

NATIONAL RURAL UTILITIES COOPERATIVE FINANCE CORP /DC/

Form 10-K

August 29, 2008

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

FORM 10-K

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

THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended May 31, 2008

OR

☐ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from _____ to _____

Commission File Number 1-7102

NATIONAL RURAL UTILITIES COOPERATIVE
FINANCE CORPORATION

(Exact name of registrant as specified in its charter)

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

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

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

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

Name of
each
exchange
on

Name of
each
exchange
on

Title of each class	which listed	Title of each class	which listed
5.75% Collateral Trust Bonds, due 2008	NYSE	7.35% Collateral Trust Bonds, due 2026	NYSE
5.70% Collateral Trust Bonds, due 2010	NYSE	6.75% Subordinated Notes, due 2043	NYSE
7.20% Collateral Trust Bonds, due 2015	NYSE	6.10% Subordinated Notes, due 2044	NYSE
6.55% Collateral Trust Bonds, due 2018	NYSE	5.95% Subordinated Notes, due 2045	NYSE

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

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

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

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

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

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

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

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

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CAUTIONARY NOTE REGARDING FORWARD-LOOKING STATEMENTS

This Form 10-K 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, the interest expense, demand for our loan products, changes in the quality or composition of our loan and investment portfolios, changes in accounting principles, policies or guidelines, and other economic and governmental factors affecting our operations. Some of these and other factors are discussed in our annual and quarterly reports previously filed with the Securities and Exchange Commission ("SEC"). Except as required by law, we undertake no obligation to update or publicly release any revisions to forward-looking statements to reflect events, circumstances or changes in expectations after the date on which the statement is made.

The information contained in this section should be read in conjunction with our consolidated financial statements and related notes and the information contained elsewhere in this Form 10-K, including that set forth under Item 1A, Risk Factors.

PART I

Item 1. Business.

General

National Rural Utilities Cooperative Finance Corporation ("National Rural" or "the Company") is a private, not-for-profit cooperative association incorporated under the laws of the District of Columbia in April 1969. The principal purpose of National Rural is to provide its members with a source of financing to supplement the loan programs of the Rural Utilities Service ("RUS") of the United States Department of Agriculture. National Rural makes loans to its rural utility system members ("utility members") to enable them to acquire, construct and operate electric distribution, generation, transmission and related facilities. National Rural also provides its members with credit enhancements in the form of letters of credit and guarantees of debt obligations. National Rural is exempt from payment of federal income taxes under the provisions of Section 501(c)(4) of the Internal Revenue Code. National Rural is a not-for-profit member-owned finance cooperative, thus its objective is not to maximize its net income, but to offer its members low cost financial products and services consistent with sound financial management. National Rural's internet address is www.nrucfc.coop, where under "Investors," copies can be found of this annual report on Form 10-K, quarterly reports on Form 10-Q and current reports on Form 8-K, and amendments thereto, all of which National Rural makes available, free of charge, as soon as reasonably practicable after the report is filed with the SEC. Information posted on National Rural's website is not incorporated by reference into this Form 10-K.

For financial statement purposes, the results of operations and financial condition of National Rural are consolidated with and include Rural Telephone Finance Cooperative ("RTFC") and National Cooperative Services Corporation ("NCSC"). Unless stated otherwise, references to the Company relate to the consolidation of National Rural, RTFC, NCSC and certain entities controlled by National Rural and created to hold foreclosed assets and effect loan securitization transactions. National Rural also reports the operations for each of National Rural, RTFC and NCSC as

separate segments. See Note 17 to the consolidated financial statements for further information on the Company's segment reporting.

RTFC is a private not-for-profit cooperative association originally incorporated in the state of South Dakota in 1987 and reincorporated in the District of Columbia in 2005. The principal purpose of RTFC is to provide and arrange financing for its rural telecommunications members and their affiliates. National Rural is the sole lender to and manages the lending and financial affairs of RTFC through a long-term management agreement. Under a guarantee agreement, RTFC pays National Rural a fee in exchange for which National Rural reimburses RTFC for loan losses. RTFC is headquartered with National Rural in Herndon, Virginia. RTFC is a taxable cooperative that pays income tax based on its net income, excluding net income allocated to its members, as allowed by law under Subchapter T of the Internal Revenue Code.

