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

x 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.

TABLE OF CONTENTS

Part No.	Item No.		Page
I.	1.	Business	1
		General	1
		Members	2
		Distribution Systems	3
		Power Supply Systems	3
		Service Organizations and Associate Systems	4
		Telecommunications Systems	4
		Loan Programs	4
		Interest Rates on Loans	5
		National Rural Loan Programs	5
		RTFC Loan Programs	6
		NCSC Loan Programs	6
		RUS Guaranteed Loans for Rural Electric Systems	7
		Conversion of Loans	7
		Prepayment of Loans	7
		Loan Security	7
		Guarantee Programs	7
		Guarantees of Long-Term Tax-Exempt Bonds	8
		Guarantees of Tax Benefit Transfers	8
		Letters of Credit	8
		Other Guarantees	8
		Disaster Recovery	9
		Tax Status	9
		Investment Policy	9
		Employees	10
		National Rural Lending Competition	10
		Member Regulation and Competition	10
		The RUS Program	12
	1A.	Risk Factors	13
	1B.	Unresolved Staff Comments	15
	2.	Properties	15
	3.	Legal Proceedings	15
	4.	Submission of Matters to a Vote of Security Holders	15
II.	5.	Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities	16
	6.	Selected Financial Data	16
	7.	Management's Discussion and Analysis of Financial Condition and Results of Operations	17
		Business Overview	17
		Critical Accounting Estimates	19
		New Accounting Pronouncements	23
		Results of Operations	24
		Ratio of Earnings to Fixed Charges	33
		Financial Condition	33
		Off-Balance Sheet Obligations	41

Part	Item		Page
		Liquidity and Capital Resources	43
		Market Risk	46
		Non-GAAP Financial Measures	51
	7A.	Quantitative and Qualitative Disclosures About Market Risk	55
	8.	Financial Statements and Supplementary Data	55
	9.	Changes in and Disagreements with Accountants on Accounting and Financial Disclosure	55
	9A(T).	Controls and Procedures	55
	9B.	Other Information	56
III.	10.	Directors, Executive Officers and Corporate Governance	57
	11.	Executive Compensation	62
	12.	Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters	72
	13.	Certain Relationships and Related Transactions, and Director Independence	72
	14.	Principal Accountant Fees and Services	74
IV.	15.	Exhibits and Financial Statement Schedules	75
		Signatures	78

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

1

---

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.

4

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.

7

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 information technologies. To achieve competition, the Telecom Act required all carriers to interconnect with all others and LECs to provide competitors with access to elements of their networks. Congress included provisions in the Telecom Act granting RLECs an exemption from the above requirement to provide competitors with access to their networks, absent a determination that it would be in the public interest.

Competition continues to be a significant factor in the telecommunications industry. A January 2007 FCC report on competition states that as of June 2006, competitive local exchange carriers ("CLECs") provided service to 30 million access lines - 17.4 % of the nation's 172 million end-user switched access lines. Wireless carriers are providing service to 217.4 million mobile telephone service subscriptions - more than LECs and CLECs combined. For the most part, local exchange competition has benefited RLECs by enabling them to enter nearby towns and cities as CLECs, leveraging their existing infrastructure and reputation for providing quality, modern telecommunications service.

In addition to competition, the Telecom Act also mandated a universal telecommunications service support mechanism and required that it be: (1) sufficient to ensure that rural customers receive reasonably comparable rates and services when compared to urban customers; and (2) portable, that is, available to all eligible providers. Congress stated its intent that implicit subsidies presently contained in the access charges local telecommunications companies levy on long distance carriers be eliminated and be made explicit in the new universal service support mechanism. Rules adopted by the FCC in 2000 to date have provided adequate levels of universal service support. This has been essential for RLECs, as other FCC rulings have reduced access charges which are a key revenue source. In addition, RLECs are experiencing some of the access line and access revenue losses experienced by the RBOCs. However, growth in digital subscriber line service (DSL) has generally offset the revenue loss created by the decline of voice access lines.

Numerous wireless carriers have entered rural markets as competitors to the RLECs. By obtaining competitive eligible telecommunications carrier ("CETC") status from state regulators (as provided for in the Telecom Act), these wireless carriers are able to receive universal service funds ("USF") based on the incumbent LEC's costs (the "identical support" rule). This has led to growth in claims on the fund and great concern for its sustainability. USF's current funding base of interstate telecommunications revenues is shrinking as long distance minutes-of-use go down due to wireless, email and voice over internet protocol substitution. Uncontrolled demand for USF funding has resulted in the rate assessed on all participants in the nationwide network (the "contribution factor") becoming unsustainably high. The second quarter 2008 contribution factor is 11.3%. Many in the industry agree that changes need to be made regarding eligibility and the funding mechanism for USF. However, there is no agreement on what those changes should be. In May 2008, the FCC ordered that payments to CETCs be capped. Total support for a CETC will be capped at what they were eligible to receive in March 2008. In January 2008 the FCC issued three notices of proposed rulemaking on universal service funding. These related proceedings addressed creation of separate funds for incumbent and competitive ETCs, elimination of the "identical support" rule, and transitioning to a reverse auction regime for determining amounts of USF support an eligible carrier would receive. RLECs universally supported the elimination of the identical support rule and opposed reverse auctions. Positions on the creation of separate funds varied among RLECs. Predictably, the wireless carriers supported reverse auctions, opposed elimination of the identical support rule and, as with the RLECs, took varying positions on creating separate universal service funds.

The FCC also has a proceeding open on intercarrier compensation – the most important components of which are access fees LECs charge to interexchange carriers that originate or terminate long distance traffic on LEC networks. While the large LECs (most of which now own long distance companies) would like to see these fees transition to zero, RLECs depend heavily on access charges and are active participants in the FCC proceeding. RLECs have come together with a unified proposal that would preserve some access fees and are promoting it with the FCC. No action has been taken in this proceeding and it is unlikely that the FCC will take any in the near future.

While uncertainty exists regarding USF and access, the Company does not anticipate that any potential revenue losses resulting from these changes will result in material losses on loans outstanding to rural telecommunications companies.

As noted above, most RLECs are expanding their service offerings to customers. Without competitors in the most rural parts of their service areas, RLECs are introducing digital video, high-speed data, and local and long distance voice service. Where they can leverage their infrastructure, they are competing with Verizon, Qwest, AT&T, Embarq and cable companies in neighboring towns. RLECs have generally been very successful competitors in these situations.

Deregulation has not had much effect on LECs thus far. The FCC has promulgated a series of rules to implement the Telecom Act, and eliminated very few existing regulatory requirements. States continue to regulate RLECs extensively.

Another aspect of the Telecom Act dealt with advanced telecommunications and information technologies. In the late 1990s there was the concern that there was a growing "digital divide" between rural and urban areas within the country. Legislators sought to provide broadband connectivity to all Americans through programs which provide funding to connect schools and libraries to the internet. RUS has issued rules liberalizing its lending criteria to facilitate provision of advanced telecommunications and information services in rural areas. Congress also created an RUS broadband loan program in 2002. To date, RUS has obligated $1.53 billion in broadband loans. Congress authorized $300 million in fiscal year 2008 lending authority. The appropriation for fiscal year 2009 has been approved at $298 million.

Given the increased availability of government financing for rural broadband, it is unlikely that the Company will be participating in this financing to any significant degree outside of incremental lending to existing RLEC borrowers to provide broadband services to their customers.

The RUS Program

Since the enactment of the Rural Electrification Act in 1936 (the "RE Act"), RUS has financed the construction of electric generating plants, transmission facilities and distribution systems in order to provide electricity to rural areas. Principally through the creation of local electric cooperatives that were originally financed under the RE Act loan program in 47 states and two U.S. territories, the percentage of farms and residences in rural areas of the United States receiving central station electric service increased from 11% in 1934 to almost 100% currently. Rural electric systems serve 12% of all consumers of electricity in the United States and its territories and account for approximately 8% of total sales of electricity and own about 5% of electricity generating capacity.

In 1949, the RE Act was amended to allow lending for the purpose of furnishing and improving rural telecommunications service. For fiscal year 2008, RUS has $690 million in lending authority for rural telephone systems and an additional $523 million for other telecommunications programs, including distance learning and broadband.

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

For the fiscal year ending September 30, 2009, the President's budget requests $100 million for hardship loans and $4 billion for loan guarantees with no requested budget for either municipal rate loans and treasury rate loans. Electric funding levels for fiscal year 2008 were as follows: hardship loans of $100 million, and loan guarantees of $6.5 billion.

Item 1A. Risk Factors.

The Company's financial condition and results of operations are subject to various risks inherent in its business. The material risks and uncertainties that management believes affect National Rural are described below. The risks and uncertainties described below are not the only ones facing National Rural. Additional risks and uncertainties that management is not aware of, or that it currently deems immaterial, may also impair business operations. If any of the events or circumstances described in the following risks actually occur, our business, financial condition or results of operations could suffer. You should consider all of the following risks together with all of the other information in this Annual Report on Form 10-K.

The Company's ability to maintain and grow our business depends on access to external financing.
The Company depends on access to the capital markets to refinance its long-term and short-term debt, fund new loan advances and if necessary, to fulfill its obligations under its guarantee and repurchase agreements. At May 31, 2008, the Company had $3,150 million of commercial paper, daily liquidity fund and bank bid notes and $3,177 million of medium-term notes, collateral trust bonds and long-term notes payable scheduled to mature during the next twelve months. 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. There can be no assurance that the Company will be able to access the markets in the future at all or on terms that are acceptable to the Company. Downgrades to the Company's long-term debt ratings and/or commercial paper ratings or other events that may deny or limit the Company's access to the capital markets could negatively impact its operations. The Company has no control over certain items that are considered by the credit rating agencies as part of their analysis for the Company, such as the overall outlook for the electric and telecommunications industries.

Fluctuating interest rates could adversely affect our income, margin and cash flow.
The Company is exposed to interest rate risk in its core lending and borrowing activities. If the Company does not set interest rates on its loans at a level to cover its cost of funding, there would be an adverse effect on net interest income and net income.

The Company provides its members with many options on its loans with regard to interest rates, the term for which the selected interest rate is in effect and the ability to prepay the loan. As a result, there is a possibility of significant changes in the composition of the loan portfolio. If the Company is not able to adjust its outstanding debt portfolio to match the changes in the loan portfolio, there could be an adverse impact on net interest income and net income.

In addition, the Company's calculated impairment on non-performing and restructured loans will increase as the Company's long-term variable and short-term interest rates increase. Based on the current balance of impaired loans at May 31, 2008, an increase or decrease of 25 basis points to the Company's variable interest rates results in an increase or decrease of approximately $9 million, respectively, to the calculated impairment on loans irrespective of a change in the credit fundamentals of the impaired borrower.

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

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

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

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

Our ability to access the capital markets depends on our ability to maintain adjusted leverage and debt to equity ratios within a reasonable range of market acceptable levels.
Maintenance of adjusted leverage and debt to equity ratios within a reasonable range of market acceptable levels is important in relation to the Company's ability to access the capital markets. A significant increase above market acceptable levels in the adjusted leverage or debt to equity ratios could impair the Company's ability to access the capital markets, its ability to access the Company's revolving lines of credit and its ability to maintain preferred credit ratings. See "Non-GAAP Financial Measures" for further explanation and a reconciliation of adjusted ratios.

A decline in our credit rating could trigger payments under our derivative agreements.
If the Company's credit rating falls to the level specified in certain of its derivative agreements, the other counterparty may terminate the agreement. If the counterparty terminates the agreement, a net payment may be due from one counterparty to the other based on the fair value of the underlying derivative instrument. Based on the fair market value of its interest rate exchange agreements subject to rating triggers at May 31, 2008, the Company may be required to make a payment of up to $1 million if its senior unsecured ratings declined to Baa1 or BBB+, and up to $31 million if its senior unsecured ratings declined below Baa1 or BBB+. In calculating the required payments, the Company only considered agreements which, when netted for each counterparty as allowed by the underlying master agreement, would require a payment upon termination. In the event the Company is required to make a payment as a result of a rating trigger, it could have a material adverse impact on its financial results.

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

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

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

The Company's credit concentration to its ten largest borrowers could increase from the current 18% of total loans and guarantees outstanding, if:

- it were to extend additional loans and/or guarantees to the current ten largest borrowers,
- its total loans and/or guarantees outstanding were to decrease, with a disproportionately large share of the decrease to borrowers not in the current ten largest, or
- it were to advance large new loans and/or guarantees to one of the borrowers below the ten largest.

We could jeopardize our federal tax exemption if we fail to conduct our business in accordance with our exemption from the Internal Revenue Service.
Legislation that removes or imposes new conditions on the federal tax exemption for 501(c)(4) social welfare organizations could have a negative impact on the Company's net income. National Rural's continued exemption depends on it conducting its business in accordance with its 501(c)(4) status.

Item 1B. Unresolved Staff Comments.

None.

Item 2. Properties.

National Rural leases office space that serves as its headquarters in Fairfax County, Virginia. In October 2005, National Rural entered into a three-year lease with the building owner for approximately 107,228 square feet of the facility's office, meeting and storage space. In September 2007, the Company exercised the option to extend the lease for an additional one-year period. The Company has the option to extend the lease for an additional one-year period in fiscal year 2009. The terms of these extensions are similar to the initial three-year lease. National Rural finalized a contract in May 2008 to purchase 42 acres of land located in Loudoun County, Virginia. National Rural will use the purchased land in connection with its plans to construct a new headquarters facility.

Item 3. Legal Proceedings.

None.

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

None.

PART II

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

Inapplicable.

Item 6. Selected Financial Data.

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

(Dollar amounts in thousands)	2008	2007	2006	2005	2004
For the year ended May 31:					
Interest income	$ 1,069,540	$ 1,054,224	$ 1,007,912	$ 1,030,853	$ 1,009,856
Net interest income	132,651	57,494	31,976	88,820	68,365
Derivative cash settlements (1)	27,033	86,442	80,883	78,287	123,363
Derivative forward value (1)	(98,743)	(79,281)	28,805	25,849	(228,840)
Foreign currency adjustments (2)	-	(14,554)	(22,594)	(22,893)	(65,310)
Income (loss) prior to income taxes, minority interest and cumulative effect of change in accounting principle (3)	36,311	16,541	105,762	126,561	(194,292)
Cumulative effect of change in accounting principle (4)	-	-	-	-	22,369
Net income (loss)	$ 45,745	$ 11,701	$ 95,497	$ 122,503	$ (177,729)
Fixed charge coverage ratio (TIER) (5)(6)	1.05	1.01	1.10	1.13	-
Adjusted fixed charge coverage ratio (Adjusted TIER) (7)	1.15	1.12	1.11	1.14	1.12
As of May 31:					
Loans to members (8)	$19,029,040	$18,131,873	$18,363,954	$18,974,108	$20,490,021

Allowance for loan losses	(514,906)	(561,663)	(611,443)	(589,749)	(573,939)
Assets	19,379,381	18,575,181	19,179,621	20,060,314	21,455,443
Short-term debt (9)	6,327,453	4,427,123	5,343,824	7,952,579	5,990,039
Long-term debt (10)	10,173,587	11,295,219	10,642,028	8,701,955	12,009,182
Subordinated deferrable debt (11)	311,440	311,440	486,440	685,000	550,000
Members' subordinated certificates	1,406,779	1,381,447	1,427,960	1,490,750	1,665,158
Members' equity (1)	613,082	566,286	545,351	523,583	483,126
Total equity	665,965	710,041	784,408	764,934	692,453
Guarantees	$ 1,037,140	$ 1,074,374	$ 1,078,980	$ 1,157,752	$ 1,331,299
Leverage ratio (6)	29.64	26.64	24.80	26.71	31.88
Adjusted leverage ratio (7)	7.50	6.81	6.38	6.50	7.07
Debt to equity ratio (6)	28.08	25.13	23.42	25.20	29.95
Adjusted debt to equity ratio (7)	7.06	6.37	5.97	6.07	6.58

(1) Derivative cash settlements represent the net settlements received/paid on interest rate and cross currency exchange agreements that do not qualify for hedge accounting. The derivative forward value represents the change in fair value on exchange agreements that do not qualify for hedge accounting, as well as amortization related to the long-term debt valuation allowance and related to the transition adjustment recorded as an other comprehensive loss on June 1, 2001. Members' equity represents total equity excluding foreign currency adjustments, derivative forward value and accumulated other comprehensive income. See "Non-GAAP Financial Measures" in Management's Discussion and Analysis for further explanation of members' equity and a reconciliation to total equity.
(2) Foreign currency adjustments represent the change on foreign denominated debt that is not related to an exchange agreement that qualifies for hedge accounting during the period. The foreign denominated debt is revalued at each reporting date based on the current exchange rate. To the extent that the current exchange rate is different than the exchange rate at the time of issuance, there will be a change in the value of the foreign denominated debt. National Rural enters into foreign currency exchange agreements at the time of each foreign denominated debt issuance to lock in the exchange rate for all principal and interest payments required through maturity.
(3) Includes $43 million gain on sale of building and land at May 31, 2006.
(4) The cumulative effect of change in accounting principle in 2004 represents the impact of implementing Financial Accounting Standards Board Interpretation No. 46 (R), Consolidation of Variable Interest Entities, an interpretation of Accounting Research Bulletin No. 51, effective June 1, 2003.
(5) The fixed charge coverage ratio is the same calculation as National Rural’s Times Interest Earned Ratio ("TIER"). For the year ended May 31, 2004, National Rural’s earnings were insufficient to cover fixed charges by $200 million.
(6) See "Non-GAAP Financial Measures" in Management's Discussion and Analysis for the GAAP calculations of these ratios.
(7) Adjusted ratios include non-GAAP adjustments that National Rural makes to financial measures in assessing its financial performance. See "Non-GAAP Financial Measures" in Management's Discussion and Analysis for further explanation of these calculations and a reconciliation of the adjustments.
(8) Certain reclassifications of prior year period amounts have been made to conform to the current reporting format. See further explanation in Note 1(w) to the consolidated financial statements.

