NATIONAL RURAL UTILITIES COOPERATIVE FINANCE CORP /DC/
Form 10-Q
October 13, 2010

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

FORM 10-Q

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF
THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended August 31, 2010

OR

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

Commission File Number 1-7102

NATIONAL RURAL UTILITIES COOPERATIVE
FINANCE CORPORATION

(Exact name of registrant as specified in its charter)

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

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

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

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

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of “large accelerated filer,” “accelerated filer,” and “smaller reporting company” in Rule 12b-2 of the Exchange Act. (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 tax-exempt cooperative and consequently is unable to issue any equity capital stock.

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PART 1. FINANCIAL INFORMATION

Item 1. Financial Statements.

NATIONAL RURAL UTILITIES COOPERATIVE FINANCE CORPORATION

CONDENSED CONSOLIDATED BALANCE SHEETS
(UNAUDITED)
(in thousands)

A S S E T S

	August 31, 2010	May 31, 2010
Cash and cash equivalents	$ 450,665}	$ 513,906}
Restricted cash	13,266}	15,709}
Investments in equity securities	58,236}	58,607}
Loans to members	19,295,792}	19,342,704}
Less: Allowance for loan losses	(580,539)	(592,764)
Loans to members, net	18,715,253}	18,749,940}
Accrued interest and other receivables	216,195}	216,650}
Fixed assets, net	58,003}	55,682}
Debt service reserve funds	45,662}	45,662}
Debt issuance costs, net	44,511}	46,562}
Foreclosed assets, net	38,121}	42,252}
Derivative assets	484,528}	373,203}
Other assets	27,835}	25,042}
	$ 20,152,275}	$ 20,143,215}

See accompanying notes.

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NATIONAL RURAL UTILITIES COOPERATIVE FINANCE CORPORATION

CONDENSED CONSOLIDATED BALANCE SHEETS
(UNAUDITED)
(in thousands)

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

	August 31, 2010	May 31, 2010
Short-term debt	$ 4,584,346}	$ 4,606,361}
Accrued interest payable	311,951}	214,072}
Long-term debt	11,996,097}	12,054,497}
Patronage capital retirement payable	50,843}	-}
Deferred income	16,157}	17,001}
Guarantee liability	22,102}	22,984}
Other liabilities	47,017}	36,553}
Derivative liabilities	668,108}	482,825}
Subordinated deferrable debt	186,440}	311,440}
Members' subordinated certificates:		
Membership subordinated certificates	643,252}	643,211}
Loan and guarantee subordinated certificates	735,344}	769,654}
Member capital securities	397,850}	397,850}
Total members' subordinated certificates	1,776,446}	1,810,715}
Commitments and contingencies		
CFC equity:		
Retained equity	480,274}	568,577}
Accumulated other comprehensive income	7,479}	8,004}
Total CFC equity	487,753}	576,581}
Noncontrolling interest	5,015}	10,186}
Total equity	492,768}	586,767}
	$ 20,152,275}	$ 20,143,215}

See accompanying notes.

NATIONAL RURAL UTILITIES COOPERATIVE FINANCE CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(UNAUDITED)
(in thousands)

	Three months ended August 31, 2010	2009
Interest income	$ 251,053}	$ 269,457
Interest expense	(219,512)	(242,629)
Net interest income	31,541}	26,828
Recovery of loan losses	12,288}	16,171
Net interest income after recovery of loan losses	43,829}	42,999
Non-interest income:		
Fee and other income	10,292}	3,734
Derivative losses	(78,254)	(14,328)
Results of operations of foreclosed assets	184}	587
Total non-interest income	(67,778)	(10,007)
Non-interest expense:		
Salaries and employee benefits	(13,026)	(9,918)
Other general and administrative expenses	(8,287)	(7,108)
Recovery of guarantee liability	548}	2,395
Market adjustment on foreclosed assets	(315)	(1,750)
Other	(96)	(146)
Total non-interest expense	(21,176)	(16,527)
(Loss) income prior to income taxes	(45,125)	16,465
Income tax benefit (expense)	2,780}	(32)
Net (loss) income	(42,345)	16,433
Less: Net loss (income) attributable to the noncontrolling interest	5,149}	(191)
Net (loss) income attributable to CFC	$ (37,196)	$ 16,242

See accompanying notes.

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NATIONAL RURAL UTILITIES COOPERATIVE FINANCE CORPORATION

CONDENSED CONSOLIDATED STATEMENT OF CHANGES IN EQUITY
(UNAUDITED)
(in thousands)

	Total	Noncontrolling Interest	Total CFC Equity	Accumulated Other Comprehensive Income	CFC Retained Equity	Unallocated Net Loss	Members' Capital Reserve	Patronage Capital Allocated	Membe Fees Educa Fur
Balance as of May 31, 2010	$ 586,767}	$ 10,186}	$ 576,581}	$ 8,004}	$ 568,577}	$ (106,984)	$ 191,993}	$ 481,120}	$ 2
Patronage capital retirement	(50,843)	-}	(50,843)	-}	(50,843)	-}	-}	(50,843)	
Net loss	(42,345)	(5,149)	(37,196)	-}	(37,196)	(37,196)	-}	-}	
Other comprehensive loss	(532)	(7)	(525)	(525)	-}	-}	-}	-}	
Total comprehensive loss	(42,877)	(5,156)	(37,721)						
Other	(279)	(15)	(264)	-}	(264)	-}	-}	-}	
Balance as of August 31, 2010	$ 492,768}	$ 5,015}	$ 487,753}	$ 7,479}	$ 480,274}	$ (144,180)	$ 191,993}	$ 430,277}	$ 2

See accompanying notes.

NATIONAL RURAL UTILITIES COOPERATIVE FINANCE CORPORATION

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

	Three months ended August 31, 2010	2009
CASH FLOWS FROM OPERATING ACTIVITIES		
Net (loss) income	$ (42,345)	$ 16,433
Adjustments to reconcile net (loss) income to net cash provided by operating activities		
Amortization of deferred income	(1,914)	(1,463)
Amortization of debt issuance costs and deferred charges	3,154}	5,419
Depreciation	488}	596
Recovery of loan losses	(12,288)	(16,171)
Recovery of guarantee liability	(548)	(2,395)
Results of operations of foreclosed assets	(184)	(587)
Market adjustment on foreclosed assets	315}	1,750
Derivative forward value	73,792}	10,834
Changes in operating assets and liabilities:		
Accrued interest and other receivables	(4,558)	20,380
Accrued interest payable	97,879}	63,486
Other	10,170}	14,065
Net cash provided by operating activities	123,961}	112,347
CASH FLOWS FROM INVESTING ACTIVITIES		
Advances made on loans	(2,336,684)	(1,666,956)
Principal collected on loans	2,338,873}	1,699,490
Net investment in fixed assets	(2,809)	(2,252)
Net cash provided by foreclosed assets	4,000}	-
Net proceeds from sale of loans	44,665}	28,626
Investments in equity securities	-}	(25,000)
Change in restricted cash	2,443}	4,935
Net cash provided by investing activities	50,488}	38,843
CASH FLOWS FROM FINANCING ACTIVITIES		
Proceeds from issuances of short-term debt, net	423,793}	687,624

Proceeds from issuance of long-term debt, net	61,082}	789,482
Payments for retirement of long-term debt	(708,045)	(1,669,172)
Proceeds from issuance of members' subordinated certificates	4,517}	72,795
Payments for retirement of members' subordinated certificates	(19,037)	(10,392)
Net cash used in financing activities	(237,690)	(129,663)
NET (DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS	(63,241)	21,527
BEGINNING CASH AND CASH EQUIVALENTS	513,906}	504,999
ENDING CASH AND CASH EQUIVALENTS	$ 450,665}	$ 526,526

See accompanying notes.

NATIONAL RURAL UTILITIES COOPERATIVE FINANCE CORPORATION

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

	Three months ended August 31, 2010	2009
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION		
Cash paid for interest	$ 118,479	$ 173,725
Cash paid for income taxes (1)	104	-
Non-cash financing and investing activities:		
Increase to patronage capital retirement payable	$ 50,843	$ 41,400
Net decrease in debt service reserve funds/debt service reserve certificates	-	(1,113)

(1) Relates to income taxes paid for National Cooperative Services Corporation.

See accompanying notes.

NATIONAL RURAL UTILITIES COOPERATIVE FINANCE CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)

(1) General Information and Accounting Policies

(a) Basis of Presentation

The accompanying financial statements include the consolidated accounts of National Rural Utilities Cooperative Finance Corporation ("CFC"), Rural Telephone Finance Cooperative ("RTFC") and National Cooperative Services Corporation ("NCSC") and certain entities created and controlled by CFC to hold foreclosed assets and accommodate loan securitization transactions, after elimination of intercompany accounts and transactions.

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

The preparation of financial statements in conformity with accounting principles generally accepted in the United States ("GAAP") requires management to make estimates and assumptions that affect the assets, liabilities, revenue and expenses reported in the financial statements, as well as amounts included in the notes thereto, including discussion and disclosure of contingent liabilities. The accounting estimates that require our most significant and subjective judgments include the allowance for loan losses and the determination of the fair value of our derivatives and foreclosed assets. While we use our best estimates and judgments based on the known facts at the date of the financial statements, actual results could differ from these estimates as future events occur.

These interim unaudited consolidated financial statements should be read in conjunction with the audited consolidated financial statements and notes thereto included in our Annual Report on Form 10-K for the fiscal year ended May 31, 2010.

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

(b) Variable Interest Entities

We are required to consolidate the financial results of RTFC and NCSC because CFC is the primary beneficiary of variable interests in RTFC and NCSC due to its exposure to absorbing the majority of their expected losses and because CFC manages the lending activities of RTFC and NCSC. Under separate guarantee agreements, RTFC and NCSC pay CFC a fee to indemnify loan losses, excluding losses in NCSC's consumer loan program. CFC manages the lending activities of RTFC and NCSC through separate management agreements. Additionally, CFC is the sole lender to RTFC and the primary source of funding to NCSC. NCSC funds its lending programs either through loans from CFC or commercial paper and long-term notes issued by NCSC and guaranteed by CFC.

