac{\text{Interest expense} + \text{net income prior to cumulative effect of change in accounting principle}}{\text{Interest expense}}$$

Our adjusted TIER is calculated as follows:

$$\text{Adjusted TIER} = \frac{\text{Adjusted interest expense} + \text{adjusted net income}}{\text{Adjusted interest expense}}$$

The following table presents our TIER and adjusted TIER:

|                   | Three months ended |      | Nine months ended |      |
|-------------------|--------------------|------|-------------------|------|
|                   | February 28,       |      | February 28,      |      |
|                   | 2010               | 2009 | 2010              | 2009 |
| TIER (1)          | 1.25}              | 1.31 | 1.14}             | -    |
| Adjusted TIER (1) | 1.12}              | 1.94 | 1.10}             | 1.10 |

(1) For the nine months ended February 28, 2009, we reported a net loss of \$143 million, therefore the TIER for this period results in a value below 1.00.

#### Adjustments to the Calculation of Leverage and Debt to Equity

The following table provides a reconciliation between the liabilities and equity used to calculate the leverage and debt to equity ratios and these financial measures adjusted to exclude the non-cash effects of derivatives and foreign currency adjustments, to subtract debt used to fund loans that are guaranteed by the Rural Utilities Service from total liabilities, to subtract from total liabilities, and add to total equity, debt with equity characteristics and to include minority interest as equity. Due to the adoption of new accounting standards for noncontrolling interests on June 1, 2009, minority interest is reported as equity on the consolidated balance sheets as of February 28, 2010 and May 31, 2009. As a result, it is not necessary to adjust equity to include minority interest in the leverage and debt to equity ratio as it was in prior periods. As required, we have reflected the changes in presentation and disclosure of noncontrolling interest in our consolidated financial statements for all periods presented in this Form 10-Q including the leverage and debt to equity ratios at May 31, 2009.

Refer to Non-GAAP Financial Measures in Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operations, in our Form 10-K/A for the year ended May 31, 2009 for an explanation of why these adjustments to the calculation of leverage and debt to equity ratios reflect management's perspective on our operations and why we believe these are useful financial measures for investors.

| (dollar amounts in thousands)  | February 28,<br>2010 | May 31,<br>2009 |
|--|----------------------|-----------------|
| Liabilities  | \$ 19,539,238}       | \$ 20,463,605   |
| Less:  |                      |                 |
| Derivative liabilities   | (461,030)            | (493,002)       |
| Debt used to fund loans guaranteed<br>by RUS   | (238,423)            | (243,997)       |
| Subordinated deferrable debt   | (311,440)            | (311,440)       |
| Subordinated certificates  | (1,828,461)          | (1,740,054)     |
| Adjusted liabilities   | \$ 16,699,884}       | \$ 17,675,112   |
| Total equity   | \$ 570,316}          | \$ 519,100      |
| Less:  |                      |                 |
| Prior year cumulative derivative<br>forward<br>value and foreign currency<br>adjustments | 103,493}             | (44,056)        |
| Year-to-date derivative forward value loss   | (24,935)             | 147,549         |
| Accumulated other comprehensive<br>income (1)  | (7,644)              | (8,115)         |
| Plus:  |                      |                 |
| Subordinated certificates  | 1,828,461}           | 1,740,054       |
| Subordinated deferrable debt   | 311,440}             | 311,440         |
| Adjusted equity  | \$ 2,781,131}        | \$ 2,665,972    |
| Guarantees   | \$ 1,198,288}        | \$ 1,275,455    |

(1) Represents the accumulated other comprehensive income related to derivatives.

The leverage and debt to equity ratios using GAAP financial measures are calculated as follows:

$$\text{Leverage ratio} = \frac{\text{Liabilities} + \text{guarantees outstanding}}{\text{Total equity}}$$

$$\text{Debt to equity ratio} = \frac{\text{Liabilities}}{\text{Total equity}}$$

The adjusted leverage and debt to equity ratios are calculated as follows:

$$\text{Adjusted leverage ratio} = \frac{\text{Adjusted liabilities} + \text{guarantees outstanding}}{\text{Adjusted equity}}$$

$$\text{Adjusted debt to equity ratio} = \frac{\text{Adjusted liabilities}}{\text{Adjusted equity}}$$

The following table provides the calculated ratio for leverage and debt to equity, as well as the adjusted ratio calculations.

|                               | February<br>28,<br>2010 | May 31,<br>2009 |
|-------------------------------|-------------------------|-----------------|
| Leverage ratio                | 36.36}                  | 41.88           |
| Adjusted leverage ratio       | 6.44}                   | 7.11            |
| Debt to equity ratio          | 34.26}                  | 39.42           |
| Adjusted debt to equity ratio | 6.00}                   | 6.63            |

Item 3. Quantitative and Qualitative Disclosures About Market Risk

See Market Risk discussion beginning on page 55.

Item 4T. Controls and Procedures

Senior management, including the Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of our disclosure controls and procedures as defined in Rules 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934 ("the Exchange Act"). At the end of the period covered by this report, based on this evaluation process, the Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures are effective. There were no changes in our internal control over financial reporting that occurred during our last fiscal quarter that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

## PART II. OTHER INFORMATION

### Item 1A. Risk Factors

Refer to Part I, Item 1A. Risk Factors in our Form 10-K/A for the year ended May 31, 2009 for information regarding factors that could affect our results of operations, financial condition and liquidity. There have been no material changes to our risk factors described in our Form 10-K/A for the year ended May 31, 2009.

### Item 6. Exhibits

4.5 –Revolving Credit Agreement dated as of March 10, 2010 for \$1,300 million expiring on March 8, 2013.

31.1 –Certification of the Chief Executive Officer required by Section 302 of the Sarbanes-Oxley Act of 2002.

31.2 –Certification of the Chief Financial Officer required by Section 302 of the Sarbanes-Oxley Act of 2002.

32.1 –Certification of the Chief Executive Officer required by Section 906 of the Sarbanes-Oxley Act of 2002.

32.2 –Certification of the Chief Financial Officer required by Section 906 of the Sarbanes-Oxley Act of 2002.

Signatures

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

NATIONAL RURAL UTILITIES COOPERATIVE  
FINANCE CORPORATION

/s/ STEVEN L. LILLY  
Steven L. Lilly  
Chief Financial Officer

/s/ ROBERT E. GEIER  
Robert E. Geier  
Controller  
(Principal Accounting Officer)

April 14, 2010