(9) Includes the foreign currency valuation account of $245 million and $40 million at May 31, 2006 and 2005, respectively.
(10) Excludes $3,177 million, $1,368 million, $1,839 million, $3,591 million, and $2,365 million in long-term debt that comes due, matures and/or will be redeemed during fiscal years 2009, 2008, 2007, 2006 and 2005, respectively (see Note 5 to the consolidated financial statements). Includes the foreign currency valuation account of $221 million and $234 million at May 31, 2005 and 2004, respectively.
(11) Excludes $175 million called in June 2007 and $150 million called in June 2006 at May 31, 2007 and 2006, respectively, reported in short-term debt.

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations.

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

Business Overview

National Rural was formed in 1969 by rural electric cooperatives to provide a source of financing to supplement the loan programs of the Rural Utilities Service ("RUS"). National Rural is organized as a cooperative in which each member (other than associates) is entitled to one vote. Under National Rural's bylaws, the board of directors is composed of 23 individuals, 20 of whom must be either general managers or directors of member systems, two of whom are designated by the National Rural Electric Cooperative Association and one at-large position who must satisfy the requirements of an audit committee financial expert as defined by Section 407 of the Sarbanes-Oxley Act of 2002 and must be a trustee, director, manager, Chief Executive Officer or Chief Financial Officer of a member. In November 2006, the National Rural Board elected an at-large director that qualifies as a financial expert who serves on the audit committee. The director took his seat on the board following the National Rural annual meeting in March 2007. National Rural is a tax-exempt entity under Section 501(c)(4) of the Internal Revenue Code.

RTFC is a not-for-profit private cooperative association created for the purpose of providing and/or arranging financing for its rural telecommunications members and their affiliates. NCSC also is a private non-profit cooperative association. The principal purpose of NCSC is to provide financing to the for-profit or non-profit entities that are owned, operated or controlled by or provide substantial benefit to, members of National Rural.

The Company's primary objective as a cooperative is to provide its members with low loan and guarantee rates while maintaining sound financial results required to attain high credit ratings on its debt instruments. As a not-for-profit, membership owned financial institution, the Company's goal is not to maximize its profit on loans to members, but rather to find a balance between charging its members low rates on loans and maintaining the financial performance required to access the capital markets on behalf of its members. Thus, the Company marks up its funding costs only to the extent necessary to cover its operating expenses and a provision for loan losses and to provide earnings sufficient to preserve interest coverage in light of the Company's financing objectives.

At May 31, 2008, the Company's consolidated membership was 1,538 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.

National Rural obtains its funding from the capital markets, private placement of debt and its membership. National Rural enters the capital markets, based on the combined strength of its members, to borrow the funds required to fulfill the financing requirements of its members. On a regular basis, National Rural obtains debt financing in the capital markets by issuing fixed rate or variable rate secured collateral trust bonds, fixed rate subordinated deferrable debt, fixed rate or variable rate unsecured medium-term notes, commercial paper and enters into bank bid note agreements. In addition, National Rural obtains debt financing from private funding sources through the issuance of

fixed rate and variable rate notes. National Rural also obtains debt financing from its membership and other qualified investors through the direct sale of its commercial paper, daily liquidity fund and unsecured medium-term notes.

Rural electric cooperatives that join National Rural are generally required to purchase membership subordinated certificates from National Rural as a condition of membership. In connection with any long-term loan or guarantee made by National Rural on behalf of one of its members, National Rural may require that the member make an additional investment in National Rural by purchasing loan or guarantee subordinated certificates. The membership subordinated certificates and the loan and guarantee subordinated certificates are unsecured and subordinate to other senior debt of National Rural.

National Rural is required by law to have a mechanism to allocate its net income to its members. National Rural allocates its net income excluding the non-cash effects of Statement of Financial Accounting Standards ("SFAS") 133, Accounting for Derivative Instruments and Hedging Activities, as amended and SFAS 52, Foreign Currency Translation annually to a cooperative educational fund, a members' capital reserve and to members based on each member's patronage of the loan programs during the year. RTFC annually allocates its net income to a cooperative educational fund and to its members based on each member's patronage of the loan programs during the year. NCSC does not allocate its net income to its members, but does allocate a portion of its margins to a cooperative educational fund.

The Company's performance is closely tied to the performance of its member rural electric and telecommunications systems due to the near 100% concentration of its loan and guarantee portfolio in those industries.

Financial Overview

Results of Operations

The Company uses a times interest earned ratio (“TIER”) instead of the dollar amount of net interest income or net income as its primary performance indicator, since its net income in dollar terms is subject to fluctuation as total loans outstanding and/or interest rates change. TIER is a measure of the Company's ability to cover the interest expense on its debt obligations. TIER is calculated by dividing the sum of interest expense and the net income prior to the cumulative effect of change in accounting principle by the interest expense.

For the year ended May 31, 2008, the Company reported net income of $46 million and TIER of 1.05, compared to a net income of $12 million and TIER of 1.01 for the prior year. For the year ended May 31, 2008, the Company reported an adjusted net income of $138 million and adjusted TIER of 1.15, compared to an adjusted net income of $108 million and adjusted TIER of 1.12 for the prior year. The $34 million and $30 million increase in the net income and adjusted net income, respectively, for the year ended May 31, 2008 was primarily due to the $23 million increase in the recovery of loan losses resulting from the decrease in calculated impairments due to lower variable rates and payments received on impaired loans. Adjusted net income is calculated by excluding the impact of derivatives and foreign currency adjustments and including minority interest. Adjusted TIER is calculated by using adjusted net income and including all derivative cash settlements in the interest expense. See "Non-GAAP Financial Measures" for more information on the adjustments the Company makes to its financial results for the purposes of its own analysis and covenant compliance.

During the year ended May 31, 2008, the Company's earnings were impacted by the level of loans on non-accrual status. Holding loans on non-accrual status resulted in a reduction of $67 million to reported interest income for the year ended May 31, 2008. During fiscal year 2009, the Company expects the outstanding balance of loans on non-accrual status to decrease due to principal repayments and the proceeds from asset sales. In addition, it is expected that Denton County Electric Cooperative, Inc. d/b/a CoServ Electric (“CoServ”) will make scheduled quarterly payments totaling $28 million in fiscal year 2009, which will all be applied as a reduction to principal.

The reduction to the amount of loans on non-accrual status should contribute to an increase to the adjusted net interest income yield during fiscal year 2009. Changes to the Company's variable interest rates will be based on the underlying cost of funding, competition and other factors. The calculated impairment on the Company's loans increases or decreases with the increases and decreases to the Company's variable interest rates. Based on the current balance of impaired loans at May 31, 2008, an increase or decrease of 25 basis points to the Company's variable interest rates results in an increase or decrease of approximately $9 million, respectively, to the calculated impairment on loans irrespective of a change in the credit fundamentals of the impaired borrower.

Financial Condition

At May 31, 2008, the Company's total loans outstanding increased by $899 million or 5% as compared to May 31, 2007. At May 31, 2008, National Rural loans outstanding increased by $1,081 million, RTFC loans outstanding decreased by $134 million and NCSC loans outstanding decreased by $48 million compared to May 31, 2007. National Rural loans outstanding increased due to net advances of $1,155 million offset by the sale of $74 million of National Rural distribution loans at par in loan securitization transactions during the year ended May 31, 2008. National Rural expects to continue such loan sales on a periodic basis. See further discussion of the Company's loan portfolio in "Loan and Guarantee Portfolio Assessment".

The Company expects that the balance of the loan portfolio will remain relatively stable during fiscal year 2009. Loans from the Federal Financing Bank ("FFB"), a division of the U.S. Treasury Department, with an RUS guarantee, represent a lower cost option for rural electric utilities compared to loans from the Company. The Company anticipates that the majority of its electric loan growth will come from distribution system borrowers that have fully prepaid their RUS loans and choose not to return to the government loan program, from distribution system borrowers that do not want to wait the 12 to 24 months it may take RUS to process and fund the loan and from power supply systems. The Company anticipates that the RTFC loan balance will continue to slowly decline due to long-term loan amortization, the strong liquidity position of rural

telecommunications companies, a general slowdown in merger and acquisition activities and low demand for capital expenditure financing.

On December 26, 2007, the President of the United States signed the Appropriations Act for Fiscal Year 2008 which set the fiscal year 2008 RUS electric and telephone loan program levels. Electric funding levels for fiscal year 2008 are $6.5 billion for FFB loans and $100 million for five percent loans. Telephone funding levels for fiscal year 2008 are $145 million for five percent loans, $250 million for FFB loans, $295 million for treasury rate loans and $300 million for broadband loans.

During the year ended May 31, 2008, short-term debt increased by $1,900 million and long-term debt decreased by $1,122 million primarily due to an increase of $1,810 million to the amount of long-term debt that will mature in the next twelve months. Holders of $2,140 million of the Company's extendible debt elected not to extend the maturity of such debt during the year ended May 31, 2008. As a result, $1,845 million of extendible debt was reclassified from long-term debt to short-term debt based on maturity dates ranging from August 2008 through February 2009. The remaining $295 million of extendible debt will mature in fiscal year 2010. Additionally, $500 million of secured notes payable was reclassified to short-term debt based on the July 2008 maturity of the debt.

Total equity decreased $44 million from May 31, 2007 to May 31, 2008 primarily due to the board authorized patronage capital retirement totaling $86 million offset by net income of $46 million for the year ended May 31, 2008. Under GAAP, the Company's reported equity balance fluctuates based on the impact of future expected changes to interest rates on the fair value of its interest rate exchange agreements. As a result, it is difficult to predict the future changes in the Company's reported GAAP equity due to the uncertainty of the movement in future interest rates. In its internal analysis and for purposes of covenant compliance under its credit agreements, the Company adjusts equity to exclude the non-cash impacts of SFAS 133 and 52.

Liquidity
At May 31, 2008, the Company had $3,150 million of commercial paper, daily liquidity fund and bank bid notes and $3,177 million of medium-term notes, collateral trust bonds and long-term notes payable scheduled to mature during the next twelve months. Members held commercial paper (including the daily liquidity fund) totaling $1,404 million or approximately 46% of the total commercial paper outstanding at May 31, 2008. Commercial paper issued through dealers and bank bid notes totaled $1,612 million and represented 9% of total debt outstanding at May 31, 2008. The Company intends to maintain the balance of dealer commercial paper and bank bid notes at 15% or less of total debt outstanding during fiscal year 2009. During the next twelve months, the Company plans to refinance the $3,177 million of medium-term notes, collateral trust bonds and long-term notes payable and fund new loan growth by issuing a combination of commercial paper, medium-term notes, collateral trust bonds and other debt.

National Rural uses member loan repayments, capital market debt issuance, private debt issuance, member investments, and net income to fund its operations. In addition, the Company maintains both short-term and long-term bank lines in the form of revolving credit agreements with its bank group. Members pay a small membership fee and are typically required to purchase subordinated certificates as a condition to receiving a long-term loan advance and as a condition of membership. National Rural has a need for funding to make loan advances to its members, to make interest payments on its public and private debt and to make payments of principal on its maturing debt. To facilitate open access to the capital markets, National Rural is a regular issuer of debt, maintains strong credit ratings and has shelf registration statements on file with the Securities and Exchange Commission ("SEC"). The Company qualifies as a well-known seasoned issuer under the SEC rules. Additionally, the Company has Board authorization to issue up to $1 billion of commercial paper and $4 billion of medium-term notes in the European market and $2 billion of medium-term notes in the Australian market.

At May 31, 2008, the Company was the guarantor and liquidity provider for $330 million of tax-exempt bonds issued for its member cooperatives. A total of $133 million of such tax-exempt bonds were in flexible and weekly mode, which reprice every seven to thirty-five days. A total of $120 million of such tax-exempt bonds reprice semi-annually. A total of $77 million of such bonds were in unit price mode and reprice approximately every 30 days. National Rural has not been required to purchase any of the bonds in its role as liquidity provider. In addition to these tax-exempt bonds, National Rural was the guarantor, but not liquidity provider, for $155 million of tax-exempt bonds that were in the auction rate mode. National Rural has not been required to perform under the guarantee of its members' tax-exempt bonds.

Critical Accounting Estimates

Allowance for Loan Losses

At May 31, 2008 and 2007, the Company had a loan loss allowance that totaled $515 million and $562 million, representing 2.71% and 3.10% of total loans outstanding, respectively. GAAP requires loans receivable to be reported on the consolidated balance sheets at net realizable value. The net realizable value is the total principal amount of loans outstanding less an estimate of the probable losses inherent in the portfolio. The Company calculates its loss allowance on a quarterly basis. The

loan loss allowance is calculated by segmenting the portfolio into three categories of loans: impaired, high risk and general portfolio. There are significant subjective assumptions and estimates used in calculating the amount of the loss allowance required by each of the three categories. Different assumptions and estimates could also be reasonable. Changes in these assumptions and estimates could have a material impact on the Company's financial statements.

Impaired Exposure

The Company calculates impairment on certain loans in accordance with SFAS 114, Accounting by Creditors for Impairment of a Loan - an Amendment of SFAS 5 and SFAS 15, as amended. SFAS 114 states that a loan is impaired when a creditor does not expect to collect all principal and interest due under the original terms of the loan other than an insignificant delay or an insignificant shortfall in amount. The Company reviews its portfolio to identify impairments at least on a quarterly basis. Factors considered in determining an impairment include, but are not limited to: the review of the borrower's audited financial statements and interim financial statements if available, the borrower's payment history, communication with the borrower, economic conditions in the borrower's service territory, pending legal action involving the borrower, restructure agreements between the borrower and the Company, and estimates of the value of the borrower's assets that have been pledged as collateral to secure the Company's loans. The Company calculates the impairment by comparing the future estimated cash flow, discounted at the interest rate on the loans at the time the loans became impaired, against its current investment in the receivable. If the current investment in the receivable is greater than the net present value of the future payments discounted at the original contractual interest rate, the impairment is equal to that difference. If it is not possible to estimate the future cash flow associated with a loan, then the impairment calculation is based on the value of the collateral pledged as security for the loan. At May 31, 2008 and 2007, the Company had a total of $331 million and $397 million reserved specifically against impaired exposure totaling $1,078 million and $1,099 million, respectively, representing 31% and 36%, respectively, of the total impaired loan exposure. The $331 million and $397 million specific reserves represented 64% and 71% of the total loan loss allowance at May 31, 2008 and 2007, respectively. The calculated impairment at May 31, 2008 was lower than at May 31, 2007 due to lower variable rates and payments received on impaired loans. See further discussion under “Financial Condition”. The original contract rate on a portion of the impaired loans at May 31, 2008 will vary with the changes in the Company's variable interest rates. Based on the current balance of impaired loans at May 31, 2008, a 25 basis point increase or decrease to the Company's variable interest rates would result in an increase or decrease, respectively, of approximately $9 million to the calculated impairment irrespective of a change in the credit fundamentals of the impaired borrower.

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

High Risk Exposure

Loan exposures considered to be high risk represent exposure in which the borrower has had a history of late payments, the borrower's financial results do not satisfy loan financial covenants, the borrower has contacted the Company to discuss pending financial difficulties or, for some other reason, the Company believes that the borrower's financial results could deteriorate resulting in an elevated potential for loss. The Company's corporate credit committee is responsible for determining which loans should be classified as high risk and the level of reserve required for each borrower. The committee meets at least quarterly to review all loan facilities with an internal risk rating above a certain level. Once it is determined that exposure to a borrower should be classified as high risk, the committee sets the required reserve level based on the facts and circumstances for each borrower, such as the

borrower's financial condition, payment history, the Company's estimate of the collateral value, pending litigation, if any, and other factors. This is an objective and subjective exercise in which the committee uses the available information to make its best estimate as to the level of loss allowance required. At any reporting date, the reserve required could vary significantly depending on the facts and circumstances, which could include, but are not limited to: changes in collateral value, deterioration in financial condition, the borrower declaring bankruptcy, payment default on the Company's loans and other factors. The borrowers in the high risk category will generally either move to the impaired category or back to the general portfolio within a period of 12 to 24 months. At May 31, 2008 and 2007, the Company had reserved $3 million and $3 million against the $8 million and $6 million of exposure classified as high risk, representing coverage of 38% and 50%, respectively. The $3 million reserved for loans in the high risk category represented less than 1% of the total loan loss allowance at May 31, 2008 and 2007.

