

Analysis

Moody's Global Infrastructure Finance

December 2009

National Rural Utilities Cooperative Finance Corporation (NRUC)

Herndon, Virginia, United States

Table of Contents:

Operational Results	2
Loan Portfolio	3
Funding	8
Liquidity	11
Leverage	12
Other Rating Considerations	13
Corporate Governance	13
Moody's Related Research	15

Analyst Contacts:

New York 1.212.553.1653

A.J. Sabatelle
Senior Vice President

Michael G. Haggarty
Vice President-Senior Credit Officer

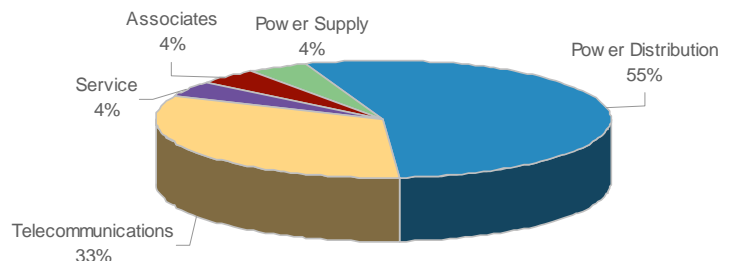
W. Larry Hess
Team Managing Director

Headquartered in Herndon, Virginia, National Rural Utilities Cooperative Finance Corporation (NRUC) is a non-bank financial institution exclusively serving rural electric, service, and telecommunication utilities. NRUC was organized in 1969 by rural electric cooperatives (RECs) as a tax exempt association that provides an economical alternative to federally subsidized funds from the Rural Utilities Service (RUS) of the U.S. Department of Agriculture. NRUC is exempt from federal income taxes under Section 501(c)(4) of the Internal Revenue Code.

As of August 31, 2009, NRUC had 1,522 member cooperatives, including 897 rural electric utility system members, 498 telecommunications members, 66 service members, and 61 associate members. Of the 897 rural electric utility system members, 829 were distribution systems and 68 were generation and transmission systems.

Membership Composition
August 31, 2009

Total: 1,522 Members



This Credit Analysis provides an in-depth discussion of credit rating(s) for National Rural Utilities Coop. Finance Corp. and should be read in conjunction with Moody's most recent Credit Opinion and rating information available on Moody's website. [Click here to link.](#)



Moody's Investors Service

National Rural Utilities Cooperative Finance Corporation (NRUC)

Loans to telecommunication members are made through Rural Telephone Finance Cooperative (RTFC), a private cooperative association formed in September 1987 to provide financing to its rural telecommunications members and affiliates. Effective June 1, 2003, RTFC's results were consolidated with those of NRUC. NRUC manages the affairs of RTFC through a long-term management arrangement and provides RTFC with all of its financing.

Loans are also made through National Cooperative Services Corporation (NCSC), a private cooperative association, which provides specialized financing and services to entities owned, operated and controlled by RECs. NCSC borrows the funds that it lends either from NRUC directly, or from another creditor with a NRUC guarantee. Based upon a guarantee from NRUC, NCSC's short-term rating for commercial paper is Prime-1.

NRUC's goal as a cooperatively-owned finance company is to set rates at levels that will provide its members with the lowest cost financing while earning a minimum profit or margin consistent with defined financial targets to support its overall credit position. Loans and guarantees supplied to members are priced to cover its funding costs, general and administrative expenses, the loan loss provision, and a modest profit in order to maintain an adjusted times interest earned ratio (TIER) of at least 1.10 times. NRUC's adjusted TIER averaged 1.12 times over the past three fiscal years, and its adjusted TIER was 1.10 times for fiscal year 2009. In calculating adjusted TIER, NRUC appropriately includes net cash derivatives settlement amounts in the cost of funds, since the amount of derivative cash settlement represents the amount of cash that is actually received (or paid) by NRUC in a given period. Prior to the introduction of Statement of Financial Accounting Standards 133, the appropriate net cash settlement amount was included in cost of funds. NRUC also appropriately removes the derivative forward value and foreign currency adjustments when it calculates adjusted TIER. Since all of the foreign currency denominated debt issued by NRUC was repaid during fiscal year 2007, NRUC did not report any foreign currency adjustments in its 2008 and 2009 results.

Operational Results

As a not-for-profit, margins and profitability are less relevant

Given NRUC's status as a not-for-profit cooperative association and its operating objective to offer the lowest reasonable borrowing costs to its members, operating margin and earnings profitability metrics have limited value from a ratings driver perspective. To that end, profitability comparisons and market share comparisons to other financial institutions also have limited value, particularly given NRUC's narrowly defined market and unique franchise position.

Notwithstanding this view, Moody's believes NRUC should demonstrate a consistent ability to produce stable operating results consistent with its adjusted TIER objectives. During 2009, NRUC recorded a GAAP loss of \$69.8 million due to a \$113.7 million provision for loan losses primarily related to the Innovative Communications Corporation (ICC) exposure as well as a \$61 million increase in derivative forward value. Net interest income for fiscal year 2009, however, increased by \$16 million from 2008 due principally to higher average loan volume, and adjusted net interest income, which factors in all derivative cash settlements, increased by \$102 million to \$249 million at year-end 2009. As such, adjusted TIER, which factors in the sizeable addition to the loan loss provision, was 1.10 times during fiscal year 2009, in line with NRUC's minimum margin objectives.

As discussed in greater detail later in the report, NRUC's loan to ICC represents its only non-performing asset. Since the remainder of the NRUC loan portfolio continues to perform as expected, we do not anticipate NRUC adding materially to its loan loss provision in the foreseeable future assuming the proposed ICC restructuring plan is consummated.

National Rural Utilities Cooperative Finance Corporation (NRUC)

Loan pricing flexibility enables NRUC to reset margins

A key support to NRUC's credit quality is the ability of NRUC to reset margins sufficient to maintain its targeted adjusted TIER of 1.10 times. NRUC manages this important aspect of its business by having terms and conditions in nearly all of their customers' loan documents that allow for a variety of re-pricing mechanisms. Additionally, basis risk is typically not a concern as the funding options afforded to NRUC's borrowers equate to NRUC's actual funding costs. For example, most variable rate loans reset monthly with the loan pricing being based on NRUC's actual variable-rate funding cost. The remaining fixed rate loan portfolio is funded with a variety of instruments whose average maturities match closely to the re-pricing tenors of the fixed rate loan portfolio. For example, a cooperative may borrow a fixed rate loan from NRUC with a final maturity date of fifteen years, and an initial re-pricing date of three years. While a fifteen year loan, NRUC will fund the loan with a three year funding instrument such that the re-pricing date of the loan matches closely the maturity date of the funding instrument. On the re-pricing date, if, for example, the cooperative re-prices the loan for two years, NRUC would fund that obligation with a new two year funding instrument. At fiscal year end 2009, approximately 25% or \$3.6 billion of NRUC's fixed rate loan portfolio will re-price over the next three fiscal years based upon the terms and conditions set forth in the specific loan documents.