NCSC was incorporated in 1981 in the District of Columbia as a private non-profit cooperative association. The principal purpose of NCSC is to provide financing to the for-profit and non-profit entities that are owned, operated or controlled by, or provide substantial benefit to, members of National Rural. NCSC also markets, through its cooperative members, a consumer loan program for home improvements and an affinity credit card program. NCSC's membership consists of National Rural and distribution systems that are members of National Rural or are eligible for such membership. National Rural is the primary source of funding to and manages the lending and financial affairs of NCSC through a management agreement which

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

Members

The Company's consolidated membership was 1,538 as of May 31, 2008 including 898 utility members, the majority of which are consumer-owned electric cooperatives, 511 telecommunications members, 66 service members and 63 associates in 49 states, the District of Columbia and two U.S. territories. The utility members included 829 distribution systems and 69 generation and transmission ("power supply") systems. Memberships between National Rural, RTFC and NCSC have been eliminated in consolidation.

National Rural currently has four classes of electric members:

- Class A - cooperative or not-for-profit distribution systems;
- Class B - cooperative or not-for-profit power supply systems;
- Class C - statewide and regional associations wholly-owned or controlled by Class A or Class B members; and
- Class D - national associations of cooperatives.

Class A membership in National Rural is limited to cooperative or not-for-profit distribution systems that receive or are eligible to receive loans or other assistance from RUS. The associates are not-for-profit entities organized on a cooperative basis which are owned, controlled or operated by Class A, B or C members and which provide non-electric services primarily for the benefit of ultimate consumers. Associates are not entitled to vote at any meeting of the members and are not eligible to be represented on National Rural's board of directors. All references to members within this document include members and associates.

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

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

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

Set forth below is a table showing by state or U.S. territory the total number of National Rural, RTFC and NCSC members, the percentage of total loans and the percentage of total loans and guarantees outstanding at May 31, 2008.

State/Territory	Number of Members	Loan %	Loan and Guarantee %	State/Territory	Number of Members	Loan %	Loan and Guarantee %
Alabama	30	2.18%	2.43%	Missouri	65	3.59%	3.78%
Alaska	30	1.96%	1.86%	Montana	40	0.70%	0.71%
American Samoa	1	-	-	Nebraska	40	0.10%	0.09%
Arizona	27	1.09%	1.20%	Nevada	7	0.82%	0.80%
Arkansas	30	2.74%	2.64%	New Hampshire	4	0.75%	0.88%
California	11	0.14%	0.16%	New Jersey	1	0.09%	0.09%
Colorado	39	4.95%	4.96%	New Mexico	25	0.19%	0.19%
Connecticut	1	1.05%	1.00%	New York	21	0.10%	0.10%
Delaware	1	0.20%	0.19%	North Carolina	42	2.56%	2.93%
District of Columbia	4	0.05%	0.13%	North Dakota	33	0.36%	0.38%
Florida	19	3.56%	3.39%	Ohio	42	2.39%	2.31%
Georgia	68	8.24%	7.94%	Oklahoma	49	2.54%	2.41%
Guam	1	-	-	Oregon	39	1.59%	1.66%
Hawaii	1	0.04%	0.04%	Pennsylvania	26	1.88%	1.87%
Idaho	17	0.83%	0.80%	South Carolina	38	2.55%	2.45%
Illinois	52	3.16%	2.99%	South Dakota	46	0.78%	0.74%
Indiana	52	2.79%	2.64%	Tennessee	29	0.57%	0.54%
Iowa	118	2.44%	2.36%	Texas	108	16.00%	16.14%
Kansas	49	4.62%	4.68%	Utah	11	3.00%	2.91%
Kentucky	33	1.91%	2.33%	Vermont	7	0.39%	0.38%
Louisiana	17	1.76%	1.67%	Virgin Islands	-	2.58%	2.45%
Maine	6	0.02%	0.02%	Virginia	27	1.24%	1.19%
Maryland	2	1.18%	1.18%	Washington	19	0.65%	0.71%
Massachusetts	1	-	-	West Virginia	4	0.03%	0.03%
Michigan	27	1.39%	1.33%	Wisconsin	62	2.02%	1.92%
Minnesota	74	3.45%	3.28%	Wyoming	15	0.70%	0.73%
Mississippi	27	2.08%	2.39%	Total	1,538	100.00%	100.00%