General Portfolio

The Company's methodology used to determine the required loan loss allowance for the general portfolio includes the use of an internal risk rating system, historical Standard & Poor’s default data on corporate bonds and Company specific loss

recovery data. The Company uses the following factors, in no particular order, to determine the level of the loan loss allowance for the general portfolio category:

- Internal risk ratings - The Company maintains risk ratings for each credit facility outstanding to its borrowers. The ratings are updated at least annually and are based on the following:
  - General financial condition of the borrower.
  - The Company's internal estimated value of the collateral securing its loans.
  - The Company's internal evaluation of the borrower's management.
  - The Company's internal evaluation of the borrower's competitive position within its service territory.
  - The Company's estimate of potential impact of proposed regulation and litigation.
  - Other factors specific to individual borrowers or classes of borrowers.
- Standard corporate default table - The table provides expected default rates based on rating level and the remaining maturity of the bond. The Company uses the standard default table for all corporate bonds published by Standard and Poor's Corporation to assist in estimating its reserve levels.
- Recovery rates - Estimated recovery rates based on historical experience of loan balance at the time of default compared to the total loss on the loan to date.

The Company aggregates the loans in the general portfolio by borrower type (distribution, power supply, telecommunications, associate and other member) and by internal risk rating within borrower type. The Company correlates its internal risk ratings to the ratings used in the standard default table based on a comparison of its rating on borrowers that have a rating from one or more of the recognized credit rating agencies and based on a standard matching used by banks.

At May 31, 2008 and 2007, the Company had a total of $17,690 million and $16,768 million of loans, respectively, in the general portfolio. This total does not include $250 million and $256 million of loans at May 31, 2008 and 2007, respectively, that have a U.S. Government guarantee of all principal and interest payments. The Company does not maintain a loan loss allowance on loans that are guaranteed by the U.S. Government. At May 31, 2008 and 2007, the Company reserved a total of $155 million and $159 million, respectively, for loans in the general portfolio representing coverage of approximately 1% of the total loans for the general portfolio at both dates.

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

The first component of the unallocated reserve is a single obligor reserve to cover the additional risk associated with the inherent risk related to large loan exposures. The Company had previously set the exposure threshold at 1.5% of total loans and guarantees outstanding and provided coverage equal to 0.5% times the internal risk rating associated with the loan exposure. During the third quarter of fiscal year 2008, the Company revised both the exposure threshold and the coverage percentage to better reflect the level of risk associated with the large loan exposures. The exposure threshold was reduced from 1.5% to 1.0% to better match the top ten credit exposures. The reserve coverage was increased to 1.0% of the internal risk rating times the exposure over the threshold, to better reflect the Company’s assessment of the additional risk related to large loan exposures. At May 31, 2008 and 2007, the Company had a single obligor reserve of $23 million and $3 million, respectively.

The second component of the unallocated reserve is an economic and environmental reserve to cover factors that the Company believes are currently impacting the financial results of borrowers, but are not reflected in the Company’s internal risk rating process and therefore present an increased risk of losses incurred as of the balance sheet date. The Company uses annual audited financial statements from its borrowers as part of its internal risk rating process. There

could be a lag between the time that various environmental and economic factors occur and the time when these factors are reflected in the annual audited financial statements of the borrower and therefore the internal risk rating determined by the Company for the borrower. This reserve component may be set at up to 5% of the amount of the calculated general reserve. The Company's corporate credit committee will make a quarterly determination of the percentage of general reserve to be held and the portions of the loan portfolio that the additional reserve percentage shall be applied. At May 31, 2008, the corporate credit committee set the economic and environmental component of the unallocated reserve to be $3 million or 2% of the amount of the total general reserve. This amount was set taking into consideration the impact on electric and telecommunications borrowers from (1) the current economic downturn, (2) the flooding in parts of the Midwest, (3) the decline in the housing market that has led to a significant increase in foreclosures, (4) the impact of rising food and gas prices on consumer spending and (5) the impact of rising fuel prices on electric utilities and the ability to pass on such costs. There was no economic and environmental unallocated reserve at May 31, 2007 as the Company added this component to the unallocated reserve during the third quarter of fiscal year 2008.

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

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

Derivative Financial Instruments

The Company accounts for derivatives in accordance with SFAS 133. SFAS 133, as amended, establishes accounting and reporting standards requiring that derivative instruments (including certain derivative instruments embedded in other contracts) be recorded in the consolidated balance sheets as either an asset or liability measured at fair value. The statement requires that changes in the derivative instrument's fair value be recognized currently in earnings unless specific hedge accounting criteria are met. Special accounting for qualifying hedges allows a derivative instrument's gains and losses to offset related results on the hedged item in the consolidated statements of operations or to be recorded as other comprehensive income, to the extent effective, and requires that a company formally document, designate, and assess the effectiveness of transactions that receive hedge accounting. The Company is neither a dealer nor trader in derivative financial instruments. The Company uses interest rate, cross currency and cross currency interest rate exchange agreements to manage its interest rate and foreign currency risk.

Generally, the Company's derivatives do not qualify for hedge accounting. To qualify for hedge accounting, there must be a high correlation between the pay leg of the interest rate exchange agreement and the asset being hedged or between the receive leg of the interest rate exchange agreement and the liability being hedged. A large portion of the Company's interest rate exchange agreements use a 30-day composite commercial paper index as the receive leg, which would have to be highly correlated to the Company's own commercial paper rates to qualify for hedge accounting. The Company sells commercial paper to its members as well as to investors in the capital markets. The Company sets its commercial paper rates daily based on its cash requirements. The correlation between the Company's commercial paper rates and the 30-day composite commercial paper index has not been consistently high enough to qualify for hedge accounting. At May 31, 2008 and 2007, the Company did not have any interest rate exchange agreements that were accounted for using hedge accounting.

The Company does not plan to adjust its practice of using the 30-day composite commercial paper or a LIBOR index as the receive portion of its interest rate exchange agreements. The Company sets the variable interest rates on its loans based on the cost of its short-term debt, which is comprised of long-term debt due within one year and commercial paper. The Company believes that it is economically hedging its net interest income on loans by using the 30-day composite commercial paper or LIBOR index, which are the rates that are most closely related to the rates it pays on its own commercial paper. During certain periods, the correlation between the LIBOR rates or the 30-day composite commercial paper rate and the Company's 90-day and 30-day commercial paper rate has been higher than the required 90% to qualify for hedge accounting. However, the correlation is not consistently above the 90% threshold, therefore the interest rate exchange agreements that use the three-month LIBOR rate or 30-day composite commercial paper rate do not qualify for hedge accounting. For the purposes of its own analysis, the Company believes that the correlation is sufficiently high to consider these agreements effective economic hedges.

As a result of applying SFAS 133, the Company has recorded derivative assets of $221 million and $223 million and derivative liabilities of $171 million and $72 million at May 31, 2008 and 2007, respectively. From inception to date, accumulated other comprehensive income related to derivatives was $9 million and $12 million as of May 31, 2008 and 2007, respectively.

The impact of derivatives on the Company's consolidated statements of operations for the years ended May 31, 2008, 2007 and 2006 was a loss of $72 million, a gain of $7 million and a gain of $107 million, respectively. The change in the fair value of derivatives for the years ended May 31, 2008, 2007 and 2006 was a loss of $99 million, a loss of $79 million and a gain of $29 million, respectively, recorded in the Company's derivative forward value. For the years ended May 31, 2008, 2007 and 2006, the derivative forward value includes amortization income of $3 million and $0.8 million and amortization expense of $0.4 million, respectively, related to the transition adjustment recorded as an other comprehensive loss on June 1, 2001, the date the Company implemented SFAS 133. In addition, income totaling $27 million, $86 million and $79 million was recorded for total net cash settlements received by the Company during the years ended May 31, 2008, 2007 and 2006, respectively, of which $27 million, $86 million and $81 million, respectively, relate to interest rate and cross currency interest rate exchange agreements that do not qualify for hedge accounting under SFAS 133 and were recorded in derivative cash settlements. The remaining expense of $2 million for the year ended May 31, 2006 relate to interest rate and cross currency interest rate exchange agreements that qualify for hedge accounting under SFAS 133 and were recorded in interest expense.

The Company is required to determine the fair value of its derivative instruments. Because there is not an active secondary market for the types of derivative instruments it uses, the Company obtains market quotes from its dealer counterparties. The market quotes are based on the expected future cash flow and estimated yield curves. The Company performs its own analysis to confirm the values obtained from the counterparties. The Company records the change in the fair value of its derivatives for each reporting period in the derivative forward value line on the consolidated statements of operations for the majority of its derivatives or in the other comprehensive income account on the consolidated balance sheets for the derivatives that qualify for hedge accounting. The counterparties are estimating future interest rates as part of the quotes they provide to the Company. The Company adjusts all derivatives to fair value on a quarterly basis. The fair value recorded by the Company will change as estimates of future interest rates change. To estimate the impact of changes to interest rates on the forward value of derivatives, the Company would need to estimate all changes to interest rates through the maturity of its outstanding derivatives. The Company has derivatives in the current portfolio that do not mature until 2045. In addition, the Company excludes the changes to the fair value of derivatives from its internal analysis since they represent the net present value of all future estimated cash settlements. Thus, the Company does not estimate the impact of changes in future interest rates to the fair value of its derivatives. The Company does not believe that volatility in the derivative forward value line on the consolidated statements of operations is meaningful in assessing its current financial condition as it represents an estimated future value and not a cash impact for the current period.

Cash settlements that the Company pays and receives for derivative instruments that do not qualify for hedge accounting are recorded in the cash settlements line in the consolidated statements of operations. Each 25 basis point increase or decrease to the 30-day composite commercial paper index and the three-month LIBOR rate would result in a $6 million increase or decrease in the Company's net cash settlements due to the composition of the portfolio at May 31, 2008. The Company's interest rate exchange agreements at May 31, 2008 include $7,660 million notional amount, or 59% of the total interest rate exchange agreements, in which the Company pays a fixed interest rate and receives a variable interest rate. For the remaining $5,256 million notional amount, or 41% of the total interest rate exchange agreements at May 31, 2008, the Company pays a variable interest rate and receives a fixed interest rate. Based on the interest rate exchange agreements in place at May 31, 2008, an increase to variable interest rates results in an increase to cash settlements due to National Rural.

New Accounting Pronouncements

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

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

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

In September 2006, the FASB issued SFAS 157, Fair Value Measurements. SFAS 157 defines fair value, sets out a framework for measuring fair value and expands on required disclosures about fair value measurement. SFAS 157 is effective as of the beginning of the first fiscal year that begins after November 15, 2007. The Company's adoption of SFAS 157 as of June 1, 2008 is not expected to have a material impact on the Company's financial position or results of operations.

In February 2007, the FASB issued SFAS 159, The Fair Value Option for Financial Assets and Financial Liabilities. The fair value option established by SFAS 159 permits entities to choose to measure eligible financial instruments at fair value. The unrealized gains and losses on items for which the fair value option has been elected should be reported in earnings. The decision to elect the fair value option is determined on an instrument by instrument basis and is irrevocable. Assets and

liabilities measured at fair value pursuant to the fair value option should be reported separately in the balance sheet from those instruments measured using other measurement attributes. SFAS 159 is effective as of the beginning of the first fiscal year that begins after November 15, 2007. As part of the Company's adoption of SFAS 159 as of June 1, 2008, it has not elected the option to measure eligible financial instruments at fair value and therefore the adoption of SFAS 159 is not expected to have a material impact on the Company's financial position or results of operations.

In December 2007, the FASB issued SFAS 160, Noncontrolling Interests in Consolidated Financial Statements, an amendment of Accounting Research Bulletin (“ARB”) 51, Consolidated Financial Statements, to establish accounting and reporting standards for the noncontrolling interests in a subsidiary and for the deconsolidation of a subsidiary. It also amends certain of ARB 51’s consolidation procedures for consistency with the requirements of SFAS 141, Business Combinations. Noncontrolling interests shall be reclassified to equity, consolidated net income shall be adjusted to include net income attributable to noncontrolling interests and consolidated comprehensive income shall be adjusted to include comprehensive income attributable to the noncontrolling interests. This statement is effective for fiscal years beginning on or after December 15, 2008. The Company’s adoption of SFAS 160 on June 1, 2009 is not expected to have a material impact on the Company’s financial position or results of operations.

In March 2008, the FASB issued SFAS 161, Disclosures about Derivative Instruments and Hedging Activities. This statement requires enhanced disclosures about an entity’s derivative and hedging activities. The statement is effective for fiscal years beginning after November 15, 2008. The Company’s adoption of SFAS 161 on June 1, 2009 is not expected to have a material impact on the Company’s financial position or results of operations.

Results of Operations

Fiscal Year 2008 versus 2007 Results

The following chart presents the results of operations for the year ended May 31, 2008 versus May 31, 2007.

	For the year ended May 31,		Increase/
(Dollar amounts in thousands)	2008	2007	(Decrease)
Interest income	$1,069,540	$1,054,224	$ 15,316
Interest expense	(936,889)	(996,730)	59,841
Net interest income	132,651	57,494	75,157
Recovery of loan losses	30,262	6,922	23,340
Net interest income after recovery of loan losses	162,913	64,416	98,497
Non-interest income:			
Rental and other income	1,461	1,533	(72)
Derivative cash settlements	27,033	86,442	(59,409)
Results of operations of foreclosed assets	7,528	9,758	(2,230)
Total non-interest income	36,022	97,733	(61,711)
Non-interest expense:			
Salaries and employee benefits	(36,428)	(33,817)	(2,611)
Other general and administrative expenses	(24,041)	(18,072)	(5,969)
Recovery of guarantee liability	3,104	1,700	1,404
Market adjustment on foreclosed assets	(5,840)	-	(5,840)
Derivative forward value	(98,743)	(79,281)	(19,462)
Foreign currency adjustments	-	(14,554)	14,554
Loss on sale of loans	(676)	(1,584)	908
Total non-interest expense	(162,624)	(145,608)	(17,016)

Income prior to income taxes and minority interest	36,311	16,541	19,770
Income tax benefit (expense)	3,335	(2,396)	5,731
Minority interest, net of income taxes	6,099	(2,444)	8,543
Net income	$ 45,745	$ 11,701	$ 34,044
TIER	1.05	1.01	
Adjusted TIER (1)	1.15	1.12	

5(1) Adjusted to exclude the impact of the derivative forward value and foreign currency adjustments from net income, to include minority interest in net income and to include all derivative cash settlements in the interest expense. See "Non-GAAP Financial Measures" for further explanation and a reconciliation of these adjustments.

24

The Company's net interest income will increase or decrease due to changes in loan volume and the interest rates that it receives on its loans and pays on its sources of funding. The Company's loan volume substantially determines its funding needs. The following Volume Rate Variance Table provides a breakout of the change to interest income, interest expense and net interest income due to changes in loan volume versus changes to interest rates. For comparability purposes, average daily loan volume is used as the denominator in calculating interest income yield, interest expense rates and net interest income yield.

The following table also includes a breakout of the change to derivative cash settlements due to changes in the average notional amount of its 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 the Company makes in its financial analysis to include all derivative cash settlements in its interest expense.

Volume Rate Variance Table
(Dollar amounts in millions)

	For the year ended May 31,								
	2008			2007			Change due to		
	Average Loan Balance	Income/(Cost)	Average Interest Rate	Average Loan Balance	Income/ (Cost)	Average Interest Rate	Volume (1)	Rate (2)	Total
Interest income									
National Rural	$ 16,167	$ 947	5.85%	$ 15,803	$ 917	5.80%	$ 21	$ 9	$ 30
RTFC	1,791	89	4.97%	1,994	106	5.30%	(11)	(6)	(17)
NCSC	442	34	7.68%	396	31	8.00%	4	(1)	3
Total	$ 18,400	$ 1,070	5.81%	$ 18,193	$ 1,054	5.79%	$ 14	$ 2	$ 16
Interest expense									
National Rural	$ 16,167	$ (826)	(5.11)%	$ 15,803	$ (870)	(5.51)%	$ (20)	$ 64	$ 44
RTFC	1,791	(84)	(4.68)%	1,994	(100)	(4.98)%	10	6	16
NCSC	442	(27)	(6.19)%	396	(27)	(6.90)%	(3)	3	-
Total	$ 18,400	$ (937)	(5.09)%	$ 18,193	$ (997)	(5.48)%	$ (13)	$ 73	$ 60
Net interest income									
National Rural	$ 16,167	$ 121	0.74%	$ 15,803	$ 47	0.29%	$ 1	$ 73	$ 74
RTFC	1,791	5	0.29%	1,994	6	0.32%	(1)	-	(1)
NCSC	442	7	1.49%	396	4	1.10%	1	2	3
Total	$ 18,400	$ 133	0.72%	$ 18,193	$ 57	0.31%	$ 1	$ 75	$ 76
Derivative cash settlements (3)									
National Rural	$ 12,852	$ 28	0.22%	$ 12,508	$ 86	0.69%	$ 2	$(60)	$(58)
NCSC	204	(1)	(0.68)%	124	1	0.33%	-	(2)	(2)
Total	$ 13,056	$ 27	0.21%	$ 12,632	$ 87	0.68%	$ 2	$(62)	$(60)

Adjusted interest expense (4)									
Total	$18,400	$ (910)	(4.94)%	$18,193	$ (910)	(5.00)%	$(11)	$ 11	$ -

(1) Variance due to volume is calculated using the following formula: (current period average balance – prior year period average balance) x prior year period average rate.
(2) Variance due to rate is calculated using the following formula: (current period average rate – prior year period average rate) x current period average balance.
(3) For derivative cash settlements, average loan balance represents the average notional amount of derivative contracts outstanding and the rate represents the net difference between the average rate paid and the average rate received for cash settlements during the period.
(4) See "Non-GAAP Financial Measures" for further explanation of the adjustment the Company makes in its financial analysis to include the derivative cash settlements in its interest expense.