NRUC's ability to execute on this re-pricing strategy is further aided by the strong competitive position that NRUC enjoys with the majority of its member cooperatives and by the relative freedom of its electric borrowers to set rates as necessary to cover their expenses and maintain required covenants. In contrast to investor-owned utilities, we understand that cooperatives representing nearly 85% of NRUC's loan portfolio have the ability to reset customer rates as necessary without significant regulatory intervention. This degree of latitude at the borrower level provides NRUC with a fairly high degree of certainty around the repayment of most loan obligations. The remaining portfolio represents loans to cooperatives that are regulated by state public utility commissions which generally carry similar regulatory risk as the investor-owned utilities operating in these specific states.

Loan Portfolio

Heavily weighted towards electric distribution cooperatives

Loans by Segment	2007		2008		2009		1Q' 2010	
	\$000	%	\$000	%	\$000	%	\$000	%
NRUC								
Distribution	12,827,772	71%	13,438,370	71%	13,730,511	68%	13,637,987	68%
Generation & Transmission	2,858,040	16%	3,339,112	18%	4,268,244	21%	4,256,807	21%
Statewide & Associate	119,478	1%	108,925	1%	92,578	1%	91,906	1%
NRUC Total	15,805,290	87%	16,886,407	89%	18,091,333	90%	17,986,700	89%
RTFC (Telecommunications)	1,860,379	10%	1,726,514	9%	1,680,154	8%	1,735,709	9%
NCSC	462,538	3%	414,074	2%	416,720	2%	404,076	2%
Total	18,128,207	100%	19,026,995	100%	20,188,207	100%	20,126,485	100%

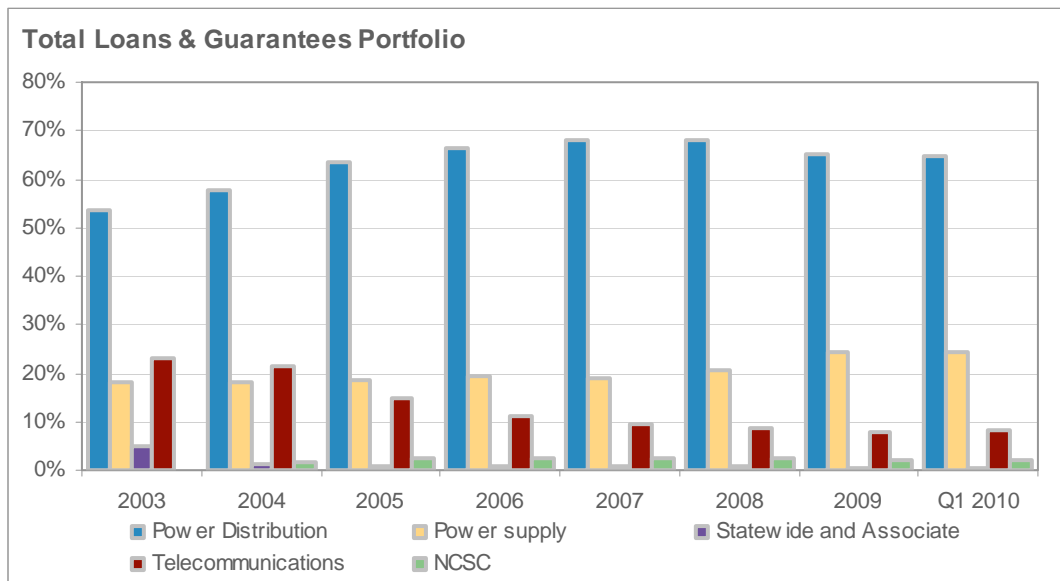
As depicted above, NRUC's loan portfolio is heavily weighted towards RECs. At August 31, 2009, 89% of the loans made by NRUC were to RECs. Furthermore, 68% of NRUC's loan portfolio represented loans to electric distribution cooperatives. NRUC is the dominant private lender in the US to this particular segment of the electric cooperative sector. Moody's considers this segment to be among the lowest risk segments across electric utilities due to the highly predictable nature of the cooperative's cash flow, the monopoly status of this group, the pass-through mechanisms that typically exist at these entities and the relatively predictable and steady capital investment requirements which often mirror service territory growth. Because the capital needs of the distribution sector are typically known by NRUC and are fairly steady, managing the funding requirements for this segment, the largest portion of NRUC's loan portfolio, is not complicated. Prospectively,

National Rural Utilities Cooperative Finance Corporation (NRUC)

we anticipate loans to the electric distribution segment to continue to hover around 70% of the consolidated loan portfolio.

Loans to power supply cooperatives (also known as generation and transmission cooperatives or G&Ts) make up the next largest segment concentration representing 21% of the loan portfolio at August 31, 2009. While this segment faces greater risks than the electric distribution segment and has larger and lumpier capital requirements, the sector also features fairly predictable cash flow and loan repayment characteristics. Typically, power supply cooperatives have all-requirements long-term contracts with their member distribution cooperatives to sell electricity at agreed upon rates. These contracts typically allow the G&T to recover all of its costs and generally have pass-through mechanisms to recover changes in fuel related costs. These contracts serve as a basic underpinning of the G&T's credit quality and provide a very predictable source of cash flow for debt service. Generally, the contracts extend beyond the final maturity date of the G&T's debt. Due to the G&T's size and capital needs relative to most distribution cooperatives, all of Moody's assigned public ratings in the cooperative sector are to generation and transmission cooperatives, with the average rating within this segment being A2 on a secured basis which is two notches higher than the average fundamental rating among investor-owned utilities in the US. While NRUC provides substantial capital to the segment, the RUS remains the dominant lender to the G&T segment of the electric cooperative sector. NRUC's loan volume to the G&T sector has increased since 2007 due to higher member needs, which include a number of bridge loans made to G&T's to finance the construction of various generation projects. Under this loan program with member G&T cooperatives and the RUS, NRUC enters into the bridge loan with the G&T in conjunction with the G&T obtaining a firm long-term takeout financing commitment from the RUS. During the next twelve months, NRUC expects about \$585 million of these bridge loans to be repaid by G&Ts largely from permanent RUS takeout financings.

The last large segment represents loans made by RTFC to telecommunications borrowers. As discussed in greater detail later in this report, loans to telecommunications borrowers have declined steadily since 2003 and now represent 9% of the total loan portfolio. While this sector carries greater risks than the electric distribution or generation and transmission segments, this portfolio tends to be shorter-dated than the other portfolios. Most of the exposure is to rural local exchange carriers (RLECs) which represent the lowest risk group within this segment. Over the past five years, single obligor risk among telecommunication borrowers has substantially subsided with the decline in the telecommunications portfolio. We anticipate exposure to the more risky telecommunication sector to remain below 10% of NRUC's loan portfolio over the foreseeable future.