RTFC and NCSC creditors have no recourse against CFC in the event of a default by RTFC and NCSC, unless there is a guarantee agreement under which CFC has guaranteed NCSC or RTFC debt obligations to a third party. At August 31, 2010, CFC had guaranteed $365 million of NCSC debt, derivative instruments and guarantees with third parties, and CFC's maximum potential exposure for these instruments totaled $379 million. The maturities for NCSC obligations guaranteed by CFC run through 2031. Guarantees of NCSC debt and derivative instruments are not included in Note 9, Guarantees, as the debt and derivatives are reported on the consolidated balance sheet. At August

31, 2010, CFC guaranteed $0.6 million of RTFC guarantees with third parties. The maturities for RTFC obligations guaranteed by CFC run through 2011. All CFC loans to RTFC and NCSC are secured by all assets and revenue of RTFC and NCSC. At August 31, 2010, RTFC had total assets of $1,608 million including loans outstanding to members of $1,434 million, and NCSC had total assets of $461 million including loans outstanding of $413 million. At August 31, 2010, CFC had committed to lend RTFC up to $4,000 million, of which $1,426 million was outstanding. Effective June 1, 2010, CFC’s commitment to NCSC increased from $1,500 million at May 31, 2010 to $2,000 million. At August 31, 2010, CFC had committed to provide up to $2,000 million of credit to NCSC, of which $503 million was outstanding, representing $138 million of outstanding loans and $365 million of credit enhancements.

(c) Reclassifications

Reclassifications of prior period amounts have been made to conform to the current reporting format and the presentation in our Form 10-K for the year ended May 31, 2010. Derivative forward value loss totaling $11 million and derivative cash settlements loss totaling $3 million for the three months ended August 31, 2009 have been reclassified to derivative losses in non-interest income on the consolidated statements of operations. The derivative forward value was classified in non-interest expense and the derivative cash settlements were classified in non-interest income in the August 31, 2009 10-Q. These reclassifications were made to present the unrealized and realized gains and losses on our derivatives in the same line on the statement of operations.

(d) Interest Income

Interest income on loans is recognized using the effective interest method. The following table presents the components of interest income:

	For the three months ended August 31,	
(dollar amounts in thousands)	2010	2009
Interest on long-term fixed-rate loans (1)	$ 222,969}	$ 223,526
Interest on long-term variable-rate loans (1)	12,656}	26,565
Interest on short-term loans (1)	11,977}	16,035
Interest on investments (2)	1,030}	1,657
Fee income	2,421}	1,674
Total interest income	$ 251,053}	$ 269,457

(1) Represents interest income on loans to members.
(2) Represents interest income on the investment of cash, debt securities and equity securities.

Deferred income on the consolidated balance sheets primarily includes deferred conversion fees totaling $11 million and $12 million at August 31, 2010 and May 31, 2010, respectively.

(e) Interest Expense

The following table presents the components of interest expense:

	For the three months ended August 31,	
(dollar amounts in thousands)	2010	2009
Interest expense on debt (1):		
Commercial paper and bank bid notes	$ 1,723}	$ 3,222
Medium-term notes	63,104}	84,595
Collateral trust bonds	78,549}	78,593
Subordinated deferrable debt	4,916}	4,916
Subordinated certificates	20,306}	19,020
Long-term private debt	45,992}	45,986
Debt issuance costs (2)	2,577}	2,980
Fee expense (3)	2,345}	3,317
Total interest expense	$ 219,512}	$ 242,629

(1) Represents interest expense and the amortization of discounts on debt.
(2) Includes amortization of all deferred charges related to the issuance of debt, principally underwriter's fees, legal fees, printing costs and comfort letter fees. Amortization is calculated using the effective interest method. Also includes issuance costs related to dealer commercial paper, which are recognized as incurred.
(3) Includes various fees related to funding activities, including fees paid to banks participating in our revolving credit agreements. Fees are recognized as incurred or amortized on a straight-line basis over the life of the respective agreement.

We exclude indirect costs, if any, related to funding activities from interest expense.

(f) Loan Sales

During the three months ended August 31, 2010, we sold distribution loans with outstanding principal balances totaling
$45 million at par to the Federal Agricultural Mortgage Corporation for cash. We recorded a loss on sale of loans totaling $0.01 million, representing the unamortized deferred loan origination costs and transaction costs for the loans sold in the first quarter of fiscal year 2011. We do not hold any continuing interest in the loans sold and have no obligation to repurchase loans from the purchaser; however, we retain the servicing rights on these loans in return for a market-based fee. As a result, we did not record a servicing asset or liability.

(g) New Accounting Pronouncements

During the three months ended August 31, 2010, we did not change or adopt any new accounting policies that had a material effect on our consolidated financial condition or results of operations.

(2) Loans and Commitments

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

	August 31, 2010		May 31, 2010	
(dollar amounts in thousands)	Loans Outstanding	Unadvanced Commitments	Loans Outstanding	Unadvanced Commitments
Total by loan type (1) (2):				
Long-term fixed-rate loans (3)	$ 15,559,047}	$ -}	$ 15,412,987}	$ -}
Long-term variable-rate loans (3)	1,894,966}	5,276,930}	2,088,829}	5,154,990}
Loans guaranteed by RUS (4)	236,274}	-}	237,356}	-}
Short-term loans	1,600,476}	8,792,791}	1,599,233}	9,039,448}
Total loans outstanding	19,290,763}	14,069,721}	19,338,405}	14,194,438}
Deferred origination costs	5,029}	-}	4,299}	-}
Less: Allowance for loan losses	(580,539)	-}	(592,764)	-}
Net loans outstanding	$ 18,715,253}	$ 14,069,721}	$ 18,749,940}	$ 14,194,438}
Total by segment (1):				
CFC:				
Distribution	$ 13,694,652}	$ 9,527,888}	$ 13,459,053}	$ 9,536,360}
Power supply	3,657,507}	3,481,966}	3,769,794}	3,599,560}
Statewide and associate	91,312}	100,170}	86,182}	112,812}
CFC total	17,443,471}	13,110,024}	17,315,029}	13,248,732}
RTFC	1,433,788}	426,486}	1,671,893}	441,719}
NCSC	413,504}	533,211}	351,483}	503,987}
Total loans outstanding	$ 19,290,763}	$ 14,069,721}	$ 19,338,405}	$ 14,194,438}

(1) Includes non-performing and restructured loans.
(2) Loans are classified as long-term or short-term based on their original maturity.
(3) Because the interest rate on unadvanced commitments is not set until drawn, long-term unadvanced loan commitments have been classified in this table as variable-rate unadvanced commitments. However, at the time of the advance, the borrower may select a fixed or a variable rate on the new loan.
(4) "RUS" is the Rural Utilities Service.

Non-Performing and Restructured Loans

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

	August 31, 2010		May 31, 2010	
(dollar amounts in thousands)	Loans Outstanding	Unadvanced Commitments (1)	Loans Outstanding	Unadvanced Commitments (1)
Non-performing and restructured loans:				
Non-performing loans (2):				
CFC:				

Long-term variable-rate loans	$ 8,280}	$ -}	$ 8,500}	$ -
Short-term loans	18,413}	-}	16,000}	-
RTFC:				
Long-term fixed-rate loans (3)	8,960}	-}	8,960}	-
Long-term variable-rate loans (3)	471,293}	3,182}	469,596}	677
Short-term loans	57,471}	-}	57,471}	-
Total non-performing loans	$ 564,417}	$ 3,182}	$ 560,527}	$ 677
Restructured loans (2):				
CFC:				
Long-term fixed-rate loans (3)	$ 40,708}	$ -}	$ 41,538}	$ -}
Long-term variable-rate loans (3)	455,290}	140,755}	462,397}	140,755}
Short-term loans	-}	12,500}	-}	12,500}
RTFC:				
Long-term fixed-rate loans	-}	-}	3,293}	-}
Long-term variable-rate loans	-}	-}	816}	-}
Total restructured loans	$ 495,998}	$ 153,255}	$ 508,044}	$ 153,255}

(1) Before advancing funds, additional information may be required to assure that all conditions for the advance of funds have been fully met and there has been no material change in the member's condition as represented in the supporting documents. Collateral and security requirements for advances on commitments are identical to those required at the time of the initial loan approval.
(2) Loans are classified as long-term or short-term based on their original maturity.
(3) Because the interest rate on unadvanced commitments is not set until drawn, long-term unadvanced loan commitments have been classified in this table as variable-rate unadvanced commitments. However, at the time of the advance, the borrower may select a fixed or a variable rate on the new loan.

Loan Loss Allowance

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

Activity in the loan loss allowance account is summarized below:

	As of and for the three months ended August 31,	
(dollar amounts in thousands)	2010	2009
Balance at beginning of period	$ 592,764}	$ 622,960}
Recovery of loan losses	(12,288)	(16,171)
Charge-offs	(9)	(23)
Recoveries	72}	73}
Balance at end of period	$ 580,539}	$ 606,839}
As a percentage of total loans outstanding	3.01}%	3.02}%

Loan Security

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

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

(dollar amounts in thousands)	August 31, 2010				May 31, 2010			
Total by loan type:	Secured	%	Unsecured	%	Secured	%	Unsecured	%
Long-term fixed-rate loans	$ 14,846,187}	95%	$ 712,860}	5 %	$ 14,799,859	96%	$ 613,128}	4 %
Long-term variable-rate loans	1,802,675}	95	92,291}	5	1,994,664	95	94,165}	5
Loans guaranteed by RUS	236,274}	100	-}	-	237,356	100	-}	-
Short-term loans	191,916}	12	1,408,560}	88	265,427	17	1,333,806}	83
Total loans	$ 17,077,052}	89	$ 2,213,711}	11	$ 17,297,306	89	$ 2,041,099}	11
Total by segment:								
CFC	$ 15,566,281}	89%	$ 1,877,190}	11%	$ 15,585,788	90%	$ 1,729,241}	10%
RTFC	1,203,487}	84	230,301}	16	1,429,982	86	241,911}	14
NCSC	307,284}	74	106,220}	26	281,536	80	69,947}	20
Total loans	$ 17,077,052}	89	$ 2,213,711}	11	$ 17,297,306	89	$ 2,041,099}	11

Pledging of Loans and Loans on Deposit

The following table summarizes our collateral pledged to secure our collateral trust bonds, Clean Renewable Energy Bonds and notes payable to the Federal Agricultural Mortgage Corporation (see Note 5, Long-Term Debt) and the amount of the corresponding debt outstanding:

(dollar amounts in thousands)	August 31, 2010	May 31, 2010
Collateral trust bonds:		
2007 indenture		
Distribution system mortgage notes	$ 3,907,711}	$ 3,951,445
Collateral trust bonds outstanding	3,100,000}	3,500,000
1994 indenture		
Distribution system mortgage notes	$ 2,041,095}	$ 2,081,716
RUS guaranteed loans qualifying as permitted investments	206,054}	207,136
Total pledged collateral	$ 2,247,149}	$ 2,288,852
Collateral trust bonds outstanding	1,980,000}	1,980,000
1972 indenture		
Cash	$ 2,032}	$ 2,032
Collateral trust bonds outstanding	1,731}	1,736
Federal Agricultural Mortgage Corporation:		
Distribution and power supply system mortgage notes	$ 1,939,865}	$ 2,094,604
Notes payable outstanding	1,487,200}	1,587,200
Clean Renewable Energy Bonds Series 2009A:		
Distribution and power supply system mortgage notes	$ 36,281}	$ 33,895
Cash	10,487}	12,913
Total pledged collateral	$ 46,768}	$ 46,808
Notes payable outstanding	27,101}	27,101