Interest Income

Total interest income reported on the consolidated statements of operations and shown in the chart above is summarized as follows by income type and as a percentage of average loans outstanding:

	For the year ended May 31,				
	2008		2007		
(Dollar amounts in thousands)	Amount	Rate	Amount	Rate	Increase/ (Decrease)
Interest on long-term fixed rate loans (1)	$ 872,488		$ 833,247		$ 39,241
Interest on long-term variable rate loans (1)	86,787		114,786		(27,999)
Interest on short-term loans (1)	77,145		72,632		4,513
Total interest income on loans	1,036,420	5.63 %	1,020,665	5.61%	15,755
Interest on investments (2)	7,394	0.04 %	9,662	0.05%	(2,268)
Conversion fees (3)	6,670	0.04 %	9,162	0.05%	(2,492)
Make-whole and prepayment fees (4)	10,759	0.06 %	4,748	0.03%	6,011
Commitment and guarantee fees (5)	5,109	0.03 %	9,161	0.05%	(4,052)
Other fees	3,188	0.01 %	826	-	2,362
Total interest income	$1,069,540	5.81 %	$1,054,224	5.79%	$ 15,316

(1) Represents interest income on loans to members.

(2) Represents interest income on the investment of excess cash.

(3) Conversion fees are deferred and recognized using the interest method over the remaining original loan interest rate pricing term, except for a small portion of the total fee charged to cover administrative costs related to the conversion, which is recognized immediately.

(4) Make-whole and prepayment fees are charged for the early repayment of principal and are recognized when collected.

(5) Commitment fees for RTFC loan commitments are, in most cases, refundable on a prorata basis according to the amount of the loan commitment that is advanced. Such refundable fees are deferred and then recognized on a prorata basis based on the portion of the loan that is not advanced prior to the expiration of the commitment. Commitment fees on National Rural loan commitments are not refundable and are billed and recognized based on the unused portion of committed lines of credit. Guarantee fees are charged based on the amount, type and term of the guarantee. Guarantee fees are deferred and amortized using the straight-line method into interest income over the life of the guarantee.

The $15 million or 1% increase to the total interest income for the year ended May 31, 2008 as compared to the prior year period was due to the increase in National Rural and NCSC loan volume and long-term fixed rate loans that repriced at higher interest rates partly offset by the decrease in RTFC loan volume and lower variable interest rates. Interest rates for approximately $703 million of National Rural long-term fixed rate loans were repriced in January 2008 with 85% selecting a new fixed rate. The weighted average interest rate of long-term loans subject to repricing in January 2008 was approximately 5.37%, which is lower than the National Rural fixed interest rates available to members at that time of between 5.65% and 7.25% (depending on the term selected). The increase in interest income was offset by the impact of the Company decreasing variable interest rates by approximately 215 to 250 basis points, depending on the loan program, since May 31, 2007.

For the year ended May 31, 2008, the Company had a reduction to interest income of $67 million due to non-accrual loans compared to a reduction of $81 million for the prior year period. The impact on National Rural interest income of non-accrual loans was a reduction of $34 million for the year ended May 31, 2008 as compared to $39 million for

the prior year period. The impact on RTFC interest income of non-accrual loans was a reduction of $33 million for the year ended May 31, 2008 as compared to $42 million for the prior year period. The impact of non-accrual loans on interest income is included in the rate variance in the chart above.

Interest Expense

Total interest expense reported on the consolidated statements of operations and shown in the Volume Rate Variance Table above is summarized as follows by expense type and as a percentage of average loans outstanding:

	For the year ended May 31, 2008		2007		
(Dollar amounts in thousands)	Amount	Rate	Amount	Rate	Increase/ (Decrease)
Interest expense - commercial paper and bid notes (1)	$ 122,786		$ 178,687		$ (55,901)
Interest expense - medium-term notes (1)	330,193		363,760		(33,567)
Interest expense - collateral trust bonds (1)	243,579		218,523		25,056
Interest expense - subordinated deferrable debt (1)	19,663		33,089		(13,426)
Interest expense - subordinated certificates (1)	48,717		47,852		865
Interest expense - long-term private debt (1)	136,779		118,722		18,057
Total interest expense on debt	901,717	4.90%	960,633	5.28%	(58,916)
Debt issuance costs (2)	9,605	0.05%	12,328	0.07%	(2,723)
Commitment and guarantee fees (3)	17,915	0.10%	16,023	0.09%	1,892
Loss on extinguishment of debt (4)	5,509	0.03%	4,806	0.03%	703
Other fees	2,143	0.01%	2,940	0.01%	(797)
Total interest expense	$ 936,889	5.09%	$ 996,730	5.48%	$ (59,841)

26

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

The $60 million or 6% decrease to total interest expense for the year ended May 31, 2008 as compared to the prior year period was due to lower interest expense on commercial paper and variable rate long-term debt as a result of a 325 basis point decrease in the federal funds rate from the rate in effect at May 31, 2007. The $500 million borrowed under the REDLG program in August 2007 represents a lower cost compared to the Company's other forms of long-term debt as a result of the guarantee of repayment by the RUS. In addition, the $175 million of 7.40% subordinated deferrable debt redeemed in June 2007 resulted in a 39 basis point decrease in the weighted average cost of subordinated deferrable debt. The Company redeemed these securities at par and recorded a charge of $6 million in interest expense for the unamortized issuance costs in the first quarter of fiscal year 2008. There was a $5 million loss on the extinguishment of debt for the year ended May 31, 2007 due to the write-off of unamortized debt issuance costs associated with the early redemption of subordinated deferrable debt.

The adjusted interest expense, which includes all derivative cash settlements, was consistent for the year ended May 31, 2008 with the prior year period based on changes to interest expense noted above and derivative cash settlements described below. See "Non-GAAP Financial Measures" for further explanation of the adjustment the Company makes in its financial analysis to include all derivative cash settlements in its interest expense.

Net Interest Income
The change in the line items described above resulted in an increase in net interest income of $75 million for the year ended May 31, 2008 compared to the prior year period. The adjusted net interest income, which includes all derivative cash settlements, for the year ended May 31, 2008 was $160 million, an increase of $16 million from the prior year period. See "Non-GAAP Financial Measures" for further explanation of the adjustment the Company makes in its financial analysis to include all derivative cash settlements in its interest expense, and therefore net interest income.

Recovery of Loan Losses
The $30 million recovery of loan losses for the year ended May 31, 2008 resulted substantially from the decrease in calculated impairments due to lower variable rates and payments received on impaired loans.

Non-interest Income
Non-interest income decreased by $62 million for the year ended May 31, 2008 compared to the prior year primarily due to decreases in cash settlements and income from the operations of foreclosed assets. The $59 million decrease in cash settlements for the year ended May 31, 2008 from the prior year period is primarily due to a $31 million payment received during the prior year for the termination of two exchange agreements compared to $8 million paid during the year ended May 31, 2008 for the termination of three exchange agreements. Additionally, cash settlements decreased for the year ended May 31, 2008 due to the 325 basis point decrease in the federal funds rate from May 31, 2007 to May 31, 2008 as the Company received a variable rate on 59% of its interest rate exchange agreements during fiscal year 2008 compared to 41% of its interest rate exchange agreements for which the Company pays a variable rate. Income from the operation of foreclosed assets decreased by $2 million for the year ended May 31, 2008

compared to the prior year due to a lower outstanding balance in foreclosed assets. At May 31, 2008, the foreclosed assets are comprised of real estate developer notes receivable and limited partnership interests in certain real estate developments.

Non-interest Expense

Non-interest expense increased by $17 million for the year ended May 31, 2008 compared to the prior year.

Salaries and employee benefits increased by $3 million for the year ended May 31, 2008 as compared to the prior year period primarily due to additional headcount and higher medical insurance rates paid by the Company. The Company had 13 additional employee positions filled at May 31, 2008 as compared to the prior year period end.

General and administrative expenses increased by $6 million for the year ended May 31, 2008 compared to the prior year period because of increased expenditures for the acceleration of information systems projects and the write-off of site work expenses on property the Company had under contract, but the seller was unable to meet the conditions to close the sale. Increased membership meeting expenses, marketing and audit fees also contributed to higher general and administrative expenses for the year ended May 31, 2008.

For the year ended May 31, 2008, the Company determined that there was a reduction of $6 million to the market value of the real estate developer notes receivable held as foreclosed assets. The reduction to the market value was primarily as a result of the slowdown in lot sales due to residential home market weakness.

The $19 million decrease in the derivative forward value during the year ended May 31, 2008 compared to the prior year period is due to changes in the estimate of future interest rates over the remaining life of the derivative contracts.

There was no foreign denominated debt outstanding during the year ended May 31, 2008, therefore resulting in no foreign currency adjustments compared to $15 million in the prior year period. When the Company issues debt in foreign currencies, it must adjust the value of the debt reported on the consolidated balance sheets for changes in foreign currency exchange rates since the date of issuance. To the extent that the current exchange rate is different than the exchange rate at the time of issuance, there will be a change in the value of the foreign denominated debt. The adjustment to the value of the debt is reported on the consolidated statements of operations as foreign currency adjustments. At the time of issuance of all foreign denominated debt, the Company typically enters into a cross currency or cross currency interest rate exchange agreement to fix the exchange rate on all principal and interest payments through maturity.

Minority Interest

Minority interest represents $0.3 million and $5.8 million of net loss for RTFC and NCSC, respectively, for the year ended May 31, 2008 compared to $0.1 million and $2.3 million of net income for RTFC and NCSC, respectively, for the prior year period. The decrease in NCSC net income is primarily due to fluctuations in the fair value of its derivative instruments.

Net Income

The change in the line items described above resulted in an increase in net income of $34 million for the year ended May 31, 2008 from the prior year period. The adjusted net income, which excludes the impact of the derivative forward value and foreign currency adjustments and adds back minority interest, was $138 million, compared to $108 million for the prior year period. See "Non-GAAP Financial Measures" for further explanation of the adjustments the Company makes in its financial analysis to net income.

Fiscal Year 2007 versus 2006 Results

The following chart presents the results for the year ended May 31, 2007 versus 2006.

	For the year ended May 31,		
(Dollar amounts in thousands)	2007	2006	Increase/ (Decrease)
Interest income	$ 1,054,224	$ 1,007,912	$ 46,312
Interest expense	(996,730)	(975,936)	(20,794)
Net interest income	57,494	31,976	25,518
Recovery of (provision for) loan losses	6,922	(23,240)	30,162
Net interest income after recovery of (provision for) loan losses	64,416	8,736	55,680
Non-interest income:			
Rental and other income	1,533	2,398	(865)
Derivative cash settlements	86,442	80,883	5,559
Results of operations of foreclosed assets	9,758	15,492	(5,734)
Gain on sale of building and land	-	43,431	(43,431)
Total non-interest income	97,733	142,204	(44,471)

Non-interest expense:			
Salaries and employee benefits	(33,817)	(31,494)	(2,323)
Other general and administrative expenses	(18,072)	(20,595)	2,523
Recovery of guarantee liability	1,700	700	1,000
Derivative forward value	(79,281)	28,805	(108,086)
Foreign currency adjustments	(14,554)	(22,594)	8,040
Loss on sale of loans	(1,584)	-	(1,584)
Total non-interest expense	(145,608)	(45,178)	(100,430)
Income prior to income taxes and minority interest	16,541	105,762	(89,221)
Income tax expense	(2,396)	(3,176)	780
Minority interest, net of income taxes	(2,444)	(7,089)	4,645
Net income	$ 11,701	$ 95,497	$ (83,796)
TIER	1.01	1.10	
Adjusted TIER (1)	1.12	1.11	

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

The Company's net interest income will increase or decrease due to changes in loan volume and the interest rates that it receives on its loans and pays on its sources of funding. The Company's loan volume substantially determines its funding needs. The following Volume Rate Variance Table provides a breakout of the change to interest income, interest expense and net interest income due to changes in loan volume versus changes to interest rates. For comparability purposes, average daily loan volume is used as the denominator in calculating interest income yield, interest expense rates and net interest income yield.

The following table also includes a breakout of the change to derivative cash settlements due to changes in the average notional amount of its derivative portfolio versus changes to the net difference between the average rate paid and the average rate received. Management calculates an adjusted net interest income, which includes all derivative cash settlements in interest expense. See "Non-GAAP Financial Measures" for further explanation of the adjustment the Company makes in its financial analysis to include all derivative cash settlements in its interest expense.

Volume Rate Variance Table
(Dollar amounts in millions)

	For the year ended May 31,								
	2007			2006			Change due to		
	Average Loan Balance	Income/ (Cost)	Average Interest Rate	Average Loan Balance	Income/ (Cost)	Average Interest Rate	Volume (1)	Rate (2)	Total
Interest income									
National Rural	$ 15,803	$ 917	5.80%	$ 15,605	$ 847	5.43%	$ 11	$ 59	$ 70
RTFC	1,994	106	5.30%	2,356	130	5.50%	(20)	(4)	(24)
NCSC	396	31	8.00%	444	31	7.08%	(4)	4	-
Total	$ 18,193	$ 1,054	5.79%	$ 18,405	$ 1,008	5.48%	$ (13)	$ 59	$ 46
Interest expense									
National Rural	$ 15,803	$ (870)	(5.51)%	$ 15,605	$ (827)	(5.30)%	$ (10)	$ (33)	$ (43)
RTFC	1,994	(100)	(4.98)%	2,356	(123)	(5.21)%	18	5	23
NCSC	396	(27)	(6.90)%	444	(26)	(5.92)%	3	(4)	(1)
Total	$ 18,193	$ (997)	(5.48)%	$ 18,405	$ (976)	(5.30)%	$ 11	$ (32)	$ (21)
Net interest income									
National Rural	$ 15,803	$ 47	0.29%	$ 15,605	$ 20	0.13%	$ 1	$ 26	$ 27
RTFC	1,994	6	0.32%	2,356	7	0.29%	(2)	1	(1)
NCSC	396	4	1.10%	444	5	1.16%	(1)	-	(1)
Total	$ 18,193	$ 57	0.31%	$ 18,405	$ 32	0.18%	$ (2)	$ 27	$ 25
Derivative cash settlements (3)									

National Rural	$ 12,508	$ 86	0.69%	$15,030	$ 82	0.54%	$(14)	$ 18	$ 4
NCSC	124	1	0.33%	110	(1)	(0.84)%	-	2	2
Total	$12,632	$ 87	0.68%	$15,140	$ 81	0.53%	$(14)	$ 20	$ 6
Adjusted interest expense (4)									
Total	$18,193	$ (910)	(5.00)%	$18,405	$ (895)	(4.86)%	$ (3)	$(12)	$(15)

(1) Variance due to volume is calculated using the following formula: (current average balance – prior year average balance) x prior year rate.

(2) Variance due to rate is calculated using the following formula: (current rate – prior year rate) x current average balance.

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

(4) See “Non-GAAP Financial Measures” for further explanation of the adjustment the Company makes in its financial analysis to include all derivative cash settlements in its interest expense.

29

Interest Income

Total interest income reported on the consolidated statements of operations and shown in the chart above includes the following as a percentage of average loans outstanding:

	For the year ended May 31,				
	2007		2006		
(Dollar amounts in thousands)	Amount	Rate	Amount	Rate	Increase/ (Decrease)
Interest on long-term fixed rate loans (1)	$ 833,247		$ 759,618		$ 73,629
Interest on long-term variable rate loans (1)	114,786		153,613		(38,827)
Interest on short-term loans (1)	72,632		57,636		14,996
Total interest income on loans	1,020,665	5.61 %	970,867	5.28%	49,798
Interest on investments (2)	9,662	0.05 %	10,391	0.05%	(729)
Conversion fees (3)	9,162	0.05 %	14,444	0.08%	(5,282)
Make-whole and prepayment fees (4)	4,748	0.03 %	5,409	0.03%	(661)
Commitment and guarantee fees (5)	9,161	0.05 %	6,488	0.04%	2,673
Other fees	826	-	313	-	513
Total interest income	$1,054,224	5.79 %	$1,007,912	5.48%	$ 46,312

(1) Represents interest income on loans to members.