Distribution Systems

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

Wholesale power supply contracts ordinarily guarantee neither an uninterrupted supply nor a constant cost of power. Contracts with RUS-financed power supply systems (which generally require the distribution system to purchase all its power requirements from the power supply system) provide for rate increases to pass along increases in sellers' costs. The wholesale power contracts permit the power supply system, subject to approval by RUS and, in certain circumstances, regulatory agencies, to establish rates to its members so as to produce revenues sufficient, with

revenues from all other sources, to meet the costs of operation and maintenance (including replacements, insurance, taxes and administrative and general overhead expenses) of all generating, transmission and related facilities, to pay the cost of any power and energy purchased for resale, to pay the costs of generation and transmission, to make all payments on account of all indebtedness and lease obligations of the power supply system and to provide for the establishment and maintenance of reasonable reserves. The board of directors of the power supply system may review the rates under the wholesale power contracts at least annually.

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

Power Supply Systems

Power supply systems are utilities that purchase or generate electric power and provide it on a wholesale basis to distribution systems for delivery to the ultimate retail consumer. Of the 61 operating power supply systems that have financing commitments from National Rural at December 31, 2007 (the most recent year for which data is available as of the date of filing this Form 10-K), 37 had generating capacity of at least 100 megawatts, 7 had less than 100 megawatts of generating capacity and 17 had no generating capacity. The systems with no generating capacity generally operated transmission lines to

supply certain distribution systems. Certain other power supply systems have been formed but do not yet own generating or transmission facilities or have financing commitments from National Rural.

Service Organizations and Associate Systems

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

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

Telecommunications Systems

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

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

Rural telecommunications companies, including all local exchange carriers ("LECs") other than Verizon, AT&T, Qwest, Cincinnati Bell and Embarq (formerly Sprint's local exchange properties) comprise less than 15% of a local exchange telecommunications industry that provides service to over 172 million access lines. These rural companies range in size from fewer than 100 customers to more than one million. Rural telecommunications companies' annual operating revenues range from less than \$100,000 to over \$2 billion. In addition to basic local exchange and access telecommunications service, most independents offer other communications services including wireless telephone, cable television and internet access. Most rural telecommunications companies' networks incorporate digital switching, fiber optics, internet protocol telephony and other advanced technologies.

Loan Programs

Set forth below is a table showing the weighted average loans outstanding to borrowers and the weighted average interest rates thereon by loan program and by segment during fiscal years ended May 31:

	2008		2007	
	Weighted average loans outstanding	Weighted average interest rate	Weighted average loans outstanding	Weighted average interest rate
(Dollar amounts in thousands)				
Total by loan type: (1)				
Long-term fixed rate loans	\$ 14,573,227	6.05%	\$ 14,323,272	5.87%
Long-term variable rate loans	1,170,017	6.94%	1,433,484	7.58%
Loans guaranteed by RUS	252,788	5.49%	258,407	5.59%
Short-term loans	1,310,313	5.89%	1,028,585	7.06%
Non-performing loans	504,310	0.01%	534,733	0.02%
Restructured loans	589,662	0.64%	614,580	0.61%
Total loans	\$ 18,400,317	5.81%	\$ 18,193,061	5.79%

Total by segment:				
National Rural	\$ 16,167,441	5.85%	\$ 15,803,285	5.80%
RTFC	1,791,100	4.97%	1,993,672	5.30%
NCSC	441,776	7.68%	396,104	8.00%
Total	\$ 18,400,317	5.81%	\$ 18,193,061	5.79%