The following table shows the collateral on deposit and the amount of the corresponding debt outstanding for the notes payable to the Federal Financing Bank of the United States Treasury issued under the Guaranteed Underwriter program of the U.S. Department of Agriculture, which supports the Rural Economic Development Loan and Grant program (see Note 5, Long-Term Debt):

(dollar amounts in thousands)	August 31, 2010	May 31, 2010
Distribution and power supply system mortgage notes on deposit	$ 3,545,525}	$ 3,559,863
Notes payable	3,000,000}	3,000,000

(3) Foreclosed Assets

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

The activity for foreclosed assets is summarized below:

	As of and for the three months ended August 31,	
(dollar amounts in thousands)	2010	2009
Beginning balance	$ 42,252}	$ 48,721}
Results of operations	184}	587}
Net cash provided by foreclosed assets	(4,000)	-}
Market adjustment	(315)	(1,750)
Ending balance	$ 38,121}	$ 47,558}

Foreclosed assets at August 31, 2010 included one land development loan, limited partnership interests in certain real estate developments and developed lots and land, raw land and underground mineral rights. During the three months ended August 31, 2010, we foreclosed on one of the land development loans included in foreclosed assets at May 31, 2010 and took ownership of the underlying assets. Additionally, we sold collateral for the remaining land development loan for $4 million, net of estimated closing costs. This land development loan was classified as impaired and on non-accrual status with regard to the recognition of interest income at August 31, 2010 and May 31, 2010.

(4) Short-Term Debt and Credit Arrangements

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

(dollar amounts in thousands)	August 31, 2010	May 31, 2010
Short-term debt:		
Commercial paper sold through dealers, net of discounts	$ 1,174,380}	$ 840,082}
Commercial paper sold directly to members, at par	1,119,327}	999,449}
Commercial paper sold directly to non-members, at par	54,414}	52,989}
Total commercial paper	2,348,121}	1,892,520}
Daily liquidity fund sold directly to members	339,903}	371,710}
Bank bid notes	30,000}	30,000}
Subtotal short-term debt	2,718,024}	2,294,230}
Long-term debt maturing within one year:		
Medium-term notes sold through dealers	639,951}	693,522}
Medium-term notes sold to members	494,827}	529,215}
Secured collateral trust bonds	506,681}	906,537}
Subordinated deferrable debt (1)	125,000}	-}
Members' subordinated certificates	17,002}	-}
Secured notes payable	78,207}	178,207}
Unsecured notes payable	4,654}	4,650}
Total long-term debt maturing within one year	1,866,322}	2,312,131}
Total short-term debt	$ 4,584,346}	$ 4,606,361}

(1) Amount was redeemed in September 2010.

Revolving Credit Agreements

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

(dollar amounts in thousands)	August 31, 2010	May 31, 2010	Termination Date	Facility fee per year (1)
Five-year agreement (2)	$ 1,049,000	$ 1,049,000	March 16, 2012	6 basis points
Five-year agreement (2)	967,313	967,313	March 22, 2011	6 basis points
Three-year agreement (3)	1,332,425	1,334,309	March 8, 2013	25 basis points
Total	$ 3,348,738	$ 3,350,622		

(1) Facility fee determined by CFC's senior unsecured credit ratings based on the pricing schedules put in place at the inception of the related agreement.
(2) Amounts as of both periods exclude Lehman Brothers Bank, FSB's portion of the credit facility totaling $134 million allocated as follows: $76 million under the five-year facility maturing in 2012 and $58 million under the five-year facility maturing in 2011. These amounts were assigned to NCSC in September 2009 by Lehman Brothers Bank, FSB and are eliminated in consolidation.
(3) The available amount presented at August 31, 2010 and May 31, 2010 is reduced by total letters of credit outstanding of $2.6 million and $0.7 million, respectively.

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

		Actual	
	Requirement	August 31, 2010	May 31, 2010
Minimum average adjusted TIER over the six most recent fiscal quarters (1)	1.025	1.12	1.25
Minimum adjusted TIER for the most recent fiscal year (1) (2)	1.05	1.12	1.12
Maximum ratio of senior debt to total equity	10.00	6.21	6.15

(1) "TIER" represents the times interest earned ratio.
(2) We must meet this requirement to retire patronage capital.

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

(5) Long-Term Debt

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

(dollar amounts in thousands)	August 31, 2010	May 31, 2010
Unsecured long-term debt:		
Medium-term notes sold through dealers	$ 2,861,888}	$ 2,905,332
Medium-term notes sold to members	89,631}	105,186
Subtotal	2,951,519}	3,010,518
Unamortized discount	(2,199)	(2,390)
Total unsecured medium-term notes	2,949,320}	3,008,128
Unsecured notes payable	3,049,047}	3,049,047
Unamortized discount	(1,432)	(1,480)
Total unsecured notes payable	3,047,615}	3,047,567
Total unsecured long-term debt	5,996,935}	6,055,695
Secured long-term debt:		
Collateral trust bonds	4,575,000}	4,575,000
Unamortized discount	(11,932)	(12,292)
Total secured collateral trust bonds	4,563,068}	4,562,708
Secured notes payable	1,436,094}	1,436,094
Total secured long-term debt	5,999,162}	5,998,802
Total long-term debt	$ 11,996,097}	$12,054,497

Secured notes payable includes debt issued to the Federal Agricultural Mortgage Corporation. Amounts outstanding and available under each note purchase agreement are summarized below:

(dollar amounts in thousands) Note Purchase Agreement	Final Maturity Date	Note Purchase Agreement Amount	Amount Outstanding August 31, 2010	May 31, 2010
December 2008 (1)	December 31, 2015	$ 500,000	$ 250,000	$ 350,000
February 2009	February 29, 2016	500,000	500,000	500,000
March 2009 (2)	April 1, 2014	400,000	312,200	312,200
May 2009	December 31, 2016	1,000,000	425,000	425,000
Total		$ 2,400,000	$1,487,200	$1,587,200

(1) Includes $100 million of secured notes payable under this program that were classified as short-term debt at May 31, 2010.

(2) Includes $76.4 million of secured notes payable under this program that were classified as short-term debt at August 31, 2010 and May 31, 2010.

(6) Subordinated Deferrable Debt

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

(dollar amounts in thousands)	August 31, 2010	May 31, 2010
NRN 6.75% due 2043 (1)	$ -	$ 125,000
NRC 6.10% due 2044	88,201	88,201
NRU 5.95% due 2045	98,239	98,239
Total	$ 186,440	$ 311,440

(1) Amount outstanding at August 31, 2010 is reported in short-term debt. In July 2010, we issued a call notice to redeem the entire issue totaling $125 million.

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

The $125 million of Series NRN due 2043 was redeemed at par on September 1, 2010. We recorded a $4 million loss on extinguishment of debt during the second quarter of fiscal year 2011 for the unamortized issuance costs.

(7) Derivative Financial Instruments

We utilize derivatives such as interest rate swaps and cross-currency interest rate swaps to mitigate interest rate risk and foreign currency exchange risk. We are neither a dealer nor a trader in derivative financial instruments. At August 31, 2010 and May 31, 2010, we did not have any derivative instruments that were accounted for using hedge accounting.

Interest Rate Swaps

The following table shows the notional amounts outstanding for our interest rate swaps by type:

(dollar amounts in thousands)	August 31, 2010	May 31, 2010
Pay fixed/receive variable	$ 5,693,050	$ 5,562,247
Pay variable/receive fixed	5,551,440	5,551,440
Total interest rate swaps	$ 11,244,490	$ 11,113,687

Income and losses recorded on the consolidated statements of operations for our interest rate swaps are summarized below:

(dollar amounts in thousands)	For the three months ended August 31, 2010	2009
Agreements that do not qualify for hedge accounting		
Derivative cash settlements (1)	$ (4,462)	$ (3,494)
Derivative forward value	(73,792)	(10,834)
Derivative losses	$ (78,254)	$ (14,328)

(1) The three months ended August 31, 2010 includes a $3 million fee we paid to terminate an interest rate swap that match funded an RTFC loan that was prepaid during the period.

Rating Triggers

Some of our interest rate swaps have credit risk-related contingent features referred to as rating triggers. Rating triggers are not separate financial instruments and are not required to be accounted for separately as derivatives. At August 31, 2010, the following derivative instruments had rating triggers based on our senior unsecured credit ratings from Moody's Investors Service or Standard & Poor's Corporation falling to a level specified in the agreement and grouped into the categories below. In calculating the payments and collections required upon termination, we netted the agreements for each counterparty, as allowed by the underlying master agreements. At August 31, 2010, our senior unsecured credit rating from Moody's Investors Service and Standard & Poor's Corporation was A2 and A, respectively. At August 31, 2010, Moody's Investors Service had our ratings on stable outlook and Standard & Poor's Corporation had our ratings on negative outlook. On September 30, 2010, Standard & Poor's Corporation affirmed our ratings and changed our outlook from negative to stable.

(dollar amounts in thousands)	Notional Amount	Our Required Payment	Amount We Would Collect	Net Total
Mutual rating trigger if ratings:				
fall to Baa1/BBB+ (1)	$ 1,384,479	$ (562)	$ 23,238	$ 22,676
fall below Baa1/BBB+ (1)	6,814,752	(165,347)	29,862	(135,485)
Total	$ 8,199,231	$ (165,909)	$ 53,100	$ (112,809)

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

excluding credit risk, of the underlying derivative instrument.

In addition to the rating triggers listed above, at August 31, 2010, we had a total notional amount of $868 million of derivative instruments with one counterparty that would require the pledging of collateral totaling $23 million (the fair value of such derivative instruments excluding credit risk) if our senior unsecured ratings from Moody's Investors Service were to fall below Baa2 or if the ratings from Standard & Poor's Corporation were to fall below BBB. The aggregate fair value of all interest rate swaps with rating triggers that were in a net liability position at August 31, 2010 was $181 million.

(8) Equity

In July 2010, CFC's Board of Directors authorized the allocation of the fiscal year 2010 net earnings as follows: $1 million to the cooperative educational fund, $102 million to members in the form of patronage capital and $5 million to the members' capital reserve. In July 2010, CFC's Board of Directors authorized the retirement of allocated net earnings totaling $51 million, representing 50 percent of the fiscal year 2010 allocation. This amount was returned to members in cash in September 2010. Future allocations and retirements of net earnings may be made annually as determined by CFC's Board of Directors with due regard for its financial condition. CFC's Board of Directors has the authority to change the current practice for allocating and retiring net earnings at any time, subject to applicable laws and regulations.