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

(3) Conversion fees are deferred and recognized using the interest method over the remaining original loan interest rate pricing term, except for a small portion of the total fee charged to cover administrative costs related to the conversion, which is recognized immediately.

(4) Make-whole and prepayment fees are charged for the early repayment of principal in full and recognized when collected.

(5) Commitment fees for RTFC loan commitments are, in most cases, refundable on a prorata basis according to the amount of the loan commitment that is advanced. Such refundable fees are deferred and then recognized on a prorata basis based on the portion of the loan that is not advanced prior to the expiration of the commitment. Commitment fees on National Rural loan commitments are not refundable and are billed and recognized based on the unused portion of committed lines of credit. Guarantee fees are charged based on the amount, type and term of the guarantee. Guarantee fees are deferred and amortized using the straight-line method into interest income over the life of the guarantee.

The $46 million or 5% increase to the total interest income for the year ended May 31, 2007 as compared to the prior year period was due to the increase to National Rural loan interest rates in the markets offset by lower RTFC loan volume. During the year ended May 31, 2007, the Company raised variable interest rates by approximately 15 basis points, while fixed interest rates remained relatively stable. For the year ended May 31, 2007, the Company had a reduction to interest income of $81 million due to non-accrual loans compared to a reduction of $79 million for the prior year period. The decrease in loan volume is due to the prepayment of RTFC loans during the year ended May 31, 2007. The $4 million decrease in fee and investment income earned during the year ended May 31, 2007 was due to lower conversion fees recognized as compared to the prior year period.

The $70 million increase in National Rural interest income during the year ended May 31, 2007 as compared to the prior year was due to the increase in interest rates and loan volume partly offset by the impact of non-accrual loans. The impact on National Rural interest income of non-accrual loans was a reduction of $39 million for the year ended

May 31, 2007 as compared to $36 million for the prior year period. The impact of non-accrual loans on interest income is included in the rate variance in the chart above. The $24 million decrease in RTFC interest income during the year ended May 31, 2007 as compared to the prior year was due to the reduction in the balance of RTFC loans outstanding. The impact on RTFC interest income of non-accrual loans was a reduction of $42 million for the year ended May 31, 2007 as compared to $43 million for the prior year period.

Interest Expense

Total interest expense reported on the consolidated statements of operations and shown in the Volume Rate Variance Table above includes the following and the weighted average interest rate thereon:

	For the year ended May 31,				
	2007		2006		Increase/
(Dollar amounts in thousands)	Amount	Rate	Amount	Rate	(Decrease)
Interest expense - commercial paper and bid notes (1)	$ 178,687		$ 133,035		$ 45,652
Interest expense - medium-term notes (1)	363,760		409,454		(45,694)
Interest expense - collateral trust bonds (1)	218,523		271,980		(53,457)
Interest expense - subordinated deferrable debt (1)	33,089		45,349		(12,260)
Interest expense - subordinated certificates (1)	47,852		47,017		835
Interest expense - long-term private debt (1)	118,722		46,201		72,521
Total interest expense on debt	960,633	5.28%	953,036	5.18%	7,597
Debt issuance costs (2)	12,328	0.07%	9,662	0.05%	2,666
Derivative cash settlements, net (3)	-	-	2,278	0.01%	(2,278)
Commitment and guarantee fees (4)	16,023	0.09%	10,595	0.06%	5,428
Gain on extinguishment of debt (5)	4,806	0.03%	(1,907)	(0.01)%	6,713
Other fees	2,940	0.01%	2,272	0.01%	668
Total interest expense	$ 996,730	5.48%	$ 975,936	5.30%	$ 20,794

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

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

(3) Represents the net cost related to swaps that qualify for hedge treatment plus the accrual from the date of the last settlement to the current period end.

(4) Includes various fees related to funding activities, including fees paid to banks participating in the Company's revolving credit agreements and fees paid under bond guarantee agreements with RUS as part of the REDLG program. Fees are recognized as incurred or amortized on a straight-line basis over the life of the respective agreement.

(5) Represents the gain on the early retirement of debt including the write-off of unamortized discount, premium and issuance costs.

The $21 million increase to the total interest expense for the year ended May 31, 2007 as compared to the prior year period was due to the increase to interest rates in the markets and an increase in guarantee fees expensed due to the increase in REDLG debt outstanding. Additionally, there was a $5 million loss on the extinguishment of debt for the year ended May 31, 2007 due to the write-off of unamortized debt issuance costs associated with the early redemption of subordinated deferrable debt. Debt issuance costs increased due to the issuance of $1.6 billion of extendible term debt with an initial maturity, and therefore amortization period, of 13 months.

The adjusted interest expense, which includes all derivative cash settlements for the year ended May 31, 2007, increased by $15 million compared to the prior year period due to the increase to interest expense noted above and the

increase to derivative cash settlements described below. See "Non-GAAP Financial Measures" for further explanation of the adjustment the Company makes in its financial analysis to include all derivative cash settlements in its interest expense.

Net Interest Income

The change in the line items described above resulted in an increase in net interest income of $25 million for the year ended May 31, 2007 compared to the prior year period. The adjusted net interest income, which includes all derivative cash settlements, for the year ended May 31, 2007 was $144 million, an increase of $31 million from the prior year period. See "Non-GAAP Financial Measures" for further explanation of the adjustment the Company makes in its financial analysis to include all derivative cash settlements in its interest expense, and therefore net interest income.

Recovery of/Provision for Loan Losses

A recovery from the allowance for loan losses of $7 million was recorded during the year ended May 31, 2007 due primarily to payments received on impaired loans. The provision for loan losses of $23 million recorded during the year ended May 31, 2006 was primarily due to an increase in the calculated loan impairments during the year.

Non-interest Income

Non-interest income decreased by $44 million for the year ended May 31, 2007 compared to the prior year primarily due to the gain on the sale of the building. On October 18, 2005, National Rural closed on the sale of its headquarters facility in Fairfax County, Virginia to an affiliate of Prentiss Properties Acquisition Partners, L.P. resulting in a gain of $43 million for the year ended May 31, 2006. Cash settlements increased $6 million for the year ended May 31, 2007 compared to the prior year period due to a $31 million payment received as a result of the termination of two interest rate exchange agreements offset by both a decrease to the net rate earned by the Company on exchange agreements and the reduction in the average notional amount of derivatives outstanding as compared to the prior year period. The results of operations of foreclosed assets for the year ended May 31, 2007 decreased $6 million compared to the prior year period primarily due to a gain of $4 million recorded for the year

ended May 31, 2006 related to the sale of real estate assets in August 2005. At May 31, 2007, the remaining balance of foreclosed assets is comprised of notes receivable which the Company continues to service.

Non-interest Expense

Non-interest expense increased by $101 million for the year ended May 31, 2007 compared to the prior year due primarily to a $108 million decrease in the derivative forward value during the year ended May 31, 2007 compared to the prior year. The decrease resulted from changes in the estimate of future interest rates over the remaining life of the derivative contracts and a 17% reduction in the average notional amount of derivatives outstanding.

This was partially offset by an increase to the Company's foreign currency adjustment for the year ended May 31, 2007 of $8 million compared to the year ended May 31, 2006. Changes in the exchange rate between the U.S. dollar and Euro and the U.S. dollar and Australian dollar may cause the value of foreign denominated debt outstanding to fluctuate. An increase in the value of the Euro or the Australian dollar versus the value of the U.S. dollar results in an increase in the recorded U.S. dollar value of foreign denominated debt and therefore a charge to expense on the consolidated statements of operations, while a decrease in exchange rates results in a reduction in the recorded U.S. dollar value of foreign denominated debt and income. The Company has entered into foreign currency exchange agreements to cover all of the cash flows associated with its foreign denominated debt. Changes in the value of the foreign currency exchange agreement are approximately offset by changes in the value of the outstanding foreign denominated debt.

Minority Interest

For the year ended May 31, 2007, minority interest decreased by $5 million to $2 million compared to $7 million for the year ended May 31, 2006. Minority interest represents the RTFC and NCSC net income.

Net Income

The change in the line items described above resulted in a decrease in net income of $84 million for the year ended May 31, 2007 from the prior year period. The adjusted net income, which excludes the impact of the derivative forward value and foreign currency adjustments and adds back minority interest, was $108 million, compared to $97 million for the prior year period. The adjusted net income for the year ended May 31, 2006 included a $43 million gain on the sale of building and land. Adjusted net income for the year ended May 31, 2006 was $54 million excluding the $43 million gain on the sale of the building and land. See "Non-GAAP Financial Measures" for further explanation of the adjustments the Company makes in its financial analysis to net income.

Operating Results as a Percentage of Average Loans Outstanding

The Company's operating results as a percentage of average loans outstanding is summarized as follows:

	For the year ended May 31,		
	2008	2007	2006
Interest income	5.81%	5.79%	5.48%
Interest expense	(5.09)%	(5.48)%	(5.30)%
Net interest income	0.72%	0.31%	0.18%
Recovery of (provision for) loan losses	0.17%	0.04%	(0.13)%
Net interest income after recovery of (provision for) loan losses	0.89%	0.35%	0.05%
Non-interest income:			
Rental and other income	0.01%	0.01%	0.01%
Derivative cash settlements	0.15%	0.48%	0.44%
Results of operations of foreclosed assets	0.04%	0.05%	0.08%
Gain on sale of building and land	-	-	0.23%
Total non-interest income	0.20%	0.54%	0.76%
Non-interest expense:			
Salaries and employee benefits	(0.20)%	(0.19)%	(0.17)%
Other general and administrative expenses	(0.14)%	(0.10)%	(0.11)%
Recovery for guarantee liability	0.02%	0.01%	0.01%
Market adjustment of foreclosed assets	(0.03)%	-	-
Derivative forward value	(0.54)%	(0.43)%	0.16%
Foreign currency adjustments	-	(0.08)%	(0.13)%
Loss on sale of loans	-	(0.01)%	-
Total non-interest expense	(0.89)%	(0.80)%	(0.24)%
Income prior to income taxes and minority interest	0.20%	0.09%	0.57%
Income tax benefit (expense)	0.02%	(0.01)%	(0.01)%
Minority interest, net of income taxes	0.03%	(0.01)%	(0.04)%
Net income	0.25%	0.07%	0.52%
Adjusted net interest income (1)	0.87%	0.79%	0.62%
Adjusted income prior to income taxes and minority interest (2)	0.74%	0.60%	0.54%

(1) Adjusted to include derivative cash settlements in the interest expense. See "Non-GAAP Financial Measures" for further explanation and a reconciliation of these adjustments.

(2) Adjusted to exclude derivative forward value and foreign currency adjustments. See "Non-GAAP Financial Measures" for further explanation and a reconciliation of these adjustments.

Ratio of Earnings to Fixed Charges

The following chart provides the calculation of the ratio of earnings to fixed charges. The ratio of earnings to fixed charges is the same calculation as TIER. See “Results of Operations” for discussion on TIER and adjustments that the Company makes to the TIER calculation.

	For the year ended May 31,		
(Dollar amounts in thousands)	2008	2007	2006

Income prior to cumulative effect of			
change in accounting principle	$ 45,745	$ 11,701	$ 95,497
Add: fixed charges	936,889	996,730	975,936
Earnings available for fixed charges	$ 982,634	$ 1,008,431	$ 1,071,433
Total fixed charges:			
Interest on all debt (including amortization of			
discount and issuance costs)	$ 936,889	$ 996,730	$ 975,936
Ratio of earnings to fixed charges	1.05	1.01	1.10

Financial Condition

Loan and Guarantee Portfolio Assessment

Loan Programs

Loans to members bear interest at rates determined from time to time by the Company after considering its interest expense, operating expenses, provision for loan losses and the maintenance of reasonable earnings levels. In keeping with its not-for-profit cooperative charter, the Company's policy is to set interest rates at the lowest levels it considers to be consistent with sound financial management.

The following chart summarizes loans by type and by segment at May 31:

(Dollar amounts in thousands)	2008		2007		Increase/ (Decrease)
Loans by type:					
Long-term loans (1):					
Long-term fixed rate loans	$ 15,418,662	81%	$ 14,881,046	82%	$ 537,616
Long-term variable rate loans	1,918,216	10%	2,031,731	11%	(113,515)
Total long-term loans	17,336,878	91%	16,912,777	93%	424,101
Short-term loans (2)	1,690,117	9%	1,215,430	7%	474,687
Total loans	$ 19,026,995	100%	$ 18,128,207	100%	$ 898,788

(Dollar amounts in thousands)	2008		2007		Increase/ (Decrease)
Loans by segment:					
National Rural:					
Distribution	$ 13,438,370	71%	$12,827,772	71%	$ 610,598
Power supply	3,339,112	17%	2,858,040	16%	481,072
Statewide and associate	108,925	1%	119,478	1%	(10,553)
National Rural Total	16,886,407	89%	15,805,290	88%	1,081,117
RTFC	1,726,514	9%	1,860,379	10%	(133,865)
NCSC	414,074	2%	462,538	2%	(48,464)
Total	$ 19,026,995	100%	$18,128,207	100%	$ 898,788

(1) Includes loans classified as restructured and non-performing and RUS guaranteed loans.
(2) Consists of secured and unsecured short-term loans that are subject to interest rate adjustment monthly or semi-monthly.

The Company's loans outstanding increased by 5% during the year ended May 31, 2008. National Rural loans outstanding increased due to net advances of $1,155 million offset by the sale of $74 million of National Rural distribution loans in loan securitization transactions during the year ended May 31, 2008. The primary reasons for the National Rural loan growth included RUS note buyouts, funding of capital expenditures, bridge financing to fund projects prior to RUS funding is received and funding for renewable energy projects.

Long-term fixed rate loans at May 31, 2008 and 2007 represented 89% and 88%, respectively, of total long-term loans. Loans converting from a variable rate to a fixed rate for the year ended May 31, 2008 totaled $711 million, which was offset by $274 million of loans that converted from a fixed rate to a variable rate. This resulted in a net conversion of $437 million from a variable rate to a fixed rate for the year ended May 31, 2008. For the year ended May 31, 2007, loans converting from a variable rate to a fixed rate totaled $372 million, which was offset by $190 million of loans that converted from a fixed rate to a variable rate. This resulted in a net conversion of $182 million from a variable rate to a fixed rate for the year ended May 31, 2007.

The following chart summarizes loans and guarantees outstanding by segment at May 31:

(Dollar amounts in thousands)	2008	2007	Increase/

					(Decrease)
National Rural:					
Distribution	$ 13,622,829	68%	$13,039,092	68%	$ 583,737
Power supply	4,125,567	20%	3,655,049	19%	470,518
Statewide and associate	131,710	1%	144,837	1%	(13,127)
National Rural Total	17,880,106	89%	16,838,978	88%	1,041,128
RTFC	1,726,774	9%	1,860,379	10%	(133,605)
NCSC	457,255	2%	503,224	2%	(45,969)
Total	$ 20,064,135	100%	$19,202,581	100%	$ 861,554

The following table summarizes the RTFC segment loans and guarantees outstanding as of May 31:

(Dollar amounts in thousands)	2008		2007		Increase/ (Decrease)
Rural local exchange carriers	$1,518,197	88%	$1,630,246	88%	$(112,049)
Cable television providers	153,539	9%	154,738	8%	(1,199)
Fiber optic network providers	16,884	1%	37,422	2%	(20,538)
Competitive local exchange carriers	29,871	2%	21,039	1%	8,832
Wireless providers	4,579	-	3,609	-	970
Long distance carriers	-	-	9,069	1%	(9,069)
Other	3,704	-	4,256	-	(552)
Total	$1,726,774	100%	$1,860,379	100%	$(133,605)

The Company's members are widely dispersed throughout the United States and its territories, including 49 states, the District of Columbia and two U.S. territories. At May 31, 2008, 2007 and 2006, loans and guarantees outstanding to members in any one state or territory did not exceed 17%, 15% and 16%, respectively, of total loans and guarantees outstanding.

Credit Concentration

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

Total exposure, as defined by the policy, includes the following:

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

At May 31, 2008 and 2007, the total exposure outstanding to any one borrower or controlled group did not exceed 2.7% and 3.0%, respectively, of total loans and guarantees outstanding. At May 31, 2008, the ten largest borrowers included five distribution systems, four power supply systems and one telecommunications system. At May 31, 2007, the ten largest borrowers included six distribution systems, two power supply systems and two telecommunications systems. The following chart shows the exposure to the ten largest borrowers as a percentage of total exposure by type and by segment at May 31:

	2008		2007		Increase/
(Dollar amounts in thousands)	Amount	% of Total	Amount	% of Total	(Decrease)
Total by type:					
Loans	$3,395,865		$3,306,986		$ 88,879
Guarantees	164,740		76,867		87,873
Total credit exposure to ten largest borrowers	$3,560,605	18%	$3,383,853	18%	$ 176,752
Total by segment:					
National Rural	$3,043,905		$2,691,060		$ 352,845
RTFC	491,700		692,793		(201,093)
NCSC	25,000		-		25,000
Total credit exposure to ten largest borrowers	$3,560,605	18%	$3,383,853	18%	$ 176,752

Security Provisions

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. Guarantee reimbursement obligations are typically secured on a 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 designed to achieve certain financial ratios.

