This Analysis provides a discussion of the factors underpinning the credit rating/s and should be read in conjunction with our Credit Opinion. The most recent ratings, opinion, and other research specific to this issuer are provided on Moodys.com. Click here to link.

Analysis

UNITED STATES
Americas

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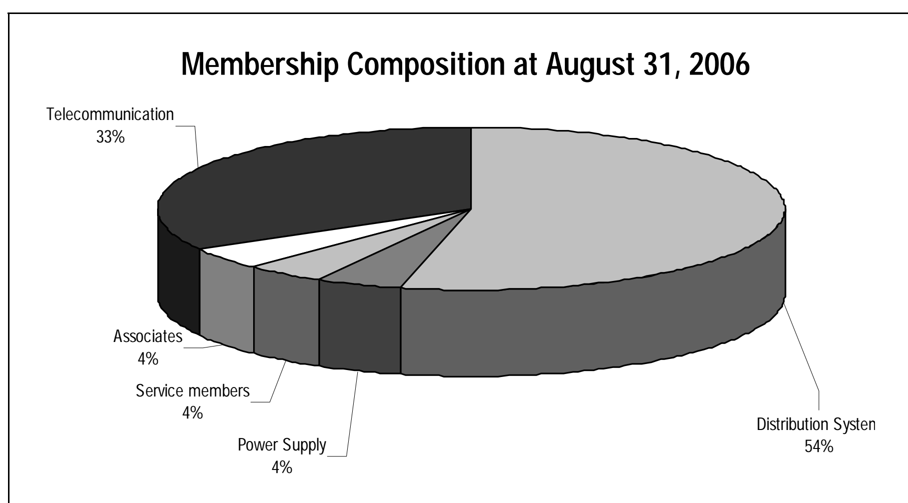
National Rural Utilities Cooperative Finance Corporation (CFC)

National Rural Utilities Cooperative Finance Corporation (CFC) is a non-bank financial institution exclusively serving rural electric, service, and telecommunication utilities. CFC was organized in 1969 by rural electric cooperatives (RECs) as a not-for-profit, tax exempt association that would provide an economical alternative to federally subsidized funds from the Rural Utilities Service (RUS) of the U.S. Department of Agriculture.

As of August 31, 2006, CFC had 1,546 member cooperatives, including 898 rural electric utility system members, 514 telecommunications members, 66 service members, and 68 associate members. Of the 898 electric utility system members, 829 were distribution systems and 69 were generation and transmission systems.



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 CFC. CFC manages the affairs of RTFC through a long-term management arrangement and provides RTFC with all of its financing.

CFC also utilizes National Cooperative Services Corporation (NCSC), a private cooperative association, to provide specialized financing and services to RECs. NCSC borrows the funds that it lends either from CFC directly,

or from another creditor with a CFC guarantee. Effective June 1, 2003, NCSC's results were consolidated with those of CFC. CFC guarantees all of NCSC's outstanding debt, including the debt incurred under NCSC's $500 million commercial paper program. Based on the guarantee from CFC, NCSC's senior unsecured long-term debt and its commercial paper program are rated the same rating as CFC's senior unsecured debt and CFC's short-term rating for commercial paper. At August 31, 2006, CFC had provided a total credit of $416 million to NCSC, of which $205 million were outstanding loans and $211 million were forms of credit enhancement.

CFC operates to earn 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 operating costs and maintain an adjusted times interest earned ratio (TIER) of at least 1.10 times. CFC's adjusted TIER averaged 1.12 times over the past three fiscal years, and its adjusted TIER was 1.11 in fiscal 2006. In calculating adjusted TIER, CFC appropriately includes SFAS 133 cash settlements in the cost of funds, since the amount of SFAS cash settlement represents the amount of cash that is actually received (or paid) by CFC in a given period. Prior to the introduction of SFAS 133, this amount was included in cost of funds. CFC also appropriately removes the derivative forward value and SFAS 52 foreign currency adjustments when it calculates adjusted TIER.

Key Rating Factors

LOAN PRICING FLEXIBILITY ENABLES CFC TO RESET MARGINS SUFFICIENT TO MAINTAIN ITS TARGETED COVERAGE RATIOS WHILE ADDING TO ITS LOAN LOSS RESERVE.

A key support to CFC's credit quality is the ability of CFC to reset margins sufficient to maintain its targeted adjusted TIER of 1.10x. CFC manages this important aspect of their business by having terms and conditions in virtually all of their customer's loan documents that allow for a variety of repricing mechanisms. Additionally, basis risk is typically not a concern as the funding options afforded to CFC's borrowers equate to CFC's actual funding costs. For example, most variable rate loans reset monthly or semi-monthly with the loan pricing being based on CFC'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 repricing tenors of the fixed rate loan portfolio. For example, over the next five fiscal years, approximately $4.7 billion of CFC's fixed rate loan portfolio will reprice based upon the terms and conditions set forth in the specific loan documents. Additionally, CFC's operating costs continue to remain low and controllable though its costs have risen over time as a share of outstanding loans due principally to the decline in CFC's loan portfolio. General and administrative expenses for last twelve months ending August 2006 were $51 million representing 28 basis points of the average loan outstanding for the same period compared to 25 basis points for fiscal year 2005 and only 17 basis points for fiscal year 2001.

CFC's ability to execute on this strategy is further aided by the dominant position that CFC enjoys with the majority of its customer base 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 (IOUs), about 70% of the RECs are unregulated, which allows them to reset utility rates as necessary without significant regulatory intervention. Another 20% of the RECs operate