(9) Guarantees

We guarantee certain contractual obligations of our members so they may obtain various forms of financing. We use the same credit policies and monitoring procedures in providing guarantees as we do for loans and commitments. If a member system defaults in its obligation to pay debt service, then we are obligated to pay any required amounts under our guarantees. Meeting our guarantee obligations satisfies the underlying obligation of our member systems and prevents the exercise of remedies based upon a payment default by a member system.

The following table summarizes total guarantees by type and segment:

(dollar amounts in thousands)	August 31, 2010	May 31, 2010
Total by type:		
Long-term tax-exempt bonds	$ 599,585}	$ 601,625}
Indemnifications of tax benefit transfers	67,893}	69,982}
Letters of credit	374,518}	380,076}
Other guarantees	118,559}	119,426}
Total	$ 1,160,555}	$ 1,171,109}
Total by segment:		
CFC:		
Distribution	$ 229,091}	$ 221,903}
Power supply	868,359}	884,828}
Statewide and associate	21,167}	22,032}
CFC total	1,118,617}	1,128,763}
RTFC	636}	636}
NCSC	41,302}	41,710}
Total	$ 1,160,555}	$ 1,171,109}

The maturities for the long-term tax-exempt bonds and the related guarantees run through calendar year 2042. Amounts in the table represent the outstanding principal amount of the guaranteed bonds. At August 31, 2010, our maximum potential exposure for the $52 million of fixed-rate tax-exempt bonds is $83 million, representing principal and interest. We are unable to determine the maximum amount of interest that we could be required to pay related to the remaining adjustable and floating-rate bonds. See below for further information about this type of guarantee. Many of these bonds have a call provision that in the event of a default would allow us to trigger the call provision. This would limit our exposure to future interest payments on these bonds. Our maximum potential exposure is secured by a mortgage lien on all of the system's assets and future revenues. If the debt is accelerated because of a determination that the interest thereon is not tax-exempt, the system's obligation to reimburse us for any guarantee payments will be treated as a long-term loan.

Of the amounts shown in the table above, $548 million and $549 million as of August 31, 2010 and May 31, 2010, respectively, are adjustable or floating/fixed-rate bonds that may be converted to a fixed rate as specified in the applicable indenture for each bond offering. During the variable-rate period (including at the time of conversion to a fixed rate), we have, in return for a fee, unconditionally agreed to purchase bonds tendered or put for redemption if the remarketing agents have not previously sold such bonds to other investors.

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

CFC for any guarantee payments would be treated as a long-term loan to the extent of any cash received by the member at the outset of the transaction. This amount is secured by a mortgage lien on substantially all of the system's assets and future revenues. The remainder would be treated as a short-term loan secured by a subordinated mortgage on substantially all of the member's property. Due to changes in federal tax law, no further guarantees of this nature are anticipated.

The maturities for letters of credit run through calendar year 2024. Additionally, letters of credit totaling $4 million at August 31, 2010 have a term of one year and automatically extend for a period of one year unless we cancel the agreement within 120 days of maturity (in which case, the beneficiary may draw on the letter of credit). The amounts shown in the table above represent our maximum potential exposure, of which $176 million is secured, at August 31, 2010. When taking into consideration reimbursement obligation agreements that we have in place with other lenders, our maximum potential exposure related to $20 million of letters of credit would be reduced to $6 million in the event of default. Security provisions include a mortgage lien on substantially all of the system's assets, future revenue and the system's commercial paper invested with us.

In addition to the letters of credit listed in the table, under master letter of credit facilities, we may be required to issue up to an additional $520 million in letters of credit to third parties for the benefit of our members at August 31, 2010. At May 31, 2010, this amount was $502 million.

The maturities for other guarantees run through calendar year 2025. The maximum potential exposure for these guarantees is $120 million, all of which is unsecured.

At August 31, 2010 and May 31, 2010, we had a total of $317 million and $320 million of guarantees, respectively, representing 27 percent of total guarantees, under which our right of recovery from our members was not secured.

Guarantee Liability

At August 31, 2010 and May 31, 2010, we recorded a guarantee liability of $22 million and $23 million, respectively, which represents the contingent and non-contingent exposures related to guarantees and liquidity obligations associated with members' debt. The contingent guarantee liability at August 31, 2010 and May 31, 2010, was $6 million based on management's estimate of exposure to losses within the guarantee portfolio. We use factors such as internal risk rating, remaining term of guarantee, corporate bond default probabilities and estimated recovery rates in estimating our contingent exposure. The remaining balance of the total guarantee liability of $16 million and $17 million at August 31, 2010 and May 31, 2010, respectively, relates to our non-contingent obligation to stand ready to perform over the term of our guarantees and liquidity obligations that we have entered into or modified since January 1, 2003. The non-contingent obligation is estimated based on guarantee and liquidity fees collectible over the life of the guarantee. The fees are deferred and amortized using the straight-line method into interest income over the term of the guarantees.

Activity in the guarantee liability account is summarized below:

	As of and for the three months ended August 31,	
(dollar amounts in thousands)	2010	2009
Beginning balance	$ 22,984}	$ 29,672
Net change in non-contingent liability	(334)	(741)
Recovery of guarantee liability	(548)	(2,395)
Ending balance	$ 22,102}	$ 26,536
Liability as a percentage of total guarantees	1.90%	2.12%

(10) Fair Value Measurement

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

Assets and Liabilities Measured at Fair Value on a Recurring Basis

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

	August 31, 2010		May 31, 2010	
(dollar amounts in thousands)	Level 1	Level 2	Level 1	Level 2

Derivative assets	$ -}	$ 484,528}	$ -	$ 373,203
Derivative liabilities	-}	668,108}	-	482,825
Investments in common stock	658}	-}	1,029	-

Assets and Liabilities Measured at Fair Value on a Non-recurring Basis
We may be required, from time to time, to measure certain assets at fair value on a non-recurring basis in accordance with GAAP. Any adjustments to fair value usually result from application of lower-of-cost or fair value accounting or write-downs of individual assets.

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

In certain instances when a loan is non-performing, we utilize the collateral fair value underlying the loan, which may be provided by a third-party consultant, in estimating the specific loan loss allowance. In these instances, the valuation is considered to be a nonrecurring item.

Assets measured at fair value on a non-recurring basis at August 31, 2010 and May 31, 2010 were classified as Level 3 within the fair value hierarchy. The following table provides the carrying/fair value of the related individual assets at August 31, 2010 and May 31, 2010 and the total losses for the three months ended August 31, 2010 and 2009:

	Level 3 Fair Value		Total losses for the three months ended	
(dollar amounts in thousands)	August 31, 2010	May 31, 2010	August 31, 2010	August 31, 2009
Foreclosed assets, net	$ 38,121}	$ 42,252}	$ (315)	$ (1,750)
Non-performing loans, net of specific reserves	158,785}	160,285}	(5,390)	-

(11) Fair Value of Financial Instruments

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

	August 31, 2010		May 31, 2010	
(dollar amounts in thousands)	Carrying Value	Fair Value	Carrying Value	Fair Value
Assets:				
Cash and cash equivalents	$ 450,665}	$ 450,665}	$ 513,906	$ 513,906
Restricted cash	13,266}	13,266}	15,709	15,709
Investments in equity securities	58,236}	58,236}	58,607	58,607
Loans to members, net	18,715,253}	19,761,682}	18,749,940	19,109,838
Debt service reserve funds	45,662}	45,662}	45,662	45,662
Interest rate exchange agreements	484,528}	484,528}	373,203	373,203
Liabilities:				
Short-term debt	4,584,346}	4,598,769}	4,606,361	4,628,410
Long-term debt	11,996,097}	13,735,349}	12,054,497	13,408,158
Guarantee liability	22,102}	25,072}	22,984	25,917
Interest rate exchange agreements	668,108}	668,108}	482,825	482,825
Subordinated deferrable debt	186,440}	186,060}	311,440	306,151
Members' subordinated certificates	1,776,446}	1,937,659}	1,810,715	1,972,393
Off-balance sheet instruments:				
Commitments	-}	-}	-	-

See Note 10, Fair Value Measurement, for more details about how fair value is determined for assets and liabilities measured at fair value on a recurring or non-recurring basis on our consolidated balance sheets. We consider relevant and observable prices in the appropriate principal market in our valuations where possible. The estimated fair value information presented is not necessarily indicative of amounts we could realize currently in a market sale since we may be unable to sell such instruments due to contractual restrictions or the lack of an established market.

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

Cash and Cash Equivalents

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

Restricted Cash

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

Investments in Equity Securities
At August 31, 2010 and May 31, 2010, our investments in equity securities included investments in the Federal Agricultural Mortgage Corporation Series A common stock and Series C preferred stock. The Series A common stock is classified as available-for-sale securities and recorded in the consolidated balance sheets at fair value. We calculate fair value based on the quoted price on the stock exchange where the stock is traded. That stock exchange is an active market based on the volume of shares transacted.

The carrying value of the Federal Agricultural Mortgage Corporation Series C preferred stock held at August 31, 2010 and May 31, 2010 is equal to cost, which approximates fair value. The fair value for the Series C preferred stock is estimated at cost because we continue to enter into new transactions with the issuer at the same terms, and the stock is callable at par. The preferred stock securities do not meet the definition of marketable securities.

Loans to Members, Net
As part of receiving a loan from us, our members have additional requirements and rights that are not typical of other financial institutions, such as the ability to receive a patronage capital allocation, the general requirement to purchase subordinated certificates or member capital securities to meet their capital contribution requirements as a condition of obtaining additional credit from us, the option to select fixed rates from one year to maturity with the fixed rate resetting or repricing at the end of each selected rate term, the ability to convert from a fixed rate to another fixed rate or the variable rate at any time, and certain interest rate discounts that are specific to the borrower’s activity with us. These features make it difficult to obtain market data for similar loans. Therefore, we must use other methods to estimate the fair value.

Fair values for fixed-rate loans are estimated by discounting the future cash flows using the current rates at which we would make similar loans to new borrowers for the same remaining maturities. The maturity date used in the fair value calculation of loans with a fixed rate for a selected rate term is the next repricing date since these borrowers must reprice their loans at various times throughout the life of the loan at the then-current market rate.

Loans with different risk characteristics, specifically non-performing and restructured loans, are valued by using collateral valuations or by adjusting cash flows for credit risk and discounting those cash flows using the current rates at which similar loans would be made by us to borrowers for the same remaining maturities. See Note 10, Fair Value Measurement, for more details about how we calculate the fair value of certain non-performing loans.