The following table summarizes the Company's unsecured credit exposure as a percentage of total exposure by type and by segment at May 31:

	2008		2007		Increase/
(Dollar amounts in thousands)	Amount	% of Total	Amount	% of Total	(Decrease)
Total by type:					
Loans	$2,150,739		$1,634,296		$ 516,443
Guarantees	235,816		220,983		14,833
Total unsecured credit exposure	$2,386,555	11%	$1,855,279	10%	$ 531,276
Total by segment:					
National Rural	$2,100,676		$1,559,097		$ 541,579
RTFC	229,287		230,300		(1,013)
NCSC	56,592		65,882		(9,290)
Total unsecured credit exposure	$2,386,555	11%	$1,855,279	10%	$ 531,276

Non-performing Loans

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

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

Once a borrower is classified as non-performing, the Company typically places the loan on non-accrual status and reverses all accrued and unpaid interest back to the date of the last payment. The Company generally applies all cash received during the non-accrual period to the reduction of principal, thereby foregoing interest income recognition. At May 31, 2008 and 2007, the Company had non-performing loans outstanding in the amount of $507 million and $502 million, respectively. All loans classified as non-performing were on a non-accrual status with respect to the recognition of interest income.

At May 31, 2008 and 2007, non-performing loans include $492 million and $493 million, respectively, to Innovative Communication Corporation (“ICC”). All loans to ICC have been on non-accrual status since February 1, 2005. ICC has not made debt service payments to the Company since June 2005. RTFC is the primary secured lender to ICC.

Beginning on June 1, 2004, RTFC filed a series of lawsuits against ICC, Jeffrey Prosser (“Prosser”) and others for failure to comply with the terms of ICC's loan agreement with RTFC dated August 27, 2001 as amended on April 4, 2003. In response to the lawsuits filed by RTFC, ICC, ICC’s subsidiary Virgin Islands Telephone Corporation d/b/a Innovative Telephone ("Vitelco"), and Prosser denied liability and asserted claims, by way of counterclaim and by filing its own lawsuits against RTFC, National Rural and certain of RTFC's officers, seeking various remedies, including reformation of the loan agreement, injunctive relief, and damages (together with the RTFC claims, the “Loan Litigation”).

In February 2006, involuntary bankruptcy petitions were filed against Prosser, ICC's immediate parent, Emerging Communication, Inc. ("Emcom") and Emcom's parent, Innovative Communication Company LLC ("ICC-LLC"); and on April 26, 2006, RTFC reached a settlement of the Loan Litigation with ICC, Vitelco, ICC-LLC, Emcom, their directors and Prosser, individually. Under the settlement, RTFC obtained entry of judgments in the District Court for the District of the Virgin Islands against ICC for approximately $525 million and Prosser for approximately $100 million. RTFC also obtained dismissals with prejudice of all counterclaims, affirmative defenses and other lawsuits alleging wrongful acts by RTFC, certain of its officers, and National Rural thereby resolving all the Loan Litigation in RTFC’s favor.

Although the judgment debtors and others were given an opportunity to satisfy the judgments at a discount, on July 31, 2006, ICC-LLC, Emcom and Prosser each filed a voluntary bankruptcy petition for reorganization. The cases are pending in the United States District Court for the Virgin Island, Bankruptcy Division (the “Bankruptcy Court”). A Chapter 11 trustee, Stan Springel, was later appointed for the ICC-LLC and Emcom estates; and Prosser’s individual case was converted to Chapter 7 liquidation in October 2007. Prosser’s Chapter 7 trustee is in the process of marshaling Prosser’s non-exempt assets for disposition and eventual payment in respect of creditor claims.

On September 21, 2007, the Bankruptcy Court entered an order placing ICC in its own bankruptcy proceeding, and on October 3, 2007 appointed Stan Springel as its trustee. The Chapter 11 trustee of ICC has assumed ownership and control of ICC, including its subsidiaries, and has begun to marshal RTFC collateral and other assets for disposition, including property in Prosser’s possession or control, and eventual payment in respect of RTFC’s claims and the claims of other parties-in-interest.

In most cases, the sale (as part of the Chapter 11 cases) of ICC or any of its subsidiaries engaged in a regulated telecommunications or cable television business, or of the regulated assets of ICC or its subsidiaries, will require the

prior consent of the respective regulators in the United States (including the Federal Communications Commission and the U.S. Virgin Islands Public Services Commission), the British Virgin Islands, France and its Caribbean territories, and the Netherlands Antilles. In certain limited cases, only a post-transaction notification will be required.

For a more detailed description of the contingencies related to the non-performing loans outstanding to ICC, see Note 15 to the consolidated financial statements. Based on its analysis, the Company believes that it is adequately reserved for its exposure to ICC at May 31, 2008.

Restructured Loans

Loans classified as restructured are loans for which agreements have been executed that changed the original terms of the loan, generally a change to the originally scheduled cash flows. The Company will make a determination on each restructured loan with regard to the accrual of interest income on the loan. 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. The Company will periodically review the decision to accrue or not to accrue interest income on restructured loans based on the borrower's past performance and current financial condition.

At May 31, 2008 and 2007, restructured loans totaled $577 million and $603 million, respectively. A total of $519 million and $545 million of restructured loans were on non-accrual status with respect to the recognition of interest income at May 31, 2008 and 2007, respectively.

At May 31, 2008 and 2007, the Company had $519 million and $545 million, respectively, of restructured loans outstanding to CoServ. All restructured CoServ loans have been on non-accrual status since January 1, 2001. In addition, $20 million was outstanding under the capital expenditure loan facility which was classified as a performing loan at both May 31, 2008 and 2007. Total loans to CoServ at May 31, 2008 and 2007 represented 2.7% and 2.9% of the Company's total loans and guarantees outstanding, respectively.

Under the terms of a bankruptcy settlement, National Rural restructured its loans to CoServ. CoServ is scheduled to make quarterly payments to National Rural through December 2037. As part of the restructuring, National Rural may be obligated to provide up to $204 million of senior secured capital expenditure loans to CoServ for electric distribution infrastructure through December 2012. When CoServ requests capital expenditure loans from National Rural, these loans are provided at the standard terms offered to all borrowers and require debt service payments in addition to the quarterly payments that CoServ is required to make to National Rural. As of May 31, 2008, a total of $20 million had been advanced to CoServ under this loan facility. To date, CoServ has made all payments required under the restructure agreement and capital expenditure loan facility. Under the terms of the restructure agreement, CoServ has the option to prepay the loan for $415 million plus an interest payment true up on or after December 13, 2007 and for $405 million plus an interest payment true up on or after December 13, 2008. National Rural has received no notice from CoServ that it intends to prepay the loan.

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

Based on its analysis, the Company believes that it is adequately reserved for its exposure to CoServ at May 31, 2008.

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

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

Based on its analysis, the Company believes that it is adequately reserved for its exposure to Pioneer at May 31, 2008.

Loan Impairment

On a quarterly basis, the Company reviews 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. The Company calculates an impairment for a borrower based on the expected future cash flow or the fair value of any collateral held by the Company as security for 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, and
- changes to the industry in which the cooperative operates.

As events related to the borrower take place and economic conditions and the Company's 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 May 31, 2008 and 2007, the Company had impaired loans totaling $1,078 million and $1,099 million, respectively. At May 31, 2008 and 2007, National Rural had specifically reserved a total of $331 million and $397 million, respectively, to cover impaired loans.

The following chart 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)	May 31, 2008	May 31, 2007	May 31, 2006
Non-performing loans	$ 506,864	$ 501,864	$ 577,869
Percent of loans outstanding	2.67%	2.77%	3.15%
Percent of loans and guarantees outstanding	2.52%	2.61%	2.97%
Restructured loans	$ 577,111	$ 603,305	$ 630,354
Percent of loans outstanding	3.03%	3.33%	3.43%
Percent of loans and guarantees outstanding	2.88%	3.14%	3.24%
Total non-performing and restructured loans	$1,083,975	$1,105,169	$1,208,223
Percent of loans outstanding	5.70%	6.10%	6.58%
Percent of loans and guarantees outstanding	5.40%	5.75%	6.21%

Allowance for Loan Losses

The Company maintains an allowance for loan losses at a level estimated by management to provide adequately for probable losses inherent in the loan portfolio, which are estimated based upon a review of the loan portfolio, past loss experience, specific problem loans, economic conditions and other pertinent factors which, in management's judgment, deserve current recognition in estimating loan losses. The Company reviews and adjusts the allowance on a quarterly basis to maintain it at a level to cover estimated probable losses in the portfolio.

Management makes recommendations to the board of directors of National Rural regarding write-offs of loan balances. In making its recommendation to write off all or a portion of a loan balance, management considers various factors including cash flow analysis and the collateral securing the borrower's loans. Since inception in 1969, write-offs totaled $212 million and recoveries totaled $34 million for a net loan loss of $178 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:

	For the year ended May 31,		
(Dollar amounts in thousands)	2008	2007	2006
Beginning balance	$561,663	$611,443	$589,749
(Recovery of) provision for loan losses	(30,262)	(6,922)	23,240
Net write-offs	(16,495)	(42,858)	(1,546)
Ending balance	$514,906	$561,663	$611,443
`			
Loan loss allowance by segment:			
National Rural	$514,626	$561,113	$610,617
NCSC	280	550	826
Total	$514,906	$561,663	$611,443
As a percentage of total loans outstanding	2.71%	3.10%	3.33%
	101.59%	111.95%	105.71%

As a percentage of total non-performing loans outstanding			
As a percentage of total restructured loans outstanding	89.22%	93.20%	96.98%

National Rural has 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 only a small loan loss allowance is required at NCSC to cover the exposure to consumer loans.

The Company's loan loss allowance decreased $47 million from May 31, 2007 to May 31, 2008. Within National Rural’s loan loss allowance at May 31, 2008 as compared to the prior year end, there was a decrease in the calculated impairments of $66 million, which was offset by an increase of $23 million to the unallocated reserve. The decrease to the calculated impairments was primarily due to a settlement agreement with VarTec resulting in a loan write-off of $17 million, payments received on impaired loans and lower variable interest rates at May 31, 2008 as compared to May 31, 2007. The increase of $23 million to the unallocated reserve was primarily due to a change in the single obligor component. During the third quarter of fiscal year 2008, the Company lowered the single obligor threshold from 1.5% to 1.0% of total outstanding credit. This lower threshold level effectively aligns the single obligor component with the top ten credit exposures.

Liabilities, Minority Interest and Equity

Outstanding Debt

The following chart provides a breakout of debt outstanding at May 31:

(Dollar amounts in thousands)	2008	2007	Increase/ (Decrease)
Short-term debt:			
Commercial paper (1)	$ 3,050,264	$ 2,784,619	$ 265,645
Bank bid notes	100,000	100,000	-
Long-term debt with remaining maturities less than one year	3,177,189	1,367,504	1,809,685
Subordinated deferrable debt with remaining maturities less than one year	-	175,000	(175,000)
Total short-term debt	6,327,453	4,427,123	1,900,330
Long-term debt:			
Collateral trust bonds	2,886,580	4,017,357	(1,130,777)
Notes payable	2,956,403	2,532,630	423,773
Medium-term notes	4,330,604	4,745,232	(414,628)
Total long-term debt	10,173,587	11,295,219	(1,121,632)
Subordinated deferrable debt	311,440	311,440	-
Members' subordinated certificates:			
Membership certificates	649,465	649,424	41
Loan certificates	654,047	624,888	29,159
Guarantee certificates	103,267	107,135	(3,868)
Total members' subordinated certificates	1,406,779	1,381,447	25,332
Total debt outstanding	$18,219,259	$17,415,229	$ 804,030
Percentage of fixed rate debt (2)	82%	83%	
Percentage of variable rate debt (3)	18%	17%	
Percentage of long-term debt	65%	75%	
Percentage of short-term debt	35%	25%	

(1) Includes $251 million and $250 million related to the daily liquidity fund at May 31, 2008 and 2007, 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 considered to be 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 chart provides additional information on the debt instruments offered by the Company:

Debt Instrument	Maturity Range	Rate Options	Market	Security	Credit Rating (1)
Daily liquidity fund	Demand note	Rate may change daily	Members	Unsecured	NA
Bank bid notes	Up to 3 months	Fixed rate	Bank institutions	Unsecured	NA
Commercial paper	1 to 270 days	Fixed rate	Public capital markets and	Unsecured	P-1, A-1, F-1

			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 2 years 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+, A-
Subordinated certificates	Up to 100 years (6)	Varies	Members	Unsecured (7)	NA

(1) Based on rates 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 May 31, 2008, primarily represents secured notes payable to Federal Agricultural Mortgage Corporation ("Farmer Mac") which are rated A1, A+, A+ by Moody's Investors Service, Standard & Poor's Corporation and Fitch Ratings, respectively, and unsecured notes payable issued under the REDLG program which do not have a credit rating. As a requirement, however, National Rural must obtain a rating for REDLG notes payable without regard to the bond guarantee agreement with RUS. See further discussion of National Rural's private debt issuances under "Sources of Liquidity."
(4) The Company has 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. The Company has the right to call the subordinated deferrable debt any time after five years, at par. To date, the Company has not exercised its option to suspend interest payments.
(5) Subordinate and junior in right of payment to senior debt and the debt obligations guaranteed by the Company, but senior to subordinated certificates.
(6) Membership subordinated certificates generally mature in 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.
(7) Subordinate and junior in right of payment to senior and subordinated debt and debt obligations guaranteed by the Company.

Other information with regard to short-term debt at May 31 is as follows:

(Dollar amounts in thousands)	2008	2007	2006
Weighted average maturity outstanding at year-end:			
Short-term debt (1)	26 days	25 days	26 days
Long-term debt maturing within one year	116 days	192 days	203 days
Total	71 days	83 days	92 days
Average amount outstanding during the year:			
Short-term debt (1)	$2,892,202	$ 3,372,639	$3,204,852
Long-term debt maturing within one year	2,961,714	1,692,083	3,502,026
Total	5,853,916	5,064,722	6,706,878
Maximum amount outstanding at any month-end during the year:			
Short-term debt (1)	3,259,556	3,847,814	4,208,796
Long-term debt maturing within one year	3,981,567	2,549,356	4,031,102

(1) Includes the daily liquidity fund and bank bid notes and does not include long-term debt due in less than one year.

Total debt outstanding at May 31, 2008 increased as compared to May 31, 2007 due primarily to the increase of $899 million to loans outstanding. During fiscal year 2008, $1,595 million of extendible collateral trust bonds and $250 million of extendible medium-term notes were reclassified from long-term debt to short-term debt because investors elected not to extend the maturity of the debt. An additional $500 million was borrowed under FFB loan facilities with bond guarantee agreements with RUS as part of the funding mechanism for the REDLG program in August 2007. In January 2008, the Company issued $700 million of 5.45% collateral trust bonds due February 2018. In March 2008, the Company sold to Farmer Mac $400 million of floating rate debt due in 2013. Subsequent to the end of the fiscal year in June 2008, the Company issued $900 million of 5.50% collateral trust bonds due 2013 and $400 million of floating rate collateral trust bonds due 2010.

During fiscal year 2008, the Company redeemed the 7.40% subordinated deferrable debt securities due 2050 totaling $175 million reported in short-term debt at May 31, 2007. The Company redeemed these securities at par and recorded a charge of $6 million in interest expense for the unamortized issuance costs in the first quarter of fiscal year 2008.

At May 31, 2008 and 2007, there was no foreign denominated debt outstanding.

The increase to members' subordinated certificates of $25 million for the year ended May 31, 2008 is primarily due to $78 million of new loan certificates related to the increase in loans outstanding offset by loan prepayments, normal amortization and maturities.

Minority Interest

At May 31, 2008 and 2007, the Company reported minority interests of $14 million and $22 million, respectively, on the consolidated balance sheets. Minority interest represented 100% of RTFC and NCSC equity as the members of RTFC and NCSC own or control 100% of the interest in their respective companies.

During the year ended May 31, 2008, the balance of minority interest decreased by $6 million of minority interest net loss for the year ended May 31, 2008 and the retirement of $2 million of patronage capital to RTFC members in January 2008.