Pictured above is a graphical depiction of NRUC's overall portfolio, including NRUC guarantees. Overall, the components of the portfolio do not materially change. As of August 31, 2009, NRUC's loans and guarantees with RECs represented 89% of the portfolio with distribution RECs approximating 65% and power supply RECs being at 24%. Moody's observes that most of NRUC's guarantees are issued for the benefit of its

National Rural Utilities Cooperative Finance Corporation (NRUC)

power supply borrowers. Loan and guarantee exposure to the rural telecommunications sector accounted for only 8% of NRUC's total loans and guarantees at August 31, 2009, representing a substantial decline from fiscal year-end 2003 when loan and guarantee exposure to the rural telecommunication sector was 23% of NRUC's total loans and guarantees. As depicted on page 8 of the report, 88% of NRUC's exposure in the rural telecommunication portfolio is to RLECs. Moody's views this shift in the portfolio towards RECs and away from the rural telecommunications sector as being supportive to NRUC's overall credit quality and to the quality of the loan portfolio.

Loan portfolio aided by security package

(\$ Amounts in Billions)	At May 31, 2007				At May 31, 2008				At May 31, 2009				At August 31, 2009			
	Sec.	%	Uns.	%	Sec.	%	Uns.	%	Sec.	%	Uns.	%	Sec.	%	Uns.	%
Total Loans by Segment																
CFC	14.5	92%	1.3	8%	15.0	89%	1.9	11%	15.6	86%	2.5	14%	15.6	87%	2.4	13%
RTFC	1.6	88%	0.2	12%	1.5	87%	0.2	13%	1.4	86%	0.2	14%	1.5	87%	0.2	13%
NCSC	0.4	87%	0.1	13%	0.4	86%	0.1	14%	0.4	84%	0.1	16%	0.3	85%	0.1	15%
Total Loans	16.5	91%	1.6	9%	16.9	89%	2.2	11%	17.4	86%	2.8	14%	17.4	87%	2.7	13%

In addition to the strong fundamental credit quality of NRUC's borrowers, NRUC's loan portfolio benefits from the collateral position that it enjoys on a significant proportion of its long-term loans. Loans are typically secured on parity with other secured lenders (primarily RUS), if any, by a mortgage lien on the borrower's total assets and a pledge of future revenues with certain exceptions typical for utility mortgages. This collateral position has helped to provide high recovery values for NRUC in past problem loan debt restructurings and often enables NRUC to receive the payment of interest and principal while a borrower is operating in bankruptcy.

At August 31, 2009, nearly 87% of NRUC's total loan portfolio is secured. In the recent past, secured loans represented around 90% of NRUC's total loan portfolio. The slight decrease in the secured loan percentage reflects an increase in short-term loans made by NRUC to RECs during 2009. Moody's expects that over time the level of secured loans will approximate 90% of the total loan portfolio.

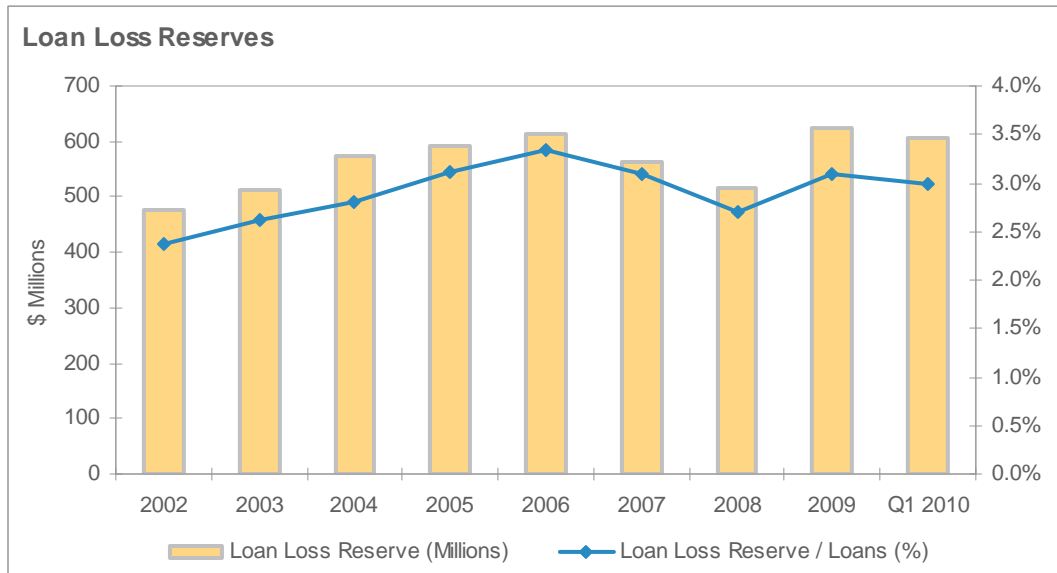
Cumulative net loan losses have been low

Historically, NRUC has an excellent loan loss experience. Since the cooperative's inception in 1969, only \$183 million in cumulative net losses have been taken. The low write-off loan history demonstrates the historically high credit quality of NRUC's portfolio, the strength of the collateral typically pledged to NRUC, and the ability of NRUC to take a long-term view concerning debt restructurings due to its unique relationship with its customer base and the fact that NRUC is a cooperatively-owned organization. At August 31, 2009 and May 31, 2009, NRUC's had one non-performing loan, a \$524 million loan that RTFC has outstanding to ICC. While Moody's believes NRUC is adequately reserved for this outstanding exposure, Moody's expects NRUC's historical loan losses to more than double once NRUC recognizes a loan loss on this exposure.

Sizeable loan loss reserve exists

Since fiscal year 2001, NRUC has consistently increased its loan loss reserve. As discussed above, during fiscal year 2009, there was a \$114 million increase to the loan loss provision primarily due to a further ICC loan impairment. At August 31, 2009, the loan loss reserve stood at \$607 million, representing a healthy 3.02% of total loans. NRUC also has a \$27 million reserve for guarantees issued by NRUC on behalf of members' debt.

National Rural Utilities Cooperative Finance Corporation (NRUC)



At August 31, 2009, non-performing loans totaled \$524 million and restructured loans totaled \$530 million. Moody's observes that NRUC continues to receive timely quarterly debt service payments on all of the \$530 million of restructured loans. NRUC generally classifies non-performing loans and restructured loans as being impaired loans. Of the \$607 million of loan loss reserves at August 31, 2009, approximately \$403 million was dedicated to the impaired loan category. In light of the size of the impaired loan portfolio and the single obligor concentration that exists among the borrowers in this impaired loan category, Moody's does not expect NRUC to materially reduce its loan loss reserve until final disposition of the ICC debt restructuring occurs. Once the ICC restructuring is completed, Moody's anticipates NRUC's loan loss reserve to represent less than 2% of NRUC's total loans.

Moody's observes that since 2003, incremental loan loss allowances have been based upon management's application of a more objective loan loss methodology that takes into account internal risk ratings of each loan, the maturity of each loan, the business segment of each loan, expected defaults based upon historical default rates, and expected recovery rates.