Credit risk for the remainder of the loan portfolio is estimated based on the associated reserve in our allowance for loan losses. Variable-rate loans are valued at cost, which approximates fair value since we can reset rates every 15 days.

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

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

Long-Term Debt

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

Subordinated Deferrable Debt

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

Members' Subordinated Certificates

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

Derivative Instruments

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

Commitments

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

Guarantees

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

(12) Restructured/Non-Performing Loans and Contingencies

At August 31, 2010 and May 31, 2010, there was a total specific loan loss allowance balance of $437 million related to impaired loans to four borrowers, totaling $1,060 million and $1,064 million, respectively. We accrued a total of $1 million of interest income on impaired loans for the three months ended August 31, 2010 and 2009. The average recorded investment in impaired loans for the three months ended August 31, 2010 and 2009 was $1,059 million and $1,034 million, respectively.

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

(dollar amounts in thousands)	August 31, 2010	May 31, 2010
Non-performing loans	$ 564,417}	$ 560,527
Restructured loans	495,998}	508,044
Total	$ 1,060,415}	$ 1,068,571

At August 31, 2010 and May 31, 2010, all loans classified as non-performing were on non-accrual status with respect to the recognition of interest income. At August 31, 2010 and May 31, 2010, $455 million and $462 million, respectively, of restructured loans to Denton County Electric Cooperative, d/b/a CoServ Electric were on non-accrual status with respect to the recognition of interest income. For the three months ended August 31, 2010 and 2009, approximately $1 million of interest income was accrued on restructured loans.

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

(dollar amounts in thousands)	For the three months ended August 31, 2010	2009
Non-performing loans	$ 7,905}	$ 7,409
Restructured loans	5,685}	6,040
Total	$ 13,590}	$ 13,449

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At August 31, 2010 and May 31, 2010, non-performing loans included $538 million and $536 million, respectively, to Innovative Communication Corporation ("ICC"). The remaining $26 million and $25 million of non-performing loans at August 31, 2010 and May 31, 2010, respectively, were to Naknek Electric Association, a distribution electric cooperative located in Naknek, Alaska, that filed for bankruptcy in September 2010.

A final sale hearing for the transfer of ownership of ICC assets and stock in ICC subsidiaries operating in the United States Virgin Islands, the British Virgin Islands and St. Maarten (the "Group 1 Assets") to designated subsidiaries of CFC was conducted during the week of July 7, 2010 in St. Croix, United States Virgin Islands. The U.S. bankruptcy court issued its order on August 17, 2010 approving the Trustee's sale of the Group 1 Assets to designated subsidiaries of CFC. Following the dissolution of court stays issued by Virgin Islands territorial courts, on October 6, 2010, CFC, through RTFC, completed the transfer of control of the ICC United States Virgin Islands operating companies and consummated the contemplated transaction with respect to those companies. RTFC has assigned to CFC its rights with respect to the United States Virgin Islands operating companies as partial satisfaction of its loan from CFC. CFC will hold such operating companies in its wholly owned subsidiary, Caribbean Asset Holdings. The amount of loan repayment CFC will credit RTFC and loan write-off will be known once the fair value of each of the operating companies acquired has been updated through the closing date.

ICC British Virgin Islands and St. Maarten entities remain subject to pending transfer. Notwithstanding the completion of the transfer of control, Jeffrey Prosser and related parties continue to assert claims against CFC and certain of its officers and directors and other parties in various proceedings and forums. CFC, therefore, anticipates that it will continue to be engaged in defense of those assertions on many fronts, as well as pursuing claims of its own.

Based on our analysis, we believe we have an adequate loan loss allowance for our exposure to non-performing and restructured loans at August 31, 2010.

(13) Segment Information

The following tables contains consolidated statements of operations for the three months ended August 31, 2010 and 2009 and consolidated balance sheet information as of August 31, 2010 and 2009, by segment.

	For the three months ended August 31, 2010			
(dollar amounts in thousands)	CFC	RTFC	NCSC	Consolidated
Statement of Operations:				
Interest income	$ 230,403}	$ 14,409}	$ 6,241}	$ 251,053}
Interest expense	(203,352)	(13,427)	(2,733)	(219,512)
Net interest income	27,051}	982}	3,508}	31,541}
Recovery of loan losses	12,268}	-}	20}	12,288}
Net interest income after recovery of loan losses	39,319}	982}	3,528}	43,829}
Non-interest income:				
Fee and other income	9,888}	62}	342}	10,292}
Derivative losses	(67,920)	-}	(10,334)	(78,254)
Results of operations from foreclosed assets	184}	-}	-}	184}
Total non-interest income	(57,848)	62}	(9,992)	(67,778)

Non-interest expense:				
General and administrative expenses	(18,865)	(1,328)	(1,120)	(21,313)
Recovery of guarantee liability	548}	-}	-}	548}
Market adjustment on foreclosed assets	(315)	-}	-}	(315)
Other	(35)	-}	(61)	(96)
Total non-interest expense	(18,667)	(1,328)	(1,181)	(21,176)
Loss prior to income taxes	(37,196)	(284)	(7,645)	(45,125)
Income tax (expense) benefit	-}	(122)	2,902}	2,780}
Net loss	$ (37,196)	$ (406)	$ (4,743)	$ (42,345)
Assets:				
Total loans outstanding	$ 17,443,471}	$ 1,433,788}	$ 413,504}	$ 19,290,763}
Deferred origination costs	5,029}	-}	-}	5,029}
Less: Allowance for loan losses	(580,530)	-}	(9)	(580,539)
Loans to members, net	16,867,970}	1,433,788}	413,495}	18,715,253}
Other assets	1,215,608}	174,302}	47,112}	1,437,022}
Total assets	$ 18,083,578}	$ 1,608,090}	$ 460,607}	$ 20,152,275}

	For the three months ended August 31, 2009			
(dollar amounts in thousands)	CFC	RTFC	NCSC	Consolidated
Statement of Operations:				
Interest income	$ 244,393	$ 18,454	$ 6,610	$ 269,457
Interest expense	(221,954)	(17,302)	(3,373)	(242,629)
Net interest income	22,439	1,152	3,237	26,828
Recovery of loan losses	16,142	-	29	16,171
Net interest income after recovery of loan losses	38,581	1,152	3,266	42,999
Non-interest income:				
Fee and other income	3,357	40	337	3,734
Derivative losses	(12,493)	-	(1,835)	(14,328)
Results of operations from foreclosed assets	587	-	-	587
Total non-interest income	(8,549)	40	(1,498)	(10,007)
Non-interest expense:				
General and administrative expenses	(14,339)	(1,514)	(1,173)	(17,026)
Recovery of guarantee liability	2,395	-	-	2,395
Market adjustment on foreclosed assets	(1,750)	-	-	(1,750)
Other	(96)	-	(50)	(146)
Total non-interest expense	(13,790)	(1,514)	(1,223)	(16,527)
Income (loss) prior to income taxes	16,242	(322)	545	16,465
Income tax benefit (expense)	-	1	(33)	(32)
Net income (loss)	$ 16,242	$ (321)	$ 512	$ 16,433
Assets:				
Total loans outstanding	$ 17,986,700	$ 1,735,709	$ 404,076	$ 20,126,485
Deferred origination costs	4,607	-	-	4,607
Less: Allowance for loan losses	(606,762)	-	(77)	(606,839)
Loans to members, net	17,384,545	1,735,709	403,999	19,524,253
Other assets	1,216,419	179,487	16,413	1,412,319
Total assets	$ 18,600,964	$ 1,915,196	$ 420,412	$ 20,936,572

(14) Subsequent Events

In September 2010 and October 2010, we issued notes totaling $400 million under our December 2008 and May 2009 note purchase agreements with the Federal Agricultural Mortgage Corporation. The notes included a $250 million two-month note at a fixed-interest rate of 0.65 percent and a $150 million four-month note at a fixed interest rate of 0.67 percent.

In September 2010, we received a commitment from the Federal Financing Bank to provide additional funding up to $500 million with a guarantee of repayment by RUS as part of the funding mechanism for the Rural Economic Development Loan and Grant program.

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

The following discussion and analysis is designed to provide a better understanding of our consolidated financial condition and results of operations and as such should be read in conjunction with the consolidated financial statements, including the notes thereto and the information contained elsewhere in this Form 10-Q, in addition to Part I, Item 1A. Risk Factors in our Form 10-K for the year ended May 31, 2010.

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

This Form 10-Q contains forward-looking statements defined by the Securities Act of 1933, as amended, and the Exchange Act of 1934, as amended. Forward-looking statements, which are based on certain assumptions and describe our future plans, strategies and expectations, are generally identified by our use of words such as "intend," "plan," "may," "should," "will," "project," "estimate," "anticipate," "believe," "expect," "continue," "potential," "opportunity" and sim expressions, whether in the negative or affirmative. All statements about future expectations or projections, including statements about loan volume, the adequacy of the loan loss allowance, net income growth, leverage and debt-to-equity ratios, borrower financial performance, impaired loans, and sources and uses of liquidity, are forward-looking statements. Although we believe that the expectations reflected in our forward-looking statements are based on reasonable assumptions, actual results and performance could materially differ. Factors that could cause future results to vary from current expectations include, but are not limited to, general economic conditions, legislative changes, governmental monetary and fiscal policies, changes in tax policies, changes in interest rates, demand for our loan products, lending competition, changes in the quality or composition of our loan and investment portfolios, changes in accounting principles, policies or guidelines, changes in our ability to access external financing, valuations of collateral supporting impaired loans, non-performance of counterparties to our derivative agreements 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 U.S. 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.

Throughout this management discussion and analysis, we will refer to our financial measures as "adjusted" that are not in accordance with generally accepted accounting principles in the United States ("GAAP"). In our Executive Summary, our discussion will focus on the key metrics that we use to evaluate our business, which are adjusted TIER and adjusted debt-to-equity ratio. The most closely related GAAP measures are TIER and debt-to-equity ratio. For the three months ended August 31, 2010, earnings were insufficient to cover the fixed charges by $42 million and, therefore, the TIER calculation for this period results in a value below 1.00. The TIER for the three months ended August 31, 2009 was 1.07. At August 31, 2010, our debt-to-equity ratio was 39.90-to-1 compared with a ratio of 33.33-to-1 at May 31, 2010. We do not measure our performance or evaluate our business based on the GAAP measures, and the financial covenants in our revolving credit agreements and debt indentures are based on our adjusted measures rather than the related GAAP measures. The main adjustments we make to calculate the non-GAAP measures compared to the related GAAP measures are to adjust interest expense to include derivative cash settlements; to adjust net income, senior debt and total equity to exclude the non-cash adjustments from the accounting for derivative financial instruments; to exclude from senior debt the amount that funds loans guaranteed by the Rural Utilities Service ("RUS"), subordinated deferrable debt and members' subordinated certificates; and to adjust total equity to include subordinated deferrable debt and members' subordinated certificates. See Non-GAAP Financial Measures for further explanation of the adjustments we make to our financial results for our own analysis and covenant compliance and for a reconciliation to the related GAAP measures.