Equity

The following chart provides a breakout of the equity balances at May 31:

(in thousands)	2008	2007	Increase/ (Decrease)
Membership fees	$ 993	$ 997	$ (4)
Education fund	1,484	1,406	78
Members' capital reserve	187,409	158,308	29,101
Allocated net income	423,249	405,598	17,651
Unallocated net income (1)	(53)	(23)	(30)
Total members' equity	613,082	566,286	46,796
Prior years cumulative derivative forward value and foreign currency adjustments	131,551	225,849	(94,298)
Current period derivative forward value (2)	(87,495)	(79,744)	(7,751)
Current period foreign currency adjustments	-	(14,554)	14,554
Total retained equity	657,138	697,837	(40,699)
Accumulated other comprehensive income	8,827	12,204	(3,377)
Total equity	$665,965	$710,041	$(44,076)

(1) Excludes derivative forward value and foreign currency adjustments.

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

Applicants are required to pay a one-time fee to become a member. The fee varies from two hundred dollars to one thousand dollars depending on the membership class. National Rural is required by the District of Columbia cooperative law to have a methodology to allocate its net earnings to its members. National Rural maintains the current year net earnings as unallocated through the end of its fiscal year. Subsequent to the end of the fiscal year, National Rural's board of directors allocates its net earnings to its members in the form of patronage capital and to board approved reserves. National Rural calculates net earnings by adjusting net income to exclude certain non-cash adjustments. Currently, National Rural has two such board approved reserves, the education fund and the members' capital reserve. National Rural adjusts the net earnings it allocates to its members and board approved reserves to exclude the non-cash impacts of SFAS 133 and 52. National Rural allocates a small portion, less than 1%, of net earnings annually to the education fund as required by cooperative law. Funds from the education fund are disbursed annually to the statewide cooperative organizations to fund the teaching of cooperative principles in the service territories of the cooperatives in each state. The board of directors determines the amount of net earnings that is allocated to the members' capital reserve, if any. The members' capital reserve represents net earnings that are held by National Rural to increase equity retention. The net earnings held in the members' capital reserve have not been specifically allocated to any member, but may be allocated to individual members in the future as patronage capital if authorized by National Rural's board of directors. All remaining net earnings are allocated to National Rural's members in the form of patronage capital. National Rural bases the amount of net earnings allocated to each member on the members' patronage of the National Rural lending programs in the year that the net earnings were earned. There is no impact on National Rural's total equity as a result of allocating net earnings to members in the form of patronage capital or to board approved reserves. National Rural annually retires a portion of the patronage capital allocated to members in prior years. National Rural's total equity is reduced by the amount of patronage capital retired to its members and by amounts disbursed from board approved reserves.

At May 31, 2008, total equity decreased by $44 million from May 31, 2007. During the year ended May 31, 2008, National Rural retired $86 million of patronage capital to its members and accumulated other comprehensive income related to derivatives decreased $3 million which was offset by net income of $46 million.

Contractual Obligations

The following table summarizes the long-term contractual obligations at May 31, 2008 and the scheduled reductions by fiscal year.

(in millions) Instrument	2009	2010	2011	2012	2013	More than 5 Years	Total
Long-term debt due in less than one year	$3,177	$ -	$ -	$ -	$ -	$ -	$ 3,177
Long-term debt	-	1,859	553	1,554	441	5,767	10,174
Subordinated deferrable debt	-	-	-	-	-	311	311
Members' subordinated certificates (1)	8	37	26	14	14	1,055	1,154
Operating leases (2)	3	2	-	-	-	-	5
Contractual interest on long-term debt (3)	641	527	482	446	359	4,265	6,720
Total contractual obligations	$ 3,829	$ 2,425	$ 1,061	$ 2,014	$ 814	$ 11,398	$ 21,541

(1) Excludes loan subordinated certificates totaling $253 million that amortize annually based on the outstanding balance of the related loan. There are many items that impact the amortization of a loan, such as loan conversions, loan repricing at the end of an interest rate term and prepayments, thus amortization schedule cannot be maintained for these certificates. Over the past three years, annual amortization on these certificates has averaged $30 million. In fiscal year 2008, amortization represented 12% of amortizing loan subordinated certificates outstanding.

(2) Represents the payment obligation related to the Company's lease of office space for its headquarters facility. In September 2007, the Company exercised the option to extend the lease for an additional one-year period. Assuming the Company exercises the option to extend the lease for an additional one-year period in fiscal year 2009, the future minimum lease payments for fiscal years 2010 and 2011 would increase to $4 million and $2 million, respectively.
(3) Represents the interest obligation on the Company's debt based on terms and conditions at May 31, 2008.

Off-Balance Sheet Obligations
Guarantees
The following chart provides a breakout of guarantees outstanding by type and by segment at May 31:

(in thousands)	2008	2007	Increase/ (Decrease)
Total by type:			
Long-term tax-exempt bonds	$ 498,495	$ 526,185	$ (27,690)
Indemnifications of tax benefit transfers	94,821	107,741	(12,920)
Letters of credit	343,424	365,766	(22,342)
Other guarantees	100,400	74,682	25,718
Total	$1,037,140	$1,074,374	$ (37,234)
Total by segment:			
National Rural	$ 993,699	$1,033,688	$ (39,989)
RTFC	260	-	260
NCSC	43,181	40,686	2,495
Total	$1,037,140	$1,074,374	$ (37,234)

The decrease in total guarantees outstanding at May 31, 2008 compared to May 31, 2007 is primarily due to the normal amortization on long-term tax-exempt bonds and tax benefit transfers and a reduction in the amount of letters of credit offset by a $26 million increase to other guarantees outstanding.

At May 31, 2008 and 2007, the Company had recorded a guarantee liability totaling $15 million and $19 million, respectively, which represents the contingent and non-contingent exposure related to guarantees of members' debt obligations.

The following table summarizes the off-balance sheet obligations at May 31, 2008 and the related principal amortization and maturities by fiscal year.

(in thousands)		Principal Amortization and Maturities					
	Outstanding Balance	2008	2009	2010	2011	2012	Remaining Years
Guarantees (1)	$1,037,140	$169,084	$191,214	$159,027	$54,318	$107,278	$356,219

(1) On a total of $330 million of tax-exempt bonds, National Rural has 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 May 31, 2008, the Company had unadvanced loan commitments totaling $13,574 million, an increase of $670 million compared to the balance of $12,904 million at May 31, 2007. Unadvanced commitments are loans for which loan contracts have been approved and executed, but funds have not been advanced. Substantially all credit commitments for long-term loans contain material adverse change clauses, thus for a borrower to qualify for the advance of long-term funds, the Company must be satisfied that there has been no material adverse change since the loan was approved based on National Rural's credit underwriting policy at that time. The Company offers lines of credit loans that may or may not contain a material adverse change clause. The majority of the short-term unadvanced commitments provide backup liquidity to the Company's borrowers; therefore, it does not anticipate funding most of these commitments. Approximately 56% of the outstanding commitments at May 31, 2008 and 2007 were for short-term or line of credit loans. Based on the information above, unadvanced loan commitments do not represent off-balance sheet liabilities and have not been included in the chart summarizing off-balance sheet obligations above. Therefore, unadvanced commitments are classified as contingent liabilities.

Ratio Analysis

Leverage Ratio

The leverage ratio is calculated by dividing the sum of total liabilities and guarantees outstanding by total equity. Based on this formula, the leverage ratio at May 31, 2008 was 29.64, an increase from 26.64 at May 31, 2007. The increase in the leverage ratio is due to an increase of $856 million in total liabililities and a decrease of $44 million in total equity offset by a decrease of $37 million in guarantees as discussed under the Liabilities, Minority Interest and Equity section and the Off-Balance Sheet Obligations section of "Financial Condition".

For the purpose of covenant compliance on its revolving credit agreements and for internal management purposes, the leverage ratio calculation is adjusted to exclude derivative liabilities, debt used to fund RUS guaranteed loans, subordinated deferrable debt and subordinated certificates from liabilities, uses members' equity rather than total equity and adds subordinated deferrable debt, subordinated certificates and minority interest to arrive at adjusted equity. At May 31, 2008 and 2007, the adjusted leverage ratio was 7.50 and 6.81, respectively. See "Non-GAAP Financial Measures" for further explanation and a reconciliation of the adjustments the Company makes in its leverage ratio calculation.

The increase in the adjusted leverage ratio is due to an increase in adjusted liabilities of $912 million and a decrease of $111 million in adjusted equity offset by a decrease in guarantees of $37 million as discussed under the Liabilities, Minority Interest 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 an investment grade rating 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. The debt to equity ratio, based on this formula at May 31, 2008 was 28.08, an increase from 25.13 at May 31, 2007. The increase in the debt to equity ratio is due to the decrease of $44 million in total equity and an increase of $856 million in total liabilities as discussed under the Liabilities, Minority Interest and Equity section of "Financial Condition".

For internal management purposes, the debt to equity ratio calculation is adjusted to exclude derivative liabilities, debt used to fund RUS guaranteed loans, subordinated deferrable debt and subordinated certificates from liabilities, uses members' equity rather than total equity and adds subordinated deferrable debt, subordinated certificates and minority interest to arrive at

adjusted equity. At May 31, 2008 and 2007, the adjusted debt to equity ratio was 7.06 and 6.37, respectively. See "Non-GAAP Financial Measures" for further explanation and a reconciliation of the adjustments made to the debt to equity ratio calculation. The increase in the adjusted debt to equity ratio is due to the decrease of $111 million in adjusted equity and an increase of $912 million in adjusted liabilities.

Credit Ratings

The Company's 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 the Company's credit ratings at May 31, 2008.

	Moody's Investors Service	Standard & Poor's Corporation	Fitch Ratings
Direct:			
Senior secured debt	A1	A+	A+
Senior unsecured debt	A2	A	A
Subordinated deferrable debt	A3	BBB+	A-
Commercial paper	P-1	A-1	F-1
Guarantees:			
Pooled bonds	A1	A	A
Other bonds	A2	A	A
Short-term	P-1	A-1	F-1

The ratings listed above have the meaning as defined by each of the respective rating agencies, are not recommendations to buy, sell or hold securities and are subject to revision or withdrawal at any time by the rating organizations.

At May 31, 2008, Standard & Poor’s Corporation and Fitch Ratings had the Company’s ratings on positive outlook and Moody's Investors Service had the Company's ratings on stable outlook.

Liquidity and Capital Resources

The following section discusses the Company's sources and uses of liquidity. The Company's primary sources of liquidity include capital market debt issuance, private debt issuance, member loan principal repayments, member loan interest payments, a revolving bank line facility and member investments. The Company's primary uses of liquidity include loan advances, interest payments on debt, principal repayments on debt and patronage capital retirements. The Company believes that its sources of liquidity are adequate to cover the uses of liquidity.

Sources of Liquidity

Capital Market Debt Issuance

At May 31, 2008, the Company had effective registration statements for the issuance of $2,788 million of medium-term notes and $165 million of subordinated deferrable debt. The Company qualifies as a well-known seasoned issuer under SEC rules and filed an automatic shelf registration statement for collateral trust bonds in October 2007. This automatic shelf registration statement is effective for three years for an unlimited amount of collateral trust bonds. The Company has Board authorization to issue up to $1 billion of commercial paper and $4 billion of medium-term notes in the European market. The Company also has Board authorization to issue $2 billion of medium-term notes in the Australian market. At May 31, 2008, the Company has not utilized any of the European or Australian market authorizations. In addition, the Company has a commercial paper program under which it sells commercial paper to investors in the capital markets. The Company limits the amount of commercial paper that can be sold to the amount of backup liquidity available under the Company's revolving credit agreements. The Company

also obtains short-term funding from the sale of floating rate demand notes under its daily liquidity fund program. The registration statement for the daily liquidity fund program is effective for a three-year period ending April 2010 for a total of $20 billion with a limitation on the aggregate principal amount outstanding at one time of $3 billion.

Subsequent to fiscal year 2008, the Company issued $900 million of 5.50% collateral trust bonds due 2013 and $400 million of floating rate collateral trust bonds due 2010 in June 2008.

Private Debt Issuance

Beginning in fiscal year 2006, the Company made use of two sources of private debt issuance. In July 2005, the Company issued a total of $500 million of 4.656% notes to Farmer Mac which matured in July 2008. In March 2008, the Company issued to Farmer Mac $400 million of floating rate debt due in 2013. Both notes payable issued to Farmer Mac are secured by the pledge of mortgage notes in an amount at least equal to the principal balance of the notes outstanding. At May 31, 2008, the Company was also authorized to borrow up to $2.5 billion under FFB loan facilities with bond guarantee

agreements with RUS as part of the funding mechanism for the REDLG program, of which $2.5 billion was outstanding. National Rural is required to place on deposit mortgage notes in an amount at least equal to the principal balance of the notes outstanding.

On December 26, 2007, the President of the United States signed the Appropriations Act for Fiscal Year 2008 which provides $500 million in additional funding from the FFB with a guarantee of repayment by the RUS as part of the funding mechanism for REDLG. In May 2008, legislation was passed which removed a limitation based on the amount of loans the Company has issued on a concurrent basis with RUS. As a result, on May 28, 2008, National Rural submitted an application to borrow an additional $500 million available under FFB loan facilities.

Member Loan Repayments

There has been significant prepayment activity over the past three fiscal years in the telecommunications loan programs. It is not anticipated that there will be significant loan prepayments over the next few years. Amortization of the Company's long-term loans in each of the five fiscal years following May 31, 2008 and thereafter are as follows:

(in thousands)	Amortization (1)
2009	$ 800,630
2010	1,538,267
2011	839,040
2012	1,118,767
2013	805,275
Thereafter	12,234,899

(1) Represents scheduled amortization based on current rates without consideration for loans that reprice.

Member Loan Interest Payments

During the year ended May 31, 2008, interest income on the loan portfolio was $1,036 million, representing an average yield of 5.63% as compared to 5.61% and 5.28% for the years ended May 31, 2007 and 2006, respectively. At May 31, 2008, 81% of the total loans outstanding had a fixed rate of interest and 19% of loans outstanding had a variable rate of interest. At May 31, 2008, a total of 5% of loans outstanding were on a non-accrual basis with respect to the recognition of interest income.

Bank Revolving Credit Facility

The following is a summary of the Company's revolving credit agreements at May 31:

(Dollar amounts in thousands)	2008	2007	Termination Date	Facility fee per annum (1)
364-day agreement	$ -	$ 1,125,000	March 14, 2008	0.05 of 1%
Five-year agreement	1,125,000	1,125,000	March 16, 2012	0.06 of 1%
Five-year agreement	1,025,000	1,025,000	March 22, 2011	0.06 of 1%
364-day agreement (2)	1,500,000	-	March 13, 2009	0.05 of 1%
Total	$ 3,650,000	$ 3,275,000		

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

(2) Any amount outstanding under these agreements may be converted to a one-year term loan at the end of the revolving credit periods. If converted to a term loan, the fee on the outstanding principal amount of the term loan is

0.10 of 1% per annum.

Upfront fees of between 0.03 and 0.05 of 1% were paid to the banks based on their commitment level to the five-year agreements in place at May 31, 2008, totaling in aggregate $1 million, which will be amortized on a straight-line basis over the life of the agreements. Upfront fees were paid to the banks for their commitment to the 364-day facility in place at May 31, 2008, totaling $0.1 million, which will be amortized on a straight-line basis over the life of the agreement. Each agreement contains a provision under which if borrowings exceed 50% of total commitments, a utilization fee must be paid on the outstanding balance. The utilization fees are 0.05 of 1% for all three agreements in place at May 31, 2008.

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

For the purpose of calculating the required financial covenants contained in its revolving credit agreements, the Company adjusts net income, senior debt and total equity to exclude the non-cash adjustments related to SFAS 133 and SFAS 52, Foreign Currency Translation. The adjusted TIER, as defined by the agreements, represents the interest expense adjusted to include the derivative cash settlements, plus minority interest net income, plus net income prior to the cumulative effect of change in accounting principle and dividing that total by the interest expense adjusted to include the derivative cash settlements. In addition to the non-cash adjustments related to SFAS 133 and 52, senior debt also excludes RUS guaranteed loans, subordinated deferrable debt,

members' subordinated certificates and minority interest. Total equity is adjusted to include subordinated deferrable debt, members' subordinated certificates and minority interest. Senior debt includes guarantees; however, it excludes:

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

The following represents the Company's required and actual financial ratios under the revolving credit agreements at or for the year ended May 31:

		Actual	
	Requirement	2008	2007
Minimum average adjusted TIER over the six most recent fiscal quarters	1.025	1.16	1.09
Minimum adjusted TIER at fiscal year end (1)	1.05	1.15	1.12
Maximum ratio of senior debt to total equity	10.00	7.33	6.65

(1) The Company must meet this requirement in order 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 National Rural must be in compliance with their other requirements, including financial ratios, in order to draw down on the facilities.