Steady improvement in risk management

Over the past several years, NRUC has strengthened its risk management capabilities. In addition to implementing an internal risk rating system and setting exposure limits for each borrower, NRUC also retains an independent bank consulting firm to provide an annual independent assessment of the functioning of the risk rating system. Also, NRUC has increased its ability to syndicate new and existing loan transactions and has developed expertise in selling portfolios of loans to targeted investors. Together, these efforts have provided liquidity to the asset side of the balance sheet and have helped to reduce single obligor risk.

With respect to single obligor risk, NRUC's total loans and guarantees outstanding to its top ten largest borrowers continued trending downward at \$4.07 billion representing 19% of NRUC's total loans and guarantees portfolio at August 31, 2009. By comparison, at May 31, 2004, NRUC's top ten largest borrowers had total loan and guarantee outstandings of \$4.7 billion representing 21% of NRUC's total loans and guarantees. Additionally, as mentioned earlier, due to efforts taken by NRUC management to reduce exposures in the telecommunications loan portfolio, single obligor risk (excluding the ICC exposure) largely exists in the electric portfolio only as the average loan outstanding among active telecommunication performing borrowers was \$11 million at August 31, 2009.

Although single obligor risk is likely to persist, a portion of this risk is mitigated by the portfolio's geographic and regulatory diversification. No single state exposure was larger than 17% of total loans at May 31, 2009. In Texas, NRUC's largest state exposure, the loans are spread among 107 cooperatives, with the largest being the \$511 million exposure to CoServ. In addition, we observe that cooperatives largely serve residential customers, thereby adding further diversity and stability to the borrower's ultimate source of cash flow.

National Rural Utilities Cooperative Finance Corporation (NRUC)

CoServ restructured loan: On Track

At August 31, 2009, approximately \$484 million of NRUC's restructured loans were to CoServ, a large electric distribution cooperative located in Denton, Texas. While all loans with CoServ have been on a non-accrual status since January 1, 2001, CoServ continues to make scheduled quarterly payments to NRUC under the terms of the bankruptcy settlement agreement with such payments being applied toward principal reduction. Total loans to CoServ at August 31, 2009, represented 2.4% of NRUC's total loans and guarantees outstanding. While Moody's believes that CoServ will continue to perform as required under the restructuring agreement, we also believe that NRUC will continue to account for this loan as a restructured asset for the foreseeable future.

Track record of managing difficult credit restructurings

NRUC has a demonstrated track record of being able to effectively manage difficult credit situations. As discussed above, some of this track record can be attributed to the strong security position associated with the vast majority of NRUC's loans. Furthermore, its status as a cooperatively-owned entity allows management to take a longer-term view towards restructuring difficult credit situations although Moody's notes that this also has the potential to delay the resolution of problems, relative to other financial institutions.

Concentration across two industry sectors

As previously mentioned, at August 31, 2009, about 90% of the company's loans and guarantees were made to RECs. As such, trends in rural electric utilities' aggregate credit quality will directly impact NRUC. While the recession has impacted demand for electricity across the US, the recession has generally impacted regions served by RECs less severely as compared to other regions. Additionally, RECs high reliance on the residential customer base (as compared to industrial or large commercial customers) provides greater stability for their respective cash flows. From a delinquency standpoint, utility receivables tend to be of high quality so long as businesses continue to operate and homeowners continue to remain in their residences. Among distribution RECs, accounts receivable delinquency has not changed from historical levels.

Over the next several years, the RECs will face additional challenges, all of which have the potential to increase the cost of providing electric service to rural systems. Since many of the larger generation cooperatives rely upon coal as a primary fuel source for generation, substantial incremental increases in capital requirements for related environmental expenditures are expected, particularly as some form of carbon legislation will eventually be enacted into law. Federal renewable energy standards are also likely to be implemented which will further add to the cost of electricity. Moody's fully expects any incremental cost to be passed along to the distribution cooperatives and ultimately to the end-use customer.

To that end, we observe that implementing rate increases during a period of economic stress can often be challenging which may lead to weaker credit metrics for RECs. While a rating concern for all utilities, Moody's has not witnessed large scale material "pushback" from customers concerning higher electric rates. The RECs' ability to seamlessly pass along higher operating and capital costs to their customer base is an important factor in maintaining credit quality across the RECs and at NRUC.

With respect to the telecommunications sector, as depicted on the next page, loan and guarantee exposure with RLECs remains the largest component of NRUC's rural telecommunications exposure. While the degree of competition experienced by RLECs is less intense than other sectors of the telecommunication space, the degree of competition for RLECs is far greater than the degree of competition experienced by RECs. Additionally, uncertainty continues surrounding the future of universal service funds (USF) and inter-carrier access fees, both of which are important revenue streams for RLECs. While NRUC anticipates that changes may occur in the way in which USF is funded and distributed as well as the manner in which access fees are determined, NRUC does not believe that any changes would materially impact the credit quality of its current telecommunication loan portfolio.

National Rural Utilities Cooperative Finance Corporation (NRUC)

RTFC Segment Loans and Guarantees

(Dollar amounts in millions)	2005		2006		2007		2008		2009		Q1 2010	
Rural local exchange carriers	2,358	79%	1,815	84%	1,630	88%	1,518	88%	1,476	88%	1,534	88%
Wireless providers	211	7%	5	0%	4	0%	5	0%	4	0%	4	0%
Cable television providers	169	6%	179	8%	155	8%	154	9%	152	9%	152	9%
Long distance carriers	135	5%	89	5%	9	1%	-	0%	-	0%	-	0%
Fiber optic network providers	67	2%	41	2%	37	2%	17	1%	8	1%	9	1%
Competitive local exchange carriers	45	1%	28	1%	21	1%	30	2%	37	2%	35	2%
Other	7	0%	5	0%	4	0%	4	0%	3	0%	3	0%
Total	2,992	100%	2,162	100%	1,860	100%	1,727	100%	1,680	100%	1,737	100%

Non-performing loans at \$524 million

NRUC's loan exposure to ICC, which is operating in bankruptcy, represents all of NRUC's current non-performing loans (\$524 million). Progress has been made to resolve this matter during calendar year 2009, including the bankruptcy court's interim approval of the sale of the ICC Group 1 assets to NRUC as well as the approval of NRUC's application to acquire BVI Cable Ltd from the Minister of Communications and Works and the Telecommunications Regulatory Commission of the British Virgin Islands. Also, on December 7, 2009, the Federal Communications Commission unconditionally approved the transfer of control of ICC's operating subsidiaries and assignment of related licenses to NRUC in connection with its agreement with the ICC Chapter 11 Trustee. Additional regulatory approval is required, and if attained, final bankruptcy court approval is necessary prior to asset transfer. It is possible that the asset transfer could occur sometime during calendar year 2010. NRUC believes it is adequately reserved for this exposure. However, given our understanding of the operating condition of the ICC properties, we believe additional impairments remain possible. A substantial portion of NRUC's existing loan loss reserve is earmarked for a potential ICC loan loss.