Executive Summary

Our primary objective as a member-owned cooperative lender is to provide cost-based financial products to our rural electric and telecommunications members while maintaining sound financial results required for investment-grade credit ratings on our debt instruments. Our objective is not to maximize net income; therefore, the rates we charge our borrowers reflect our adjusted interest expense plus a spread to cover our operating expenses, a provision for loan losses and earnings sufficient to preserve interest coverage to meet our financial objectives. Our key operating metrics are adjusted TIER and the adjusted debt-to-equity ratio. Our goal is to earn an annual minimum adjusted TIER of 1.10 and an adjusted debt-to-equity ratio of 6.00-to-1.

Lending Activity

The balance of loans outstanding decreased by $48 million during the quarter ended August 31, 2010 mainly due to the prepayment of $204 million of telecommunications loans related to a recapitalization of one of our borrowers and the anticipated prepayment of $122 million of power supply bridge loans with RUS funding. While the overall loan balance decreased, there were significant loan advances for CFC distribution borrowers and NCSC borrowers to refinance debt issued by other lenders. CFC advanced $267 million of distribution loans and NCSC advanced $46 million of loans to refinance other lender debt.

Funding Activity

At August 31, 2010, we had a total of $2,688 million, of commercial paper and daily liquidity fund outstanding, representing 85 percent of our issuance capacity provided by the revolving credit agreements. Due to the loan prepayments that occurred in the first part of the quarter ended August 31, 2010, there was little or no demand for the issuance of debt and thus our average commercial paper balance outstanding was at a lower level than the prior-year quarter. The utilization of commercial paper funding increased towards the end of the quarter due to the maturity of $400 million of collateral trust bonds in July 2010 and an increase in loan advance activity. In the current low interest rate environment, a higher utilization of commercial paper capacity, our lowest cost source of funding, is a key factor in our efforts to lower our overall effective rate of borrowing.

Financial Results

We experienced an increase of $4 million, or 16 percent, to adjusted net interest income for the quarter ended August 31, 2010 as compared to the prior-year quarter. This increase was driven primarily by a decrease to interest expense that was greater than the decrease to interest income. We incurred additional interest expense during the quarter ended August 31, 2009 due to prefunding large debt maturities as we maintained commercial paper issuance capacity in reserve to address liquidity concerns in the market at that time. There was also an increase to fee income during the quarter ended August 31, 2010 of $6 million related to the prepayment of loans to a telecommunications borrower which was partially offset by $3 million we had to pay to terminate interest rate swaps used in the funding of such loans.

The change in the items described above resulted in adjusted net income of $31 million for the three months ended August 31, 2010 compared with $27 million for the same prior-year period.

Our adjusted debt-to-equity ratio increased to 5.98-to-1 at August 31, 2010 as compared to 5.93-to-1 at May 31, 2010. This increase was caused by the reclassification of $51 million from equity to a payable account during the three months ended August 31, 2010 representing the patronage capital retirement approved by CFC’s Board of Directors for fiscal year 2010. We paid the $51 million to our borrowers in September 2010.

Expectations for the Remainder of Fiscal Year 2011

We expect an increase in demand for loan advances to repay debt of other lenders through the second quarter of fiscal year 2011. Due to the expected increase in loan activity and debt maturities, we anticipate the need to issue additional debt.

Subsequent to the end of the quarter, in September 2010, we redeemed the $125 million 6.75 percent series NRN subordinated deferrable debt, and $500 million of 4.375 percent collateral trust bonds matured on October 1, 2010. In refinancing this debt, we continued to utilize commercial paper to capitalize on the current low interest rate environment. Additionally, we issued notes totaling $400 million to the Federal Agricultural Mortgage Corporation in September 2010 and October 2010 to refinance maturing debt and fund loan advances. The amount available under note purchase agreements with the Federal Agricultural Mortgage Corporation subsequent to these issuances and at the time of this filing is $513 million.

We have $750 million of funding under the Guaranteed Underwriter program of the U.S. Department of Agriculture, which supports the Rural Economic Development Loan and Grant program, that is eligible to be repriced in January 2011. We also have approximately $1,000 million of member and dealer medium-term notes maturing through May 31, 2011. We expect these debt maturities and repricings will provide us with an opportunity to lower our overall effective rate of borrowing assuming that interest rates do not change significantly from current levels. We anticipate that the redemption of the $125 million of NRN subordinated deferrable debt and the increase to the debt outstanding to fund new loan advances will negatively affect our adjusted debt-to-equity ratio.

In September 2010, we received a commitment from the Federal Financing Bank to provide additional funding up to $500 million with a guarantee of repayment by RUS as part of the funding mechanism for the Rural Economic Development Loan and Grant program. As a result, we anticipate we can borrow up to $500 million under Federal Financing Bank loan facilities during the three-year period following the date of closing.

On October 6, 2010, CFC, through RTFC, completed the transfer of control of the United States Virgin Islands operating companies of Innovative Communication Corporation ("ICC"). RTFC has assigned to CFC its rights with respect to the United States Virgin Islands operating companies as partial satisfaction of its loan from CFC. CFC will hold such operating companies in its wholly owned subsidiary, Caribbean Asset Holdings. The amount of loan repayment CFC will credit RTFC and loan write-off will be known once the fair value of each of the operating companies acquired has been updated through the closing date. This transfer of assets as partial payment on our loans to ICC will result in a reduction to the total outstanding loan balance, but did not result in a cash inflow as the loans were settled by a combination of the receipt of foreclosed assets and loan write-off.

We believe that we have sufficient liquidity from the combination of capital markets issuance, member debt issuance and private placement of debt to the Federal Agricultural Mortgage Corporation and the Federal Financing Bank to satisfy the need for additional funding. At August 31, 2010, we were in compliance with all covenants and conditions under our revolving credit agreements and debt indentures.

New Accounting Pronouncements

During the three months ended August 31, 2010, we did not change or adopt any new accounting policies that had a material effect on our consolidated financial condition or results of operations.

Results of Operations

The derivative cash settlements and derivative forward value line items for the three months ended August 31, 2009 were combined and reported as derivative losses in the non-interest income section of the consolidated statement of operations to conform to the August 31, 2010 presentation.

Three months ended August 31, 2010 versus August 31, 2009 results
The following table presents the results of operations for the three months ended August 31, 2010 and 2009.

	For the three months ended August 31,		Change	
(dollar amounts in thousands)	2010	2009	Amount	%
Interest income	$ 251,053}	$ 269,457}	$ (18,404)	(7)%
Interest expense	(219,512)	(242,629)	23,117}	(10)
Net interest income	31,541}	26,828	4,713}	18}
Recovery of loan losses	12,288}	16,171}	(3,883)	(24)
Net interest income after recovery of loan losses	43,829}	42,999}	830}	2}
Non-interest income:				
Fee and other income	10,292}	3,734}	6,558}	176}
Derivative losses	(78,254)	(14,328)	(63,926)	446}
Results of operations of foreclosed assets	184}	587}	(403)	(69)
Total non-interest income	(67,778)	(10,007)	(57,771)	577}
Non-interest expense:				
Salaries and employee benefits	(13,026)	(9,918)	(3,108)	31}
Other general and administrative expenses	(8,287)	(7,108)	(1,179)	17}
Recovery of guarantee liability	548}	2,395}	(1,847)	(77)

Market adjustment on foreclosed assets	(315)	(1,750)	1,435}	(82)
Other	(96)	(146)	50}	(34)
Total non-interest expense	(21,176)	(16,527)	(4,649)	28}
(Loss) income prior to income taxes	(45,125)	16,465}	(61,590)	(374)
Income tax benefit (expense)	2,780}	(32)	2,812}	(8,788)
Net (loss) income	(42,345)	16,433}	(58,778)	(358)
Less: Net loss (income) attributable to noncontrolling interest	5,149}	(191)	5,340}	(2,796)
Net (loss) income attributable to CFC	$ (37,196)	$ 16,242}	$ (53,438)	(329)
TIER (1)	-}	1.07		
Adjusted TIER (2)	1.14}	1.11		

(1) For the three months ended August 31, 2010, earnings were insufficient to cover the fixed charges by $42 million and, therefore, the TIER calculation for this period results in a value below 1.00.
(2) Adjusted to exclude the effect of the derivative forward value from net income and to include all derivative cash settlements in the interest expense. The derivative forward value and derivative cash settlements are combined in the derivative losses line item in the chart above. See Non-GAAP Financial Measures for further explanation and a reconciliation of these adjustments.

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

Average balances and interest rates - Assets

	For the three months ended August 31,					
	2010	2009	2010	2009	2010	2009
(dollar amounts in thousands)	Average volume		Interest income		Average yield	
Long-term fixed-rate loans (1)	$ 15,633,931	$ 15,177,050	$ 222,969	$ 223,526	5.66%	5.84%
Long-term variable-rate loans (1)	1,455,295	2,618,435	12,656	26,565	3.45	4.03
Short-term loans (1)	1,537,923	1,897,878	11,977	16,035	3.09	3.35
Non-performing loans	561,222	523,759	-	-	-	-
Total average loans	19,188,371	20,217,122	247,602	266,126	5.12	5.22
Investments (2)	267,549	984,400	1,030	1,657	1.53	0.67
Fee income	-	-	2,421	1,674	-	-
Total assets earning interest income	$ 19,455,920	$ 21,201,522	$ 251,053	$ 269,457	5.12	5.04

(1) Interest income on loans to members.
(2) Interest income on the investment of cash, debt securities and equity securities.

Analysis of changes in interest income

	August 31, 2010 vs. August 31, 2009		
	Change due to (3)		
(dollar amounts in thousands)	Average volume (1)	Average rate (2)	Net change
Increase (decrease) in interest income:			
Long-term fixed-rate loans	$ 6,729	$ (7,286)	$ (557)
Long-term variable-rate loans	(11,800)	(2,109)	(13,909)
Short-term loans	(3,041)	(1,017)	(4,058)
Total interest income on loans (4)	(8,112)	(10,412)	(18,524)
Investments	(1,207)	580	(627)

Fee income	-}	747}	747}
Total interest income (4)	(9,319)	(9,085)	(18,404)

(1) Calculated using the following formula: (current period average balance – prior-year period average balance) x prior-year period average rate.
(2) Calculated using the following formula: (current period average rate – prior-year period average rate) x current period average balance.
(3) The net change attributable to the combined impact of volume and rate has been allocated to each in proportion to the absolute dollar amounts of change.
(4) Changes due to average volume and average rate represent a calculated amount and are not intended to sum.