Member Investments

At May 31, 2008 and 2007, members funded 19.7% and 20.9%, respectively, of total assets as follows:

	2008		2007		Increase/
(Dollar amounts in thousands)	Amount	% of Total (1)	Amount	% of Total (1)	(Decrease)
Commercial paper (2)	$1,403,960	46%	$1,633,653	59%	$(229,693)
Medium-term notes	392,739	8%	307,622	6%	85,117
Members' subordinated certificates	1,406,779	100%	1,381,447	100%	25,332
Members' equity (3)	613,082	100%	566,286	100%	46,796
Total	$3,816,560		$3,889,008		$(72,448)
Percentage of total assets	19.7%		20.9%		
Percentage of total assets less derivative assets (3)	19.9%		21.2%		

(1) Represents the percentage of each line item outstanding to the Company’s members.
(2) Includes $251 million and $250 million related to the daily liquidity fund at May 31, 2008 and 2007, respectively.
(3) See "Non-GAAP Financial Measures" for further explanation and a reconciliation of the adjustments made to total capitalization and a breakout of members' equity.

Uses of Liquidity

Loan Advances

Loan advances are the result of new loans approved to members and from the unadvanced portion of loans that were approved prior to May 31, 2008. At May 31, 2008, the Company had unadvanced loan commitments totaling $13,574

million. The Company does not expect to advance the full amount of the unadvanced commitments at May 31, 2008. 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 56% of the outstanding commitments at May 31, 2008 were for short-term or line of credit loans. The Company anticipates that over the next twelve months, loan advances will be approximately equal to the scheduled loan repayments.

Interest Expense on Debt

For the year ended May 31, 2008, interest expense on debt was $902 million, representing 4.90% of the average loan volume for which the debt was used as funding. The interest expense on debt represented 5.28% and 5.18% of the average loan volume for which the debt was used as funding for the years ended May 31, 2007 and 2006, respectively. At May 31, 2008, a total of 82% of outstanding debt had a fixed interest rate and 18% of outstanding debt 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 May 31, 2008 and thereafter is as follows:

(Dollar amounts in thousands)	Amount Maturing (1)	Weighted Average Interest Rate
2009	$ 3,185,351	3.77%
2010	1,895,923	5.18%
2011	578,508	4.46%
2012	1,568,240	7.13%
2013	454,843	3.47%
Thereafter	7,133,617	5.55%
Total	$14,816,482	5.18%

(1) Excludes loan subordinated certificates totaling $253 million that amortize annually based on the outstanding balance of the related loan. There are many items that impact the amortization of a loan, such as loan conversions, loan repricing at the end of an interest rate term and prepayments, thus an amortization schedule cannot be maintained for these certificates. Over the past three years, annual amortization on these certificates has averaged $30 million. In fiscal year 2008, amortization represented 12% of amortizing loan subordinated certificates outstanding.

Patronage Capital Retirements
The Company has made annual retirements of its allocated patronage capital in 28 of the last 29 years. In July 2008, the National Rural board of directors approved the allocation of a total of $103 million from fiscal year 2008 net earnings to the National Rural members. National Rural is scheduled to make a cash payment of $85 million to its members in September 2008 as retirement of 70% of the amount allocated for fiscal year 2008 and 1/9th of the amount allocated for fiscal years 1991, 1992 and 1993.

Market Risk

The Company's primary market risks are interest rate risk and liquidity risk. The Company is also exposed to counterparty risk as a result of entering into interest rate exchange agreements.

Interest Rate Risk
The interest rate risk exposure is related to the funding of the fixed rate loan portfolio. The Company does not match fund the majority of its fixed rate loans with a specific debt issuance at the time the loans are advanced. The Company aggregates fixed rate loans until the volume reaches a level that will allow an economically efficient issuance of debt. The Company uses fixed rate collateral trust bonds, medium-term notes, subordinated deferrable debt, members' subordinated certificates, members' equity and variable rate debt to fund fixed rate loans. The Company allows borrowers flexibility in the selection of the period for which 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. To mitigate interest rate risk in the funding of fixed rate loans, the Company performs a monthly gap analysis, a comparison of fixed rate assets repricing or maturing by year to fixed rate liabilities and members' equity maturing by year (see chart on page 47). 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 May 31, 2008 and 2007, 19% and 18%, respectively, of loans carried variable interest rates.

Matched Funding Policy

To monitor interest rate risk in the funding of fixed rate loans, the Company performs a monthly gap analysis (see chart on page 47). It is the Company's funding objective to manage the matched funding of asset and liability repricing terms within a range of 3% of total assets excluding derivative assets. At May 31, 2008, the Company had $15,203 million of fixed rate assets amortizing or repricing, funded by $13,124 million of fixed rate liabilities maturing during the next 30 years and $1,771 million of members' equity and members' subordinated certificates, a portion of which does not have a scheduled maturity. The difference of $308 million, or less than 2% 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. Fixed rate loans are funded with fixed rate collateral trust bonds, medium-term notes, long-term notes payable, subordinated deferrable debt, members' subordinated certificates and members' equity. With the exception of members' subordinated certificates, which are generally issued at rates below the Company's long-term cost of funding and with extended maturities, and commercial paper, the Company's liabilities have average maturities that closely match the repricing terms (but not the maturities) of its fixed interest rate loans. The Company also uses commercial paper supported by interest rate exchange agreements to fund its portfolio of fixed rate loans. Variable rate assets which reprice monthly or semi-monthly are funded with short-term liabilities, primarily commercial paper, collateral trust bonds, long-term notes payable and medium-term notes issued with a fixed rate and swapped to a variable rate, medium-term notes issued at a variable rate, subordinated certificates, members’ equity and bank bid notes. The schedule allows the Company to analyze the impact on the overall adjusted TIER of issuing a

certain amount of debt at a fixed rate for various maturities, prior to issuance of the debt. See "Non-GAAP Financial Measures" for further explanation and a reconciliation of the adjustments to TIER.

Certain of the Company's collateral trust bonds, subordinated deferrable debt and medium-term notes were issued with early redemption provisions. To the extent borrowers are allowed to convert their fixed rate loans to a variable interest rate and to the extent it is beneficial, the Company takes advantage of these early redemption provisions. However, because conversions and prepayments can take place at different intervals from early redemptions, the Company charges conversion fees designed to compensate for any additional interest rate risk it assumes.

The following chart shows the scheduled amortization and repricing of fixed rate assets and liabilities outstanding at May 31, 2008.

INTEREST RATE GAP ANALYSIS
(Fixed Rate Assets/Liabilities)
As of May 31, 2008

(Dollar amounts in millions)	May 31, 2009 or prior	June 1, 2009 to May 31, 2011	June 1, 2011 to May 31, 2013	June 1, 2013 to May 31, 2018	June 1, 2018 to May 31, 2028	Beyond June 1, 2028	Total
Assets:							
Amortization and repricing	$2,044	$3,437	$2,784	$3,359	$2,622	$ 957	$15,203
Total assets	$2,044	$3,437	$2,784	$3,359	$2,622	$ 957	$15,203
Liabilities and members' equity:							
Long-term debt	$1,766	$3,103	$3,455	$3,763	$ 782	$ 255	$13,124
Subordinated certificates	26	55	79	67	535	490	1,252
Members' equity (1)	15	25	31	127	109	212	519
Total liabilities and members' equity	$ 1,807	$ 3,183	$ 3,565	$ 3,957	$ 1,426	$ 957	$ 14,895
Gap (2)	$ 237	$ 254	$ (781)	$ (598)	$1,196	$ -	$ 308
Cumulative gap	$ 237	$ 491	$ (290)	$ (888)	$ 308	$ 308	
Cumulative gap as a % of total assets	1.22%	2.53%	(1.50)%	(4.58)%	1.59%	1.59%	
Cumulative gap as a % of adjusted total assets (3)	1.24%	2.56%	(1.51)%	(4.63)%	1.61%	1.61%	

(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 National Rural uses members' equity in its analysis of the funding of its loan portfolio.
(2) Assets less liabilities and members' equity.
(3) Adjusted total assets represents total assets in the consolidated balance sheet less derivative assets.

Use of Derivatives
At May 31, 2008 and 2007, the Company was a party to interest rate exchange agreements with a total notional amount of $12,916 million and $12,533 million, respectively. The Company uses interest rate exchange agreements as part of its overall interest rate matching strategy. Interest rate exchange agreements are used when they provide a

lower cost of funding or minimize interest rate risk. The Company will enter into interest rate exchange agreements only with highly rated financial institutions. National Rural used interest rate exchange agreements to synthetically change the interest rate from a variable rate to a fixed rate on $7,660 million as of May 31, 2008 and $7,277 million as of May 31, 2007 of debt used to fund long-term fixed rate loans. Interest rate exchange agreements were used to synthetically change the interest rates from fixed to variable on $5,256 million of long-term debt as of May 31, 2008 and 2007. The Company has not invested in derivative financial instruments for trading purposes in the past and does not anticipate doing so in the future.

At May 31, 2008 and 2007, there were no foreign currency exchange agreements outstanding.

Counterparty Risk

The Company is exposed to counterparty risk related to the performance of the parties with which it has entered into interest rate exchange agreements. To mitigate this risk, the Company only enters into these agreements with financial institutions with investment grade ratings. At May 31, 2008 and 2007, the Company was a party to interest rate exchange agreements with notional amounts totaling $12,916 million and $12,533 million, respectively. To date, the Company has not experienced a failure of a counterparty to perform as required under any of these agreements. At the time counterparties are selected to participate in the Company's exchange agreements, the counterparty must be a participant in one of its revolving credit agreements. At May 31, 2008, the Company's interest rate exchange agreement counterparties had credit ratings ranging from AAA to A- as assigned by Standard & Poor's Corporation.

The Company currently uses two types of interest rate exchange agreements: (1) the Company pays a fixed rate and receives a variable rate and (2) the Company pays a variable rate and receives a fixed rate. The following chart provides a breakout of the interest rate exchange agreements at May 31, 2008 by type of agreement.

(Dollar amounts in thousands)	Notional Amount	Weighted Average Rate Paid	Weighted Average Rate Received
Pay fixed / receive variable	$ 7,659,973	4.59%	2.64%
Pay variable / receive fixed	5,256,440	3.50%	6.15%
Total	$12,916,413	4.15%	4.07%

Foreign Currency Risk

The Company may issue commercial paper, medium-term notes or bonds denominated in foreign currencies. At May 31, 2008 and 2007, there was no foreign denominated debt outstanding. When the Company issues foreign denominated debt, it typically mitigates foreign currency risk by entering into an exchange agreement to lock in the exchange rate for all interest and principal payments through maturity.

Rating Triggers

The Company has certain interest rate exchange agreements that contain a condition that will allow one counterparty to terminate the agreement if the credit rating of the other counterparty drops to a certain level. This condition is commonly called a rating trigger. Under the rating trigger, if the credit rating for either counterparty falls to the level specified in the agreement, the other counterparty may, but is not obligated to, terminate the agreement. If either counterparty terminates the agreement, a net payment may be due from one counterparty to the other based on the fair value of the underlying derivative instrument. Rating triggers are not separate financial instruments and are not separate derivatives under SFAS 133.

At May 31, 2008, the Company had the following notional amount and fair values associated with exchange agreements that contain rating triggers. For the purpose of the presentation, the Company has grouped the rating triggers into two categories: (1) ratings from Moody's Investors Service falls to Baa1 or from Standard & Poor's Corporation falls to BBB+ and (2) ratings from Moody's Investors Service falls below Baa1 or from Standard & Poor's Corporation falls below BBB+. In calculating the required payments and collections required upon termination, the Company netted the agreements for each counterparty, as allowed by the underlying master agreement.

(in thousands)	Notional Amount	Required Company Payment	Amount Company Would Collect	Net Total
Rating Level:				
Fall to Baa1/BBB+	$ 1,851,658	$ (637)	$ 38,492	$ 37,855
Fall below Baa1/BBB+	7,028,358	(31,472)	30,584	(888)
Total	$ 8,880,016	$ (32,109)	$ 69,076	$ 36,967

See chart on page 43 for National Rural's senior unsecured credit ratings as of May 31, 2008.

In addition to the rating triggers listed above, at May 31, 2008, the Company had $717 million of notional amount of exchange agreements, with one counterparty, that would require the pledging of collateral in an amount equal to the

fair value of the exchange agreements if the Company's senior secured ratings from Moody's Investors Service fall below Baa2 or from Standard & Poor's Corporation fall below BBB. At May 31, 2008, the net obligation totaled $9 million for the $717 million notional amount of exchange agreements subject to this rating trigger.

Liquidity Risk

The Company faces liquidity risk in the funding of its loan portfolio and refinancing its maturing obligations. The Company offers 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, the Company offers a variety of interest rate options including the ability to fix the interest rate for terms of one year through maturity. At May 31, 2008, the Company has a total of $3,177 million of long-term debt maturing during the next twelve months. The Company funds the loan portfolio with a variety of debt instruments and its members' equity. The Company typically does not match fund each of its loans with a debt instrument of similar final maturity. Debt instruments such as subordinated certificates have maturities that vary from the term of the associated loan or guarantee to 100 years and subordinated deferrable debt has been issued with maturities of up to 49 years.

The Company may issue collateral trust bonds and medium-term notes for periods of up to 30 years, but typically issues such debt instruments with maturities of 2, 3, 5, 7 and 10 years. Debt instruments such as commercial paper and bank bid notes typically have maturities of 90 days or less. Therefore, the Company is at risk if it is not able to issue new debt instruments to replace debt

that matures prior to the maturity of the loans for which they are used as funding. Factors that mitigate liquidity risk include the Company 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. At May 31, 2008 and 2007, the Company had a total of $3,650 million and $3,275 million, respectively, in revolving credit agreements and bank lines of credit. In addition, the Company limits the amount of dealer commercial paper and bank bid notes used in the funding of loans. The Company's objective is to maintain the amount of dealer commercial paper and bank bid notes used to 15% or less of total debt outstanding. At May 31, 2008 and 2007, there was a total of $1,612 million and $1,118 million, respectively, of dealer commercial paper and bank bid notes outstanding, representing 9% and 6%, respectively, of the Company's total debt outstanding.

National Rural continues to see significant investment support from its members with $3.2 billion of commercial paper, daily liquidity fund, medium-term notes and subordinated certificate investments outstanding at May 31, 2008. The member debt investments represented 18% of the total debt outstanding at May 31, 2008. In addition, National Rural had a total of $3.5 billion of privately placed debt outstanding at May 31, 2008, $2.5 billion of which was guaranteed by the U.S. Government under the REDLG program. The private placements of debt represented 19% of total debt outstanding at May 31, 2008. National Rural did not experience any difficulty issuing its commercial paper in the capital markets during fiscal year 2008, although there was a slight widening of the spread demanded by investors at certain times during the year. NCSC did experience some issues with the issuance of its commercial paper, which carries a guarantee from National Rural. Due to the significant increase in spread demanded by investors, NCSC was limited to issuing very short maturities for a period of time during the year ended May 31, 2008. The slightly higher spread paid on dealer commercial paper did not have a significant impact on National Rural's funding cost, as dealer commercial paper represented 8% of total debt at May 31, 2008. At the time of this filing, neither National Rural or NCSC are experiencing any difficulties issuing commercial paper and current spreads are consistent with National Rural’s historic trading levels.

At May 31, 2008, the Company was the guarantor and liquidity provider for $330 million of tax-exempt bonds issued for its member cooperatives. A total of $133 million of such tax-exempt bonds were in flexible and weekly mode, which reprice every seven to thirty-five days. A total of $120 million of such tax-exempt bonds reprice semi-annually. A total of $77 million of such bonds were in unit price mode and reprice approximately every 30 days. National Rural has not been required to purchase any of the bonds in its role as liquidity provider. In addition to these tax-exempt bonds, National Rural was the guarantor, but not liquidity provider, for $155 million of tax-exempt bonds that were in the auction rate mode. National Rural has not been required to perform under the guarantee of its members’ tax-exempt bonds.

For additional information about the risks related to the Company's business, see Item 1A. "Risk Factors".

Financial Instruments and Derivatives

All financial instruments to which the Company was a party at May 31, 2008 were entered into or contracted for purposes other than trading. The following table provides the significant balances and contract terms related to the financial instruments at May 31, 2008.

(Dollar amounts in millions)	Outstanding		Principal Amortization and Maturities					Remaining
Instrument	Balance	Fair Value	2009	2010	2011	2012	2013	Years
Assets:								
Long-term fixed rate loans (1)	15,141	14,384	704	933	718	1,046	718	11,022
Average rate	6.17%		5.98%	5.96%	6.03%	6.07%	6.04%	6.22%
Long-term variable rate loans (2)	1,103	1,103	76	117	106	57	71	676
Average rate (3)	5.15%		-	-	-	-	-	-
Short-term loans (4)	1,664	1,664	1,664	-	-	-	-	-
Average rate (3)	4.23%		4.23%	-	-	-	-	-
RUS Guaranteed FFB Refinance	35	35	2	3	3	3	3	21
Average rate (3)	2.46%		-	-	-	-	-	-
Non-performing loans (5)	507	281	8	499	-	-	-	-
Average rate (5)	-		-	-	-	-	-	-
Restructured loans (5)	577	377	12	12	12	13	13	515
Average rate (5)	0.60%		-	-	-			