Funding

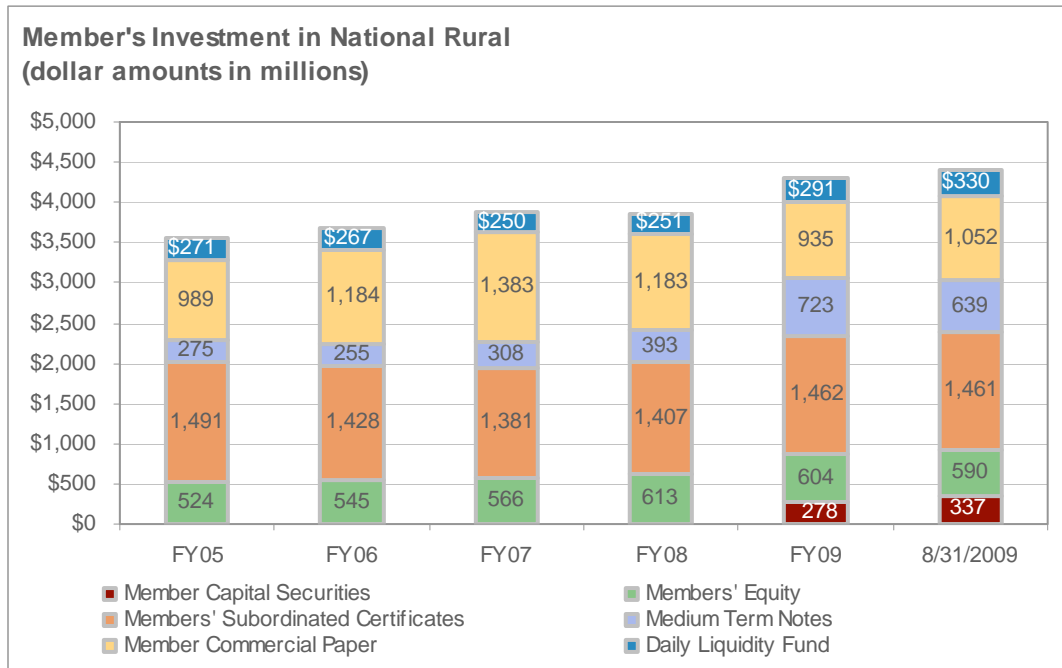
Member Cooperatives: an important funding source

One of NRUC's unique characteristics is the relationship that it has with its member cooperatives. The member cooperatives collectively own NRUC and the members look to NRUC as a source of funding for their capital requirements. As depicted on page 9, member cooperatives continue to provide increasing levels of short-term and long-term capital to NRUC. Generally speaking, members have provided about 20% of NRUC's funding for each of the last several years and Moody's views members funding as being "core" with limited flight risk.

During fiscal year 2009, the member cooperatives provided NRUC with a new form of equity capital with their funding of \$278 million in member capital securities. These securities rank pari-passu with NRUC's members' subordinated certificates. An additional \$59 million of member capital securities was raised during first quarter of fiscal year 2010 bringing the total to \$337 million at August 31, 2009. Moody's understands that this funding source will continue as an ongoing investment program offered to member cooperatives.

Also, as discussed in the Leverage section of this report, in June 2009, NRUC modified the guidelines related to the timing and amount of patronage capital to be distributed. Over time, this action should lead to sustained increase in the level of Members' Equity that is retained at NRUC

National Rural Utilities Cooperative Finance Corporation (NRUC)



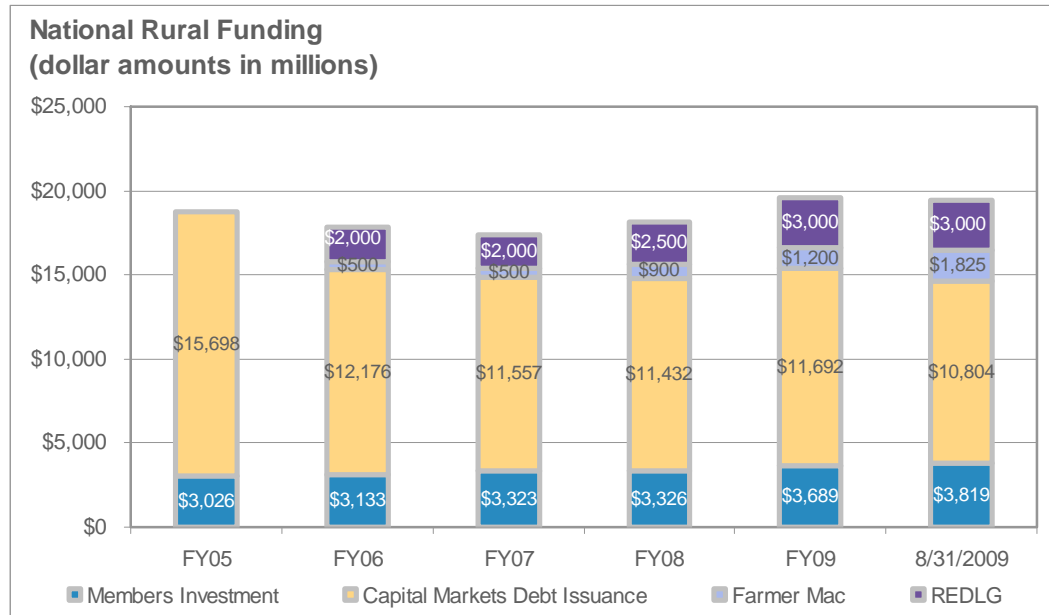
Funding becomes somewhat less capital market dependent

Like other non-bank finance companies, CFC is dependent upon access to the long-term and short-term capital markets for financing its business and for refunding debt maturities. In addition to annual operating cash flow, member loan repayments averaged about \$1 billion for the last several years and are expected to be in that range for fiscal year 2011 through 2013. For the remaining three quarters of fiscal year 2010, anticipated loan repayments of \$1.14 billion are expected; plus NRUC anticipates receiving an additional \$585 million of long-term loan prepayments primarily from the repayment of power supply bridge loans with committed RUS take-out financing.

At August 31, 2009, including members' equity, NRUC members invested about \$4.41 billion of capital representing about 21.4% of total assets (less derivatives) at Aug 31, 2009. Of the \$4.41 billion, \$1.383 billion represented short-term debt funding through \$1.053 billion in members' commercial paper and \$330 million in members' contributions to the daily liquidity fund. NRUC uses the dealer commercial paper market to supplement any additional short-term funding requirements.