During the three months ended August 31, 2010, interest income decreased 7 percent compared to the prior-year period due to the 5 percent decrease in average loan volume and the 10 basis point decrease in the average yield on loans resulting from the overall lower interest rate environment and pressure from competition. The average loan balance for the three months ended August 31, 2010 decreased compared to the prior-year period due to significant repayments from power supply bridge loans with loan funds from RUS and the sale of distribution loans to the Federal Agricultural Mortgage Corporation since August 31, 2009, as well as the prepayment of $204 million of telecommunications loans related to a recapitalization of a borrower during the quarter ended August 31, 2010. The average long-term fixed interest rates we offered on electric and telecommunication loans for the three months ended August 31, 2010 decreased 81 basis points and 189 basis points, respectively, compared to the prior-year period.

As a cost-based lender, we extend new loans with fixed rates based on our cost of debt at the time of the advance. The financial crisis beginning in September 2008 increased our cost of issuing new debt and, therefore, long-term fixed rates were higher during the three months ended August 31, 2009. Since that time, corporate spreads tightened, thus lowering long-term fixed rates offered on our new loans. The effect of changes to interest rates in the capital markets on our interest income is limited to a certain extent since 81 percent and 75 percent of our average loan balance was for long-term fixed-rate loans during the three months ended August 31, 2010 and 2009, respectively.

The reduction in interest rates earned on the loan portfolio during the three months ended August 31, 2010 compared to the prior-year period is also due to continued pressures from alternative sources of funding available to our members. These sources have access to lower-cost capital due to their government agency or government-sponsored enterprise status. Our members have the opportunity to consider other interest rate options we offer at repricing, or refinancing with another lender. We expect to remain competitive with our interest rate pricing options by increasing the use of commercial paper, which is our lowest-cost funding, in our funding mix during the remainder of fiscal year 2011 as compared to the utilization over the past fiscal year. Furthermore, we developed and continue to offer attractively priced options for our members, such as the program under which we sell loans to the Federal Agricultural Mortgage Corporation at 100 percent of the principal amount while retaining the servicing rights.

At August 31, 2010, approximately 58 percent of the outstanding balance of our interest-bearing line of credit loans were priced at rates lower than our standard line of credit interest rates because of loan syndications and our need to competitively price these loans due to competition for the business. Of the line of credit loans priced lower than our standard rates at August 31, 2010, 27 percent were made as part of loan syndications where the pricing was agreed upon by all of the participating banks and is based on current market conditions rather than our standard line of credit rates.

Our non-performing and restructured loans on non-accrual status continue to affect interest income for both the current and prior-year periods. The effect of non-accrual loans on interest income is included in the rate variance in the table above. Interest income was reduced as follows as a result of holding loans on non-accrual status:

	For the three months ended August 31,	
(dollar amounts in thousands)	2010	2009
Electric	$ 6,186}	$ 6,040
Telecommunications	7,404}	7,409
Total	$ 13,590}	$ 13,449

The restructured loan to Denton County Electric Cooperative, d/b/a CoServ Electric (“CoServ”) is on non-accrual status; however, the decrease to interest income is largely offset by the reduction to the calculated impairment due to the principal payments, which results in a reduction to the required loan loss provision or increases the recovery for the period. During the three months ended August 31, 2010, CoServ made scheduled payments of $7 million, all of which were applied as a reduction to the loan principal balance and resulted in a reduction of $5 million to the calculated impairment.

Interest Expense

The following tables break out the average cost of debt and the change to interest expense due to changes in average debt volume versus changes to interest rates summarized by debt type. We do not fund each individual loan borrowed by our members with specific debt. Rather, we attempt to minimize cost and maximize efficiency by funding large aggregated amounts of loans.

The following tables also break out the change to derivative cash settlements due to changes in the average notional amount of our derivative portfolio versus changes to the net difference between the average rate paid and the average rate received. Management calculates an adjusted interest expense, which includes all derivative cash settlements in interest expense. See Non-GAAP Financial Measures for further explanation of the adjustment we make in our financial analysis to include all derivative cash settlements in interest expense.

Average balances and interest rates - Liabilities

	For the three months ended August 31,					
	2010	2009	2010	2009	2010	2009
(dollar amounts in thousands)	Average volume		Interest expense		Average cost	
Commercial paper and bank bid notes (1) (2)	$ 2,074,096}	$ 2,469,643	$ (1,723)	$ (3,222)	(0.33)%	(0.52)%
Medium-term notes (1)	4,182,446}	5,628,536	(63,104)	(84,595)	(5.99)	(5.96)
Collateral trust bonds (1)	5,228,937}	5,181,804	(78,549)	(78,593)	(5.96)	(6.02)
Subordinated deferrable debt (1)	301,962}	301,886	(4,916)	(4,916)	(6.46)	(6.46)
Subordinated certificates (1)	1,757,587}	1,699,839	(20,306)	(19,020)	(4.58)	(4.44)
Long-term private debt (1)	4,534,469}	4,467,609	(45,992)	(45,986)	(4.02)	(4.08)
Total average debt	18,079,497}	19,749,317	(214,590)	(236,332)	(4.71)	(4.75)
Debt issuance costs (3)	-}	-	(2,577)	(2,980)	-}	-
Fee expense (4)	-}	-	(2,345)	(3,317)	-}	-
Total	$ 18,079,497}	$ 19,749,317	$ (219,512)	$ (242,629)	(4.82)	(4.87)
Derivative cash settlements (5)	$ 11,155,158}	$ 11,756,650	$ (4,462)	$ (3,494)	(0.16)%	(0.12)%
Adjusted interest expense (6)	18,079,497}	19,749,317	(223,974)	(246,123)	(4.91)	(4.94)

(1) Interest expense includes the amortization of discounts on debt.
(2) Average volume includes the daily liquidity fund.
(3) Interest expense includes amortization of all deferred charges related to debt issuances, principally underwriter's fees, legal fees, printing costs and comfort letter fees. Amortization is calculated on the effective interest method. Also includes issuance costs related to dealer commercial paper, which are recognized as incurred.
(4) Interest expense includes various fees related to funding activities, including fees paid to banks participating in our revolving credit agreements. Fees are recognized as incurred or amortized on a straight-line basis over the life of the respective agreement.
(5) For derivative cash settlements, average volume represents the average notional amount of derivative contracts outstanding, and the average cost represents the net difference between the average rate paid and the average rate received for cash settlements during the period.
(6) See Non-GAAP Financial Measures for further explanation of the adjustment we make in our financial analysis to include the derivative cash settlements in interest expense.

Analysis of changes in interest expense

	August 31, 2010 vs. August 31, 2009		
	Change due to (3)		
(dollar amounts in thousands)	Average volume (1)	Average rate (2)	Net change
(Increase) decrease in interest expense:			
Commercial paper and bank bid notes	$ 516}	$ 983}	$ 1,499}
Medium-term notes	21,734}	(243)	21,491}
Collateral trust bonds	(715)	759}	44}
Subordinated deferrable debt	(1)	1}	-}
Subordinated certificates	(646)	(640)	(1,286)
Long-term private debt	(688)	682}	(6)
Total interest expense on debt (4)	20,200}	1,542}	21,742}
Debt issuance costs	-}	403}	403}
Fee expense	-}	972}	972}
Total interest expense (4)	20,200}	2,917}	23,117}
Derivative cash settlements (5)	$ 179}	$ (1,147)	$ (968)
Adjusted interest expense (6)	20,810}	1,339}	22,149}

(1) Calculated using the following formula: (current period average balance – prior-year period average balance) x prior-year period average rate.
(2) Calculated using the following formula: (current period average rate – prior-year period average rate) x current period average balance.
(3) The net change attributable to the combined impact of volume and rate has been allocated to each in proportion to the absolute dollar amounts of change.
(4) Changes due to average volume and average rate represent a calculated amount and are not intended to sum.
(5) For derivative cash settlements, variance due to average volume represents the change in derivative cash settlements that resulted from the change in the average notional amount of derivative contracts outstanding. Variance due to average rate represents the change in derivative cash settlements that resulted from the net difference between the average rate paid and the average rate received for interest rate swaps during the period.
(6) See Non-GAAP Financial Measures for further explanation of the adjustment we make in our financial analysis to include the derivative cash settlements in interest expense.

During the three months ended August 31, 2010, interest expense decreased 10 percent compared with the same prior-year period. The largest factors contributing to this decrease were the reduction to the average volume of medium-term notes and the 5 basis point reduction in the overall cost of debt during the three months ended August 31, 2010 compared with the same prior-year period.

The average volume of medium-term notes for the three months ended August 31, 2010 decreased primarily due to the maturity of $1,495 million of medium-term notes during the three months ended August 31, 2009. The medium-term notes were replaced by collateral trust bonds and long-term private placement debt issued to the Federal Agricultural Mortgage Corporation. Existing variable-rate debt in a lower interest environment in the capital markets caused a decrease in the average interest rate during the three months ended August 31, 2010 compared with the same prior-year period as a result of new debt issuances since August 31, 2009.

The adjusted interest expense, which includes all derivative cash settlements, was $224 million for the three months ended August 31, 2010, compared to $246 million for the three months ended August 31, 2009. The adjusted interest expense was lower during the three months ended August 31, 2010 due to the lower interest expense noted above partially offset by the increase in the derivative cash settlement expense discussed further below. See Non-GAAP Financial Measures for further explanation of the adjustment we make in our financial analysis to include all derivative cash settlements in interest expense.

Net Interest Income

The following tables represent a summary of the effect on net interest income and adjusted net interest income from changes in the components of total interest income and total interest expense described above. The following tables also summarize the net yield and adjusted net yield and the changes to net interest income and adjusted net interest income due to changes in average volume versus changes to interest rates.

Average interest rates – Assets and Liabilities

	For the three months ended August 31,			
	2010	2009	2010	2009
(dollar amounts in thousands)	Interest income (expense)		Average yield (cost)	
Total interest income	$ 251,053}	$ 269,457}	5.12%	5.04}%
Total interest expense	(219,512)	(242,629)	(4.82)	(4.87)
Net interest income/Net yield (cost)	$ 31,541}	$ 26,828}	0.30%	0.17}%
Derivative cash settlements	(4,462)	(3,494)	(0.16)	(0.12)
Adjusted net interest income/Adjusted net yield (1)	$ 27,079}	$ 23,334}	0.21	0.10}

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

Analysis of changes in net interest income

	August 31, 2010 vs. August 31, 2009		
	Change due to (3)		
(dollar amounts in thousands)	Average volume (1)	Average rate (2)	Net change

Increase (decrease) in net interest income	$ 10,881}	$ (6,168)	$ 4,713}
Increase (decrease) in adjusted net interest income	11,491}	(7,746)	3,745}

(1) Calculated using the following formula: (current period average balance – prior-year period average balance) x prior-year period average rate.
(2) Calculated using the following formula: (current period average rate – prior-year period average rate) x current period average balance.
(3) The net change attributable to the combined impact of volume and rate has been allocated to each in proportion to the absolute dollar amounts of change.