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

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

(in thousands)							
State/Territory	2008	2007	2006	State/Territory	2008	2007	2006
Alabama	\$ 414,961	\$ 347,723	\$ 355,420	Montana	\$ 133,655	\$ 132,603	\$ 147,731
Alaska	371,768	335,352	333,716	Nebraska	18,756	16,447	14,149
American Samoa	769	769	1,604	Nevada	155,625	147,401	137,701
Arizona	206,558	178,659	169,754	New Hampshire	143,417	149,496	164,651
Arkansas	522,018	518,273	549,552	New Jersey	17,747	18,217	18,211
California	25,968	27,283	24,362	New Mexico	36,636	32,344	36,528
Colorado	942,179	922,558	876,100	New York	19,735	19,844	21,782
Connecticut	200,000	200,000	200,000	North Carolina	487,249	519,214	522,194
Delaware	37,950	39,582	23,842	North Dakota	69,120	77,072	77,002
District of Columbia	9,514	9,717	9,908	Ohio	455,491	390,350	410,346
Florida	677,365	617,010	659,416	Oklahoma	483,623	480,536	490,351
Georgia	1,567,108	1,566,308	1,557,675	Oregon	303,166	305,506	305,961
Hawaii	6,804	7,157	7,500	Pennsylvania	357,337	376,193	438,914
Idaho	157,703	168,253	165,035	South Carolina	484,733	476,139	501,990
Illinois	600,571	543,389	509,391	South Dakota	147,916	161,247	169,335
Indiana	530,008	481,243	432,953	Tennessee	107,575	96,073	111,043
Iowa	465,056	482,513	468,236	Texas	3,044,117	2,618,010	2,877,586
Kansas	878,630	849,864	593,670	Utah	570,971	565,768	580,472
Kentucky	363,720	355,503	335,551	Vermont	74,957	75,905	81,761
Louisiana	333,984	320,765	382,505	Virgin Islands	491,706	492,795	488,392
Maine	4,566	9,884	11,737	Virginia	235,916	184,986	209,153
Maryland	224,754	206,491	176,797	Washington	122,674	110,907	102,128
Michigan	265,116	271,541	294,162	West Virginia	6,109	5,355	7,700
Minnesota	655,576	731,883	744,941	Wisconsin	384,748	369,427	348,351
Mississippi	395,423	366,989	426,634	Wyoming	133,087	117,374	117,098
Missouri	682,860	630,289	669,914	Total	\$19,026,995	\$18,128,207	\$18,360,905

The Company's loan portfolio is widely dispersed throughout the United States and its territories, including 48 states, the District of Columbia, American Samoa and the U.S. Virgin Islands. At May 31, 2008, 2007 and 2006, loans outstanding to borrowers located in any one state or territory did not exceed 16%, 15% and 16%, respectively, of total loans outstanding.

Interest Rates on Loans

National Rural's goal as a not-for-profit cooperatively-owned finance company is to set rates at levels that will provide its members with low cost financing while maintaining sound financial results as required to obtain high credit ratings on its debt instruments. National Rural sets its interest rates primarily based on its cost of funding, as well as general and administrative expenses, the loan loss provision and a reasonable level of earnings. Various discounts, which reduce the stated interest rates, are available to borrowers meeting certain criteria related to business type, performance, volume and whether National Rural is their sole mortgage holder.

National Rural Loan Programs

Long-Term Loans

Long-term loans are generally for terms of up to 35 years and can be either amortizing or bullet loans with serial payment structures. These loans finance electric plant and equipment which typically have a useful life equal to or in excess of the loan maturity. A borrower can select a fixed interest rate for periods of one to 35 years or a variable rate. Upon the expiration of the selected fixed interest rate term, the borrower may select another fixed rate term or the variable rate. National Rural sets long-term fixed rates daily and the long-term variable rate is set on the first business day of each month. The fixed rate on a loan is determined on the day the loan is advanced or repriced based on the rate term selected. A borrower may divide its loan into various tranches. The borrower then has the option of selecting a fixed or variable interest rate for each tranche.

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

Short-Term Loans

National Rural's short-term loans are line of credit loans and generally are advanced only at a variable interest rate. The line of credit variable interest rate is set on the first business day of each month. The principal amount of line of credit loans with maturities of greater than one year generally must be paid down to a zero outstanding principal balance for five consecutive days during each 12-month period.

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

RTFC Loan Programs

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

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

Long-Term Loans

RTFC makes long-term loans to rural telecommunications companies and their affiliates for the acquisition, construction or upgrade of wireline telecommunications systems, wireless telecommunications systems, fiber optic networks, cable television systems and other corporate purposes. Long-term loans are generally for periods not exceeding 15 years. Loans may be advanced at a fixed or variable interest rate. Fixed rates are generally available for periods from one year to the final loan maturity. Upon the expiration of the selected fixed interest rate term, the borrower may select another fixed rate term or a variable rate. Long-term fixed rates for telecommunications loans are set daily and the long-term variable rate is set on the first business day of each month. The fixed rate on a loan is determined on the day the loan is advanced or converted to a fixed rate based on the term selected. A borrower may divide its loan into various tranches. The borrower then has the option of selecting a fixed or variable interest rate for each tranche.

To borrow from RTFC, a wireline telecommunications system generally must be able to demonstrate the ability to achieve and maintain an annual debt service coverage ratio ("DSC") and an annual TIER of 1.25 and 1.50, respectively. To borrow from RTFC, a cable television system, fiber optic network or wireless telecommunications system generally must be able to demonstrate the ability to achieve and maintain an annual DSC of 1.25. Loans made to start-up ventures using emerging technologies are evaluated based on the quality of the business plan, experience of the management team and the level and quality of credit support from established companies. Based on the business plan, specific covenants are developed for each transaction which require performance at levels deemed sufficient to repay the RTFC obligations under the approved terms.

Short-Term Loans

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

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

NCSC Loan Programs

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

Lease and General Loan Program

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

Associate Member Loan Program

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

RUS Guaranteed Loans for Rural Electric Systems

National Rural may participate as an eligible lender in the RUS loan guarantee program under the terms and conditions of a master loan guarantee and servicing agreement between RUS and National Rural. Under this agreement, National Rural may make long-term secured loans to eligible members for periods of up to 35 years, at fixed or variable rates established by National Rural. RUS guarantees the principal and interest payments on the notes evidencing such loans. At May 31, 2008, National Rural had \$215 million of loans outstanding under this program. In addition, at May 31, 2008, National Rural was holding certificates totaling \$35 million representing interests in trusts holding RUS guaranteed loans.

Conversion of Loans

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

Prepayment of Loans

Generally, borrowers may prepay long-term loans at any time, subject to the payment of a prepayment fee of 33 to 50 basis points and a make-whole premium, if applicable. Line of credit loans may be repaid at any time without a premium if in variable interest rate mode.

Loan Security

Except when providing short-term loans, the Company typically lends to its members on a senior secured basis. Long-term loans are typically secured on a parity with other secured lenders (primarily RUS), if any, by all assets and revenues of the borrower with exceptions typical in utility mortgages. Short-term loans are generally unsecured lines of credit.

The following tables summarize the Company's secured and unsecured loans outstanding by loan program and by segment at May 31:

(Dollar amounts in thousands)		2008				2007			
Total by loan program:	Secured	%	Unsecured	%	Secured	%	Unsecured	%	
Long-term fixed rate loans	\$ 14,732,058	97%	\$ 472,556	3%	\$ 14,180,956	97%	\$ 482,384	3%	
Long-term variable rate loans	1,728,803	92%	153,292	8%	1,865,821	94%	127,713	6%	
Loans guaranteed by RUS	250,169	100%	-	-	255,903	100%	-	-	
Short-term loans	165,226	10%	1,524,891	90%	191,231	16%	1,024,199	84%	
Total loans	\$ 16,876,256	89%	\$ 2,150,739	11%	\$ 16,493,911	91%	\$ 1,634,296	9%	

Total by segment:

National Rural	\$ 15,021,067	89%	\$ 1,865,340	11%	\$ 14,462,448	92%	\$ 1,342,842	8%
RTFC	1,497,487	87%	229,027	13%	1,630,079	88%	230,300	12%
NCSC	357,702	86%	56,372	14%	401,384	87%	61,154	13%
Total loans	\$ 16,876,256	89%	\$ 2,150,739	11%	\$ 16,493,911	91%	\$ 1,634,296	9%

Guarantee Programs

The Company uses the same credit policies and monitoring procedures in providing guarantees as it does for loans and commitments. The following chart provides a breakout of guarantees outstanding by type at May 31:

(in thousands)	2008	2007
Long-term tax-exempt bonds	\$ 498,495	\$ 526,185
Indemnifications of tax benefit transfers	94,821	107,741
Letters of credit	343,424	365,766
Other guarantees	100,400	74,682
Total	\$ 1,037,140	\$ 1,074,374

Members' interest expense for the years ended May 31, 2008 and 2007 on debt obligations guaranteed by the Company was approximately \$21 million and \$20 million, respectively.

Guarantees of Long-Term Tax-Exempt Bonds

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

In the event of a default by a system for non-payment of debt service, the Company is obligated to pay, after available debt service reserve funds have been exhausted, scheduled debt service under its guarantee. The bond issue may not be accelerated due to such non-payment by the system so long as the Company performs under its guarantee. The system is required to repay, on demand, any amount advanced by the Company pursuant to its guarantee. This repayment obligation is secured on a *pari passu* basis with other lenders (including, in most cases, RUS), by a lien on substantially all of the system's assets. If the security instrument is a common mortgage with RUS, then in general, the Company may not exercise remedies thereunder for up to two years following default. However, if the debt is accelerated under the common mortgage because of a determination that the interest thereon is not tax-exempt, the system's obligation to reimburse the Company for any guarantee payments will be treated as a long-term loan. The system is required to pay to the Company initial and/or on-going guarantee fees in connection with these transactions.

Certain guaranteed long-term debt bears interest at variable rates which are adjusted at intervals of one to 270 days, weekly, each five weeks or semi-annually to a level expected to permit their resale or auction at par. At the option of the member on whose behalf it is issued, and provided funding sources are available, rates on such debt may be fixed until maturity. Holders have the right to tender the debt for purchase at par at the time rates are reset when the debt bears interest at a variable rate and the Company has committed to purchase debt so tendered if it cannot otherwise be remarketed. If the Company held the securities, the cooperative would pay interest to the Company at its short-term rate. Since the inception of the program in the mid-1980s, all bonds have been successfully remarketed and thus, the Company has not been required to purchase any bonds. At May 31, 2008, the Company was the guarantor and liquidity provider for \$330 million of tax-exempt bonds issued for its member cooperatives. Additionally, National Rural was the guarantor, but not liquidity provider, for \$155 million of tax-exempt bonds that were in the auction rate mode.

Guarantees of Tax Benefit Transfers

The Company also has guaranteed members' obligations to indemnify against loss of tax benefits in certain tax benefit transfers that occurred in 1981 and 1982. A member's obligation to reimburse the Company for any guarantee payments would be treated as a long-term loan, secured on a *pari passu* basis with RUS by a first lien on substantially all the member's property to the extent of any cash received by the member at the outset of the transaction. The remainder would be treated as a short-term loan secured by a subordinated mortgage on substantially all of the member's property. Due to changes in federal tax law, no guarantees of this nature have been put in place since 1982. The maturities for this type of guarantee run through 2015.

Letters of Credit

The Company issues irrevocable letters of credit to support members' obligations to energy marketers, other third parties and to the Rural Business and Cooperative Development Service. Letters of credit may be issued on a secured or unsecured basis and with such issuance fees as may be determined from time to time. Each letter of credit issued by National Rural is supported by a reimbursement agreement with the member on whose behalf the letter of credit was issued. In the event a beneficiary draws on a letter of credit, the agreement generally requires the member to reimburse the Company within one year from the date of the draw, with interest accruing from such date at the Company's short-term variable rate of interest.

Other Guarantees

The Company may provide other guarantees as requested by its members. Such guarantees may be made on a secured or unsecured basis with guarantee fees set to cover the Company's general and administrative expenses, a provision for losses and a reasonable margin.

The following chart summarizes total guarantees by segment at May 31:

(Dollar amounts in thousands)

National Rural:	2008		2007	
Distribution	\$ 184,459	18%	\$ 211,320	20%
Power supply	786,455	76%	797,009	74%
Statewide and associate	22,785	2%	25,359	2%
National Rural Total	993,699	96%	1,033,688	96%
RTFC	260	-	-	-
NCSC	43,181	4%	40,686	4%
Total	\$1,037,140	100%	\$1,074,374	100%

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

(in thousands)

State/Territory	2008	2007	2006	State/Territory	2008	2007	2006
Alabama	\$ 72,070	\$ 72,348	\$ 22,250	Montana	\$ 9,056	\$ 9,029	\$ 145
Alaska	1,900	1,900	1,800	Nebraska	4	6	-
Arizona	33,745	38,301	43,699	Nevada	5,400	5,400	-
Arkansas	8,008	12,027	15,921	New Hampshire	32,767	34,550	9,550
California	6,110	1,010	-	New Mexico	1,048	1,020	1,016
Colorado	53,467	54,236	55,131	North Carolina	99,729	100,630	107,817
District of Columbia	17,448	20,998	21,428	North Dakota	6,474	7,115	-
Florida	3,725	4,623	100,038	Ohio	8,000	5,500	2,000
Georgia	26,775	26,027	35,283	Oklahoma	754	3,056	4,358
Idaho	3,173	3,173	-	Oregon	29,034	29,439	24,922
Illinois	229	219	225	Pennsylvania	17,416	17,519	18,307
Indiana	13	7	911	South Carolina	6,300	7,819	50
Iowa	8,271	8,240	8,517	South Dakota	20	6	-
Kansas	60,797	55,472	42,561	Tennessee	1,460	296	295
Kentucky	102,423	124,013	121,864	Texas	194,214	152,307	167,881
Louisiana	389	4,733	4,778	Utah	13,495	17,193	20,594
Maine	2	1	-	Vermont	1,250	3,500	1,250
Maryland	11,725	25,266	24,800	Virginia	3,447	3,935	4,133
Michigan	2,232	2,123	1,163	Washington	19,050	23,171	250
Minnesota	3,025	10,585	76,010	Wisconsin	320	32	322
Mississippi	83,549	88,312	37,267	Wyoming	13,724	13,969	9,370
Missouri	75,102	85,268	93,074	Total	\$ 1,037,140	\$ 1,074,374	\$ 1,078,980

Disaster Recovery

The Company has had a comprehensive disaster recovery and business continuity plan in place since May of 2001. The plan includes a duplication of the Company's production information systems at an off-site facility coupled with an extensive business recovery plan to utilize those remote systems. The Company's production data is replicated in real time to the recovery site 24 hours a day, 7 days a week. The plan also includes steps for each of the Company's operating groups to conduct business with a view to minimizing disruption for customers. The Company has conducted Disaster Recovery exercises twice a year that include both the information technology group and business areas. The Company contracts with an external vendor for the facilities to house the National Rural owned backup systems as well as office space and related office equipment. Backup tapes are also stored at an off-site storage location managed by an external vendor.

Tax Status

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

Investment Policy

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

Employees

At May 31, 2008, National Rural had 231 employees, including financial and legal personnel, management specialists, credit analysts, accountants and support staff. National Rural believes that its relations with its employees are good.

National Rural Lending Competition

National Rural competes with other lenders on price, the variety of financing options offered and additional services provided to its member/owners. National Rural is primarily in competition with other banks for the business of its members. The primary bank competitor is CoBank, ACB ("CoBank"), a government sponsored enterprise and member of the Farm Credit System whose status as such gives it the ability to offer lower interest rates in many situations. In addition, there are some members that are large enough to access the capital markets for funding. In these cases, National Rural is competing with the pricing and funding options the member is able to obtain in the capital markets. National Rural attempts to minimize the impact of competition by offering a variety of loan options and complimentary services and by leveraging the working relationship that it has developed with the majority of the members for more than 35 years.

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

According to December 31, 2006 financial data (the latest full calendar year for which this data is available as of the date of filing this Form 10-K) provided to National Rural by its 811 reporting electric cooperative distribution and 57 reporting power supply systems, those entities had a total of \$53 billion in long-term debt outstanding at December 31, 2006. RUS is the dominant lender to the electric cooperative industry with \$29 billion or 54% of the total outstanding debt for the 868 systems reporting 2006 results to National Rural. At December 31, 2006, National Rural had a total of \$16 billion of long-term exposure to its distribution and power supply member systems, including \$15 billion of long-term loans and \$1 billion of guarantees. National Rural's \$16 billion long-term exposure represented 30% of the total long-term debt to these electric systems. The remaining \$9 billion or 16% was borrowed from other sources.

At December 31, 2007, CFC had a total of \$16 billion of long-term exposure to its distribution and power supply member systems, including \$15 billion of long-term loans and \$1 billion of guarantees.

The competitive market for providing credit to the rural telecommunications industry is difficult to quantify, since many rural telecommunications companies are not RUS borrowers. At December 31, 2007, RUS had a total of approximately \$3.7 billion outstanding to telecommunications borrowers. The Rural Telephone Bank ("RTB") was fully liquidated in November 2007 which resulted in the transfer of the RTB loan portfolio to RUS. RTFC is not in direct competition with RUS, but rather competes with other lenders for supplemental lending and for the full lending requirement of the rural telecommunications companies that have decided not to borrow from RUS or for projects not eligible for RUS financing. RTFC's competition includes commercial banks, CoBank and insurance companies. At December 31, 2007, RTFC had a total of \$1.7 billion in long-term loans outstanding to telecommunications borrowers.

Member Regulation and Competition

Electric Systems

The movement toward electric competition at the retail level has faltered, while the wholesale level has become largely competitive. The electric utility industry has settled into a "hybrid" model in which there are significant differences in the retail regulatory approaches followed in different states and regions. As of May 31, 2008, retail customer choice has been implemented in 15 states. Those states are Arizona, Connecticut, Delaware, Illinois, Maine, Maryland, Massachusetts, Michigan, New Hampshire, New Jersey, New York, Ohio, Pennsylvania, Rhode Island, and Texas. Of the remaining states, retail customer choice was not under consideration in 26 states, delayed in four states (Nevada, Oklahoma, Oregon, and West Virginia), repealed in four states (Arkansas, Montana, New Mexico, and Virginia), and suspended in one state (California).

In the 15 states where retail customer choice has been implemented, the Company had 158 distribution members and 19 power supply members with a total of \$5,164 million of loans outstanding at May 31, 2008. In New York, where the Company has four distribution members and \$9 million of loans to electric systems, cooperatives are not required to file competition plans with the state utility commission. The Company continues to believe that the distribution systems, which comprise the majority of its membership and loan exposure, will not be materially impacted by customer choice. In general, even in those states where customers have a choice of alternative energy suppliers, very few customers have switched from the traditional supplier.

In addition, in four of the 15 states where retail customer choice has been implemented, cooperatives may decide whether to "opt in" to competition or retain a monopoly position with respect to energy sales. Those states are Illinois, New Jersey, Ohio, and Texas. As of May 31, 2008, National Rural had loans outstanding in the amount of \$4,002 million in those states. Even if customers choose to purchase energy from an alternative supplier, the distribution systems own the lines to the customer and it would not be feasible for a competitor to build a second line to serve the same customers in almost all situations. Therefore, the distribution systems will still be charging a fee or access tariff for the service of delivering power, regardless of who supplies the power. Customer choice has had no impact on power supply cooperatives and the Company does not expect any impact.

Even in states where retail customer choice laws have been passed, there are many factors that may delay or influence the choices that customers have available to them and the timing of competition for cooperatives. One such factor will be the level of fees that systems will be allowed to charge other utilities for use of their transmission and distribution system. Other issues that may further delay retail competition in areas served by cooperatives include, but are not limited to, the following:

- Ability of cooperatives to "opt out" of the provisions of the customer choice laws in some states;
- Utilities in many states may still be regulated regarding rates on non-competitive services, such as distribution;
 - Many states will still regulate the securities issued by utilities, including cooperatives;
 - FERC regulation of rates as well as terms and conditions of transmission service;
- Reconciling the differences between state laws, such that out-of-state utilities can compete with in-state utilities; and
- The fact that few competitors have demonstrated much interest in providing electric energy to residential or rural customers.

In addition to retail customer choice laws, some state agencies regulate electric cooperatives with regard to rates and borrowing. There are 16 states that regulate the rates electric systems charge. Those states are Arizona, Arkansas, Georgia, Hawaii, Kentucky, Louisiana, Maine, Maryland, Michigan, New Mexico, New York, Utah, Vermont, Virginia, West Virginia, and Wyoming. Two of these states (Georgia and Utah) have partial oversight authority over the cooperatives' rates, but not the specific authority to set rates. Nine states allow cooperatives the right to opt in or out of state regulation. There are 19 states that regulate electric systems regarding the issuance of long-term debt. Those states are Alabama, Arizona, Colorado, Delaware, Georgia, Hawaii, Indiana, Kansas, Kentucky, Louisiana, Maine, Maryland, Massachusetts, New Hampshire, Rhode Island, Utah, Vermont, Virginia and Wyoming. One of these states (Alabama) regulates both the issuance of short-term and long-term debt. FERC also has jurisdiction to regulate transmission rates, wholesale rates, terms and conditions of service, and the issuance of securities by public utilities within its jurisdiction, which includes only a few cooperatives.

Telecommunications Systems

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

The Telecommunications Act of 1996 (the "Telecom Act") created a framework for competition and deregulation in the local telecommunications market. The Telecom Act had four basic goals: competition, universal service, deregulation and fostering advanced telecommunications and in