As depicted on the next page, since 2006, longer-term funding sources have been supplemented through two separate private programs. Under the Rural Economic Development Loan and Grant (REDLG) program, NRUC has been able to secure \$3 billion of twenty year funding from the Federal Financing Bank of the US Treasury. Additional funding under the REDLG program remains available each year through 2013 but is dependant upon the annual federal budget process. In addition, starting in fiscal year 2006, NRUC established a relationship with Federal Agricultural Mortgage Corporation (Farmer Mac), where Farmer Mac can provide funding to NRUC through the purchase of NRUC loans or through an investment in their securities. At August 31, 2009, Farmer Mac had \$1.825 billion in outstandings with NRUC under various arrangements. Also, at August 31, 2009, NRUC had the ability to borrow an additional \$575 million under a seven-year \$1.0 billion revolving note purchase agreement between NRUC and Farmer Mac that expires in 2016.

National Rural Utilities Cooperative Finance Corporation (NRUC)



The Farmer Mac program requires NRUC to pledge collateral equal to the amount of debt outstanding under the revolving agreements. NRUC pledges distribution and power supply mortgage loans under the debt issuance agreements with Farmer Mac which permits up to 20% of the loans pledged to be from power supply systems. Under the REDLG program, fundings are on an unsecured basis but NRUC is required to deposit collateral equal to 100% of the outstanding debt balance under REDLG. This collateral could be pledged to FFB should NRUC's ratings decline to levels outlined under the Rating Trigger section of this analysis. Moody's views the arrangements under REDLG and with Farmer Mac as positive to the funding profile of NRUC as it provides a reliable source of cost-effective funding and makes NRUC less dependent on the capital markets.

Notwithstanding NRUC's relationship with its members, Farmer Mac, and its access to REDLG funding, NRUC remains dependent upon wholesale short-term and long-term funding. NRUC's primary sources of long-term capital market funding includes secured collateral trust bonds (CTBs), unsecured medium term notes (MTNs), and subordinated deferrable debt. Collateral pledged to secure NRUC's CTBs include qualified distribution loans at least equal to the amount of CTBs outstanding as well as other permitted investments.

During calendar year 2009, NRUC maintained continued access to the capital markets, including the unsecured medium term note market through the issuance of retail InterNotes which have totaled nearly \$900 million year-to-date.

Please refer to the Liquidity section of this analysis for additional information on NRUC's recent capital market activity.

Portfolio is match funded

NRUC's policy is to avoid bearing interest rate risk by match funding assets with offsetting liabilities and through interest rate derivatives. Small mismatches occur from time to time because NRUC delays funding long-term fixed rate assets until the funding requirements accumulate to create an economical transaction size. It is NRUC's policy to match fund asset and liability re-pricing terms within a range of 3% of total assets excluding derivative assets. At August 31, 2009, fixed rate assets funded with variable rate debt were \$148 million and represented less than 1% of total assets (excluding derivative assets). NRUC uses derivatives to convert a portion of variable rate funding to fixed rate, to change the basis of floating LIBOR rates to a U.S. commercial paper index rate, and to hedge currency risk, as needed. At August 31, 2009, the outstanding notional principal on interest rate derivatives was \$11.363 billion.

National Rural Utilities Cooperative Finance Corporation (NRUC)

Liquidity

NRUC has a short-term rating of Prime-1 for its commercial paper, for the guaranteed commercial paper issued by NCSC, variable rate tax-exempt demand bonds, and extendible commercial notes. While NRUC has alternative short and long-term funding sources from its members and from private sources, NRUC still remains dependent on the capital markets as a funding source. Aside from fiscal year 2010, where NRUC's internal sources could reach \$1.7 billion, NRUC's internal sources are expected to approximate \$1 billion annually, principally in the form of loan amortization payments.

During fiscal year 2009, NRUC raised \$2.3 billion of CTBs in the capital markets. In June 2008, NRUC issued \$900 million of 5.50% CTBs due 2013 and \$400 million of secured floating rate notes due 2010, and in October 2008, NRUC issued \$1 billion of 10.375% CTBs due 2018. Moody's observes that as a cost-plus lender, NRUC has incorporated the higher cost funding experienced from the October 2008 financing into the loan pricing offered to members.

During fiscal year 2009 and during the first quarter of fiscal year 2010, NRUC's private funding sources provided \$1.925 billion of incremental funding with the RDLG program providing \$500 million of funding and Farmer Mac providing \$1.425 billion of incremental funding. As mentioned, at August 31, 2009, NRUC had \$575 million of availability under the seven year Farmer Mac note facility.

Subsequent to first quarter end, in September 2009, NRUC raised \$500 million in the capital markets issuing \$250 million of 2.625% of CTBs due 2012 and \$250 million of 3.875% of CTBs due 2015. While the tenor of these transactions were shorter in duration and the amount raised was smaller, these transaction priced at considerably lower relative spreads than the October 2008 transaction reflecting the improvement in the capital markets for all issuers including non-bank financials.

NRUC has established a goal of maintaining its dealer commercial paper and bank bid notes at no more than 15% of total debt. At Aug 31, 2009, dealer commercial paper and bank bid notes totaled approximately 8% of total debt outstanding. Moody's expects outstanding dealer commercial paper and bank bid notes to remain below 15% during fiscal year 2010.

NRUC limits the amount of commercial paper issued to the amount of back-up liquidity provided by its revolving credit agreements so that there is at least 100% coverage of outstanding commercial paper. NRUC's bank facilities aggregate \$3.016 billion (adjusted for its commitment from Lehman Brothers Bank) and represent NRUC's principal form of liquidity support. Of the \$3.016 billion in committed bank facilities, nearly 67% of the credit facilities have a multi-year maturity. Approximately \$1.049 billion of the facilities expire on March 16, 2012, and \$967 million expire on March 22, 2011. The remaining \$1.0 billion of these commitments expire on March 12, 2010. A failure to maintain access to adequate levels of multi-year credit facilities could impact NRUC's ratings.

The credit facilities do not contain a MAC clause but have financial covenants which are set at levels that provide substantial cushion. The agreements require an adjusted TIER average of 1.025 for the last six quarters (excluding any non-cash adjustments for derivatives and foreign currency transactions) and a maximum senior debt to equity ratio, as defined in the bank agreement, to not be more than 10x (excluding any non-cash adjustments for derivatives and foreign currency transactions). NRUC was comfortably in compliance with these covenants at August 31, 2009 as adjusted TIER was 1.15x and senior debt to equity ratio was 6.75x.

Given NRUC's short-term rating for commercial paper with Moody's and Standard and Poor's Corporation (S&P), NRUC is an eligible issuer of commercial paper under the Commercial Paper Funding Facility (CPFF) established by the Federal Reserve Bank on October 7, 2008 for up to an amount of \$3.083 billion. NRUC issued \$1 billion of commercial paper through the CPFF in the second quarter of fiscal year 2009 (September – November 2008) which matured and was repaid in March 2009. NRUC has not issued any additional commercial paper through the CPFF as their own funding programs offer lower cost alternatives. NRUC is still qualified to use the CPFF as the expiration date of the program was extended to February 1, 2010 but Moody's does not expect any further use given NRUC's access to its own lower cost alternatives.

National Rural Utilities Cooperative Finance Corporation (NRUC)

Refinancing needs for fiscal year 2010 have been largely addressed with the repayment of \$1.495 billion of medium term notes in the first quarter of fiscal year 2010 and with the company's September 2009 issuance of \$500 million of CTBs. Prospectively, for the one year period from September 1, 2009 through August 31, 2010, NRUC has \$1.482 billion of notes and bonds maturing in this time frame, of which \$412 million are owed to member cooperatives, leaving \$1.07 billion of maturing notes and bonds. Approximately \$188 million of the remaining \$1.07 billion is due to Farmer Mac, which Moody's believes will be extended at the maturity date. Of the remaining \$882 million, \$200 million of CTBs mature in January 2010 and \$400 million of CTBs mature in July 2010. Beyond the July 2010 maturity, NRUC has \$500 million of CTBs maturing in October 2010 with the next sizeable maturity occurring in March 2012 when \$1.5 billion of senior unsecured notes mature. Moody's expects NRUC to meet these financing requirements through internal sources, loan repayments, capital market offerings, and access to various private financing programs.

Leverage

Leverage, while slowly declining, remains high

Due to the nature of its composition, NRUC does not have common stock in its capital structure. Instead, most RECs, as a condition of NRUC membership, are required to purchase deeply subordinated capital term certificates in an amount equal to 1% of the member's revenue for a 15-year period. These capital term certificates bear below-market interest rates and have maturities of up to 100 years. When members either borrow from NRUC or obtain a guarantee, they may be required to purchase similar subordinated obligations (long-term certificates or subordinated term certificates) in amounts ranging from 3.0-12.0% of the credit exposure that matches the maturity of the borrowing or guarantee. For analytical purposes, Moody's treats the combination of allocated but unretired margins, membership fees, education fund, members' capital reserve, and member subordinated certificates as equity.

Capitalization Ratios (calculated by Moody's)	2003	2004	2005	2006	2007	2008	2009	1Q 2010
Adjusted Funded Debt / Adjusted Member's Equity*	8.2x	8.6x	8.5x	8.3x	8.1x	8.3x	8.1x	8.0x
Adjusted Funded Debt (inc. Guarantees) / Adjusted Member's Equity (inc. Loss Reserve)**	7.2x	7.2x	7.0x	6.7x	6.7x	7.0x	6.8x	6.7x

* Moody's defines the Adjusted Funded Debt to Adjusted Members' Equity ratio as being the sum of the Notes Payable and Long Term Debt (including Subordinated Deferrable Debt) on NRUC's balance sheet divided by the sum of the Members' Subordinated Certificates and Members' Equity excluding derivative forward value and foreign currency adjustments. Member Capital Securities receive equity credit, as determined by Moody's.

** Moody's defines the Adjusted Funded Debt (including Guarantees) to Adjusted Members' Equity (including Loss Reserves) ratio as being the sum of the Notes Payable, Long Term Debt (including Subordinated Deferrable Debt) and Guarantees in NRUC's financial statements divided by the sum of the Members' Subordinated Certificates, Members' Equity excluding derivative forward value and foreign currency adjustments and the Loan and Guarantee Loss Reserve. Member Capital Securities receive equity credit, as determined by Moody's.

Since 2004, NRUC's leverage has been on a slow declining trend. At August 31, 2009 adjusted funded debt / adjusted member's equity, as calculated by Moody's, was 8.0x, compared to 8.3x at May 31, 2008. A primary reason for the decline was NRUC's decision to offer member capital securities to its cooperative members. Since their introduction in November 2008, NRUC has raised \$337 million as of August 31, 2009.

In June 2009, as a means of increasing its equity retention, NRUC revised its guidelines related to the timing and amount of patronage capital to be distributed. Under the new guidelines, NRUC will retire 50% of prior year's allocated net earnings and hold the remaining 50% for 25 years. Under the previous guidelines, NRUC retired 70% of prior year's allocated net earnings and held the remaining 30% for 15 years. The retirement amount and timing remains subject to annual approval by NRUC's board of directors. Moody's views the decisions to offer member capital securities and to alter the patronage capital cycle as credit supportive actions by NRUC. Moody's believes these two initiatives should enable leverage, as calculated by Moody's, to continue a downward trend.

National Rural Utilities Cooperative Finance Corporation (NRUC)

Other Rating Considerations

Derivative accounting adds volatility to GAAP results

Due to derivative accounting, NRUC has experienced and will continue to experience volatility in reported GAAP results. The company enters into these exchange agreements as part of its risk management strategy. As interest rates in the capital markets increase or decrease, the fair value of these derivative instruments changes, requiring companies to record the fair value of its derivative assets and liabilities on its balance sheet. NRUC uses "mark to market" accounting (rather than hedge accounting) for all of its derivative transactions thereby increasing income statement volatility. Moody's evaluation of adjusted TIER, leverage, and cash flow eliminates all non-cash derivative related adjustments.

Rating Triggers

At August 31, 2009, there were rating triggers associated with \$7.483 billion notional amount of interest rate exchange agreements. The rating triggers are based on NRUC's senior unsecured credit rating from Moody's and S&P. If NRUC's rating for senior unsecured debt from either agency falls below the level specified in the agreement, the counterparty may, but is not obligated to, terminate the agreement. Upon termination, both parties would be required to make all payments that might be due to the other party. If NRUC's rating from Moody's falls to and below Baa1 or NRUC's rating from S&P falls to and below BBB+, counterparties may terminate the agreements with a total notional amount of \$6.311 billion. If NRUC's rating from Moody's falls below Baa1 or NRUC's ratings from S&P falls below BBB+, a counterparty may terminate the agreement with a total notional amount of \$1.172 billion.

At August 31, 2009, NRUC had a derivative fair value of negative \$141.0 million, comprised of \$12 million that would be due to NRUC and \$153.0 million that NRUC would have to pay if all interest rate exchange agreements were terminated.

In addition to the rating triggers listed above, at August 31, 2009, NRUC had a total notional amount of \$645 million of derivative instruments with one counterparty that would require the pledging of collateral totaling \$26 million representing the net cash settlement amount of the derivative instruments if the senior unsecured ratings from Moody's were to fall below Baa2 or if the senior unsecured rating from S&P 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, 2009 was a manageable \$173 million.

In addition to these rating triggers which require NRUC to pay or receive collateral depending on NRUC's position with its counterparty, a rating trigger exists in the financing documents with the FFB under the REDLG program. Specifically, if NRUC's senior secured credit ratings were to fall below A3 from Moody's, A- from S&P, or A- from Fitch Ratings by two rating agencies, the notes on deposit at that time would need to be pledged as collateral rather than being held on deposit. As such, this rating trigger is not considered a liquidity event.

Corporate Governance

NRUC's board of directors is comprised of twenty-three members. According to the company's by-laws, twenty of the directors must be either general managers of the member cooperatives or directors of the member systems. Two of the directors are designated by the National Rural Electric Cooperative Association, a national lobbyist group for rural electric cooperatives. During fiscal year 2004, NRUC modified its by-laws to add one additional director to its board. This position must be filled by an at-large director, who must satisfy the requirements of an audit committee financial expert as defined by Section 407 of the Sarbanes-Oxley Act of 2002 and must be elected from the general membership. This at-large position can be filled at the discretion of the board.

During 2007, NRUC filled the at-large directorship seat. Moody's understands that this individual, a director of the East Kentucky Power Cooperative, is a Certified Public Accountant, a Certified Forensic Accountant and

National Rural Utilities Cooperative Finance Corporation (NRUC)

has experience as a director of a publicly-traded bank. In Moody's opinion, while filling its by-law mandate, the board's financial expertise was strengthened; however, Moody's believes that given the nature and size of the financial transactions that underpin NRUC's business, the selection of additional directors with corporate accounting or financial services industry experience would be beneficial.

No member of NRUC management holds a board seat. Each board member serves a three-year term and is limited to a maximum of two consecutive terms. In contrast to a public company, where voting is in proportion to the share of ownership, each full member cooperative is entitled to one vote irrespective of the size of its capital contribution. In addition, NRUC is not subject to regulation by any federal or state authorities as a bank would be.

National Rural Utilities Cooperative Finance Corporation (NRUC)

Moody's Related Research

Credit Opinions:

- National Rural Utilities Cooperative Finance Corporation, December 2009

Rating Methodology:

- U.S. Electric Generation & Transmission Cooperatives, December 2009 (121189)
- Analyzing the Credit Risks of Finance Companies, October 2000 (60730)

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.

Report Number: 121305

Author	Senior Associate	Senior Production Associate
A.J. Sabatelle	Jessica Sutphin	Shubhra Bhatnagar Judy Yuen

CREDIT RATINGS ARE MOODY'S INVESTORS SERVICE, INC.'S (MIS) CURRENT OPINIONS OF THE RELATIVE FUTURE CREDIT RISK OF ENTITIES, CREDIT COMMITMENTS, OR DEBT OR DEBT-LIKE SECURITIES. MIS DEFINES CREDIT RISK AS THE RISK THAT AN ENTITY MAY NOT MEET ITS CONTRACTUAL, FINANCIAL OBLIGATIONS AS THEY COME DUE AND ANY ESTIMATED FINANCIAL LOSS IN THE EVENT OF DEFAULT. CREDIT RATINGS DO NOT ADDRESS ANY OTHER RISK, INCLUDING BUT NOT LIMITED TO: LIQUIDITY RISK, MARKET VALUE RISK, OR PRICE VOLATILITY. CREDIT RATINGS ARE NOT STATEMENTS OF CURRENT OR HISTORICAL FACT. CREDIT RATINGS DO NOT CONSTITUTE INVESTMENT OR FINANCIAL ADVICE, AND CREDIT RATINGS ARE NOT RECOMMENDATIONS TO PURCHASE, SELL, OR HOLD PARTICULAR SECURITIES. CREDIT RATINGS DO NOT COMMENT ON THE SUITABILITY OF AN INVESTMENT FOR ANY PARTICULAR INVESTOR. MIS ISSUES ITS CREDIT RATINGS WITH THE EXPECTATION AND UNDERSTANDING THAT EACH INVESTOR WILL MAKE ITS OWN STUDY AND EVALUATION OF EACH SECURITY THAT IS UNDER CONSIDERATION FOR PURCHASE, HOLDING, OR SALE.

© Copyright 2009, Moody's Investors Service, Inc., and/or its licensors and affiliates (together, "MOODY'S"). All rights reserved. **ALL INFORMATION CONTAINED HEREIN IS PROTECTED BY COPYRIGHT LAW AND NONE OF SUCH INFORMATION MAY BE COPIED OR OTHERWISE REPRODUCED, REPACKAGED, FURTHER TRANSMITTED, TRANSFERRED, DISSEMINATED, REDISTRIBUTED OR RESOLD, OR STORED FOR SUBSEQUENT USE FOR ANY SUCH PURPOSE, IN WHOLE OR IN PART, IN ANY FORM OR MANNER OR BY ANY MEANS WHATSOEVER, BY ANY PERSON WITHOUT MOODY'S PRIOR WRITTEN CONSENT.** All information contained herein is obtained by MOODY'S from sources believed by it to be accurate and reliable. Because of the possibility of human or mechanical error as well as other factors, however, such information is provided "as is" without warranty of any kind and MOODY'S, in particular, makes no representation or warranty, express or implied, as to the accuracy, timeliness, completeness, merchantability or fitness for any particular purpose of any such information. Under no circumstances shall MOODY'S have any liability to any person or entity for (a) any loss or damage in whole or in part caused by, resulting from, or relating to, any error (negligent or otherwise) or other circumstance or contingency within or outside the control of MOODY'S or any of its directors, officers, employees or agents in connection with the procurement, collection, compilation, analysis, interpretation, communication, publication or delivery of any such information, or (b) any direct, indirect, special, consequential, compensatory or incidental damages whatsoever (including without limitation, lost profits), even if MOODY'S is advised in advance of the possibility of such damages, resulting from the use of or inability to use, any such information. The credit ratings and financial reporting analysis observations, if any, constituting part of the information contained herein are, and must be construed solely as, statements of opinion and not statements of fact or recommendations to purchase, sell or hold any securities. **NO WARRANTY, EXPRESS OR IMPLIED, AS TO THE ACCURACY, TIMELINESS, COMPLETENESS, MERCHANTABILITY OR FITNESS FOR ANY PARTICULAR PURPOSE OF ANY SUCH RATING OR OTHER OPINION OR INFORMATION IS GIVEN OR MADE BY MOODY'S IN ANY FORM OR MANNER WHATSOEVER.** Each rating or other opinion must be weighed solely as one factor in any investment decision made by or on behalf of any user of the information contained herein, and each such user must accordingly make its own study and evaluation of each security and of each issuer and guarantor of, and each provider of credit support for, each security that it may consider purchasing, holding or selling. MOODY'S hereby discloses that most issuers of debt securities (including corporate and municipal bonds, debentures, notes and commercial paper) and preferred stock rated by MOODY'S have, prior to assignment of any rating, agreed to pay to MOODY'S for appraisal and rating services rendered by it fees ranging from \$1,500 to approximately \$2,400,000. Moody's Corporation (MCO) and its wholly-owned credit rating agency subsidiary, Moody's Investors Service (MIS), also maintain policies and procedures to address the independence of MIS's ratings and rating processes. Information regarding certain affiliations that may exist between directors of MCO and rated entities, and between entities who hold ratings from MIS and have also publicly reported to the SEC an ownership interest in MCO of more than 5%, is posted annually on Moody's website at www.moody's.com under the heading "Shareholder Relations — Corporate Governance — Director and Shareholder Affiliation Policy."



Moody's Investors Service