During the three months ended August 31, 2010, the net interest income increased by $5 million, or 18 percent, compared with the same prior-year period. This increase is due to the following factors:

- the $1,670 million, or 8 percent, decrease in the average debt volume and
- the 5 basis points decrease in the overall cost of debt, offset by
- the 10 basis point decrease in the average yield of our loan portfolio and
- the $1,029 million, or 5 percent, decrease in average loan volume.

The adjusted net interest income, which includes all derivative cash settlements, for the three months ended August 31, 2010 was $27 million, an increase compared to $23 million for the three months ended August 31, 2009. Adjusted net interest income increased during the three months ended August 31, 2010 compared to the same prior-year period primarily due to the increase of net interest income due to factors discussed above, partially offset by the increase in the derivative cash settlement loss.

Recovery of Loan Losses
The recovery of loan losses of $12 million for the three months ended August 31, 2010 was primarily due to decreases of $6 million to the general reserve and $6 million to the unallocated reserve associated with large loan exposures.

The $6 million decrease in the general reserve was driven by a reduction to loans outstanding and improvement to the average internal risk rating for borrowers in the general portfolio. The $6 million reduction to the unallocated reserve associated with large loan exposures was due to loan repayments and improvement to the average internal risk rating during the three months ended August 31, 2010 for borrowers that meet the exposure threshold. The reserve for impaired loans remained unchanged during the three months ended August 31, 2010 as the $5 million decrease to the CoServ impairment due to payments received was offset by a $5 million increase in the reserve for two non-performing borrowers at August 31, 2010, primarily ICC. The fair value of the collateral supporting ICC loans decreased $4 million during the three months ended August 31, 2010 as a result of loan advances and a lower estimated fair value for real estate assets included in the collateral. See Non-Performing and Restructured Loans in the Financial Condition section for additional discussion on our non-performing loans.

Non-Interest Income
Non-interest income decreased by $58 million for the three months ended August 31, 2010, compared with the prior-year period. The primary reason for the decrease in non-interest income for the three months ended August 31, 2010 is the increase of $64 million to derivative losses partly offset by the increase in fee income compared to the prior-year period. RTFC loan prepayments totaling $204 million during the three months ended August 31, 2010 resulted in prepayment fee income of $6 million. The prepayment fee income was partially offset by cash settlements expense of $3 million for a fee we paid during the three months ended August 31, 2010 to terminate the interest rate swap that was match funding the prepaid loans.

The derivative losses line item includes income and losses recorded for our interest rate swaps as summarized below:

	For the three months ended August 31,	
(dollar amounts in thousands)	2010	2009
Derivative cash settlements	$ (4,462)	$ (3,494)
Derivative forward value	(73,792)	(10,834)
Derivative losses	$ (78,254)	$ (14,328)

The derivative forward value, which represents the change in fair value of our interest rate swaps during the reporting period, increased by $63 million for the three months ended August 31, 2010 compared to the prior-year period due to significant changes in the estimate of future interest rates over the remaining life of our derivative contracts. The swap valuation curve decreased on average by 82 basis points during the three months ended August 31, 2010, which caused a reduction in the fair value of pay fixed/receive variable interest rate swaps, particularly those with long-dated maturities. The decrease in fair value of pay fixed/receive variable interest rate swaps during the three months ended August 31, 2010 outweighed the gains in fair value for pay variable/receive fixed interest rate swaps. The overall mix of pay variable/receive fixed interest rate swaps remained consistent at 49 percent of the overall portfolio at August 31, 2010 compared to 50 percent at May 31, 2010.

Non-Interest Expense

The $5 million increase to non-interest expense for the three months ended August 31, 2010 compared with the prior-year period was primarily due to the $3 million increase to salaries and employee benefits expense and the smaller recovery of guarantee liability partially offset by a lower reduction in the fair value of foreclosed assets. The increase to salaries and employee benefits expense is mainly due to approximately $2 million of severance expense related to the early retirement of certain qualifying employees. There was a smaller reduction to the fair value of the collateral supporting our foreclosed assets during the quarter ended August 31, 2010 as natural gas prices did not drop as much as in the prior-year period.

Noncontrolling Interest

Noncontrolling interest for the three months ended August 31, 2010 contributed $0.4 million of consolidated net loss from RTFC and $4.7 million of consolidated net loss from NCSC compared with an RTFC net loss of $0.3 million and NCSC net income of $0.5 million for the three months ended August 31, 2009. The NCSC net loss for the three months ended August 31, 2010 is primarily due to fluctuations in the fair value of its derivative instruments.

Net (Loss) Income

The change in the items described above resulted in a net loss of $42 million for the three months ended August 31, 2010 compared with net income of $16 million in the prior-year period. The adjusted net income, which excludes the effect of the derivative forward value, was $31 million and $27 million for the three months ended August 31, 2010 and 2009, respectively. See Non-GAAP Financial Measures for further explanation of the adjustments we make in our financial analysis to net income.

Ratio of Earnings to Fixed Charges

The following table provides the calculation of the ratio of earnings to fixed charges. The fixed charge coverage ratio includes capitalized interest in total fixed charges, which is not included in our TIER calculation.

	For the three months ended August 31,	
(dollar amounts in thousands)	2010	2009
(Loss) income prior to cumulative effect of change in accounting principle	$ (42,345)	$ 16,433
Add: fixed charges	219,549}	242,660
Less: interest capitalized	(37)	(31)
Earnings available for fixed charges	$ 177,167}	$ 259,062
Total fixed charges:		
Interest on all debt (including amortization of discount and issuance costs)	$ 219,512}	$ 242,629
Interest capitalized	37}	31
Total fixed charges	$ 219,549}	$ 242,660
Ratio of earnings to fixed charges (1)	-}	1.07

(1) For the three months ended August 31, 2010, earnings were insufficient to cover the fixed charges by $42 million and, therefore, the TIER calculation for that period results in a value below 1.00.

Financial Condition

Loan and Guarantee Portfolio Assessment

Loan Programs

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

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

(dollar amounts in thousands)	August 31, 2010		May 31, 2010		Increase/ (Decrease)
Loans by type (1) (2):					
Long-term loans:					
	$ 15,559,047}	81%	$ 15,412,987	80%	$ 146,060}

Long-term fixed-rate loans					
Long-term variable-rate loans	1,894,966}	10	2,088,829	11	(193,863)
Loans guaranteed by RUS	236,274}	1	237,356	1	(1,082)
Total long-term loans	17,690,287}	92	17,739,172	92	(48,885)
Short-term loans	1,600,476}	8	1,599,233	8	1,243}
Total loans	$ 19,290,763}	100%	$19,338,405	100%	$ (47,642)

(dollar amounts in thousands)	August 31, 2010		May 31, 2010		Increase/ (Decrease)
Loans by segment (1):					
CFC:					
Distribution	$ 13,694,652}	71%	$ 13,459,053	70%	$ 235,599}
Power supply	3,657,507}	19	3,769,794	19	(112,287)
Statewide and associate	91,312}	-	86,182	-	5,130}
CFC total	17,443,471}	90	17,315,029	89	128,442}
RTFC	1,433,788}	8	1,671,893	9	(238,105)
NCSC	413,504}	2	351,483	2	62,021}
Total loans	$ 19,290,763}	100%	$ 19,338,405	100%	$ (47,642)

(1) Includes loans classified as restructured and non-performing.

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

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The decrease in loans outstanding from May 31, 2010 to August 31, 2010 was driven by RTFC loan prepayments and anticipated repayments of power supply loans. One of our telecommunication borrowers was acquired, so all of our loans to them, totaling $204 million, were prepaid in July 2010. We also had approximately $122 million of repayments from power supply bridge loans with loan funds from RUS as anticipated during the quarter ended August 31, 2010. CFC distribution and NCSC loans increased $267 million and $46 million, respectively, during the quarter due to members taking advantage of the lower interest rate environment by using our loans to refinance their debt with other lenders.

The following table summarizes loans and guarantees outstanding by segment:

(dollar amounts in thousands)	August 31, 2010		May 31, 2010		Increase/
	Amount	% of Total	Amount	% of Total	(Decrease)
CFC:					
Distribution	$ 13,923,743}	68 %	$ 13,680,956}	67 %	$ 242,787}
Power supply	4,525,866}	22	4,654,622}	22	(128,756)
Statewide and associate	112,479}	1	108,214}	1	4,265}
CFC total	18,562,088}	91	18,443,792}	90	118,296}
RTFC	1,434,424}	7	1,672,529}	8	(238,105)
NCSC	454,806}	2	393,193}	2	61,613}
Total	$ 20,451,318}	100 %	$ 20,509,514}	100 %	$ (58,196)

Credit Concentration

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

At August 31, 2010 and May 31, 2010, the total exposure outstanding to any one borrower or controlled group did not exceed 2.6 percent of total loans and guarantees outstanding. At August 31, 2010, the 10 largest borrowers included four distribution systems, five power supply systems and one telecommunications system. At May 31, 2010, the 10 largest borrowers included three distribution systems, six power supply systems and one telecommunications system. The following table shows the exposure to the 10 largest borrowers as a percentage of total exposure by type and by segment:

	August 31, 2010		May 31, 2010		Increase/
(dollar amounts in thousands)	Amount	% of Total	Amount	% of Total	(Decrease)
Total by type:					
Loans	$ 3,330,704}	16%	$ 3,478,271	17%	$ (147,567)
Guarantees	318,701}	2	342,325	2	(23,624)
Total credit exposure to 10 largest borrowers	$ 3,649,405}	18 %	$ 3,820,596	19%	$ (171,191)
Total by segment:					
CFC	$ 3,089,182}	15%	$ 3,274,247	16%	$ (185,065)
RTFC	537,723}	3	523,849	3	13,874}
NCSC	22,500}	-	22,500	-	-}
Total credit exposure to 10 largest borrowers	$ 3,649,405}	18%	$ 3,820,596	19%	$ (171,191)

Security Provisions

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

	August 31, 2010		May 31, 2010		Increase/
(dollar amounts in thousands)	Amount	% of Total	Amount	% of Total	(Decrease)
Total by type:					
Loans	$ 2,213,711}	11%	$ 2,041,099	10%	$ 172,612}
Guarantees	317,487}	1	320,761	2	(3,274)
Total unsecured credit exposure	$ 2,531,198}	12 %	$ 2,361,860	12%	$ 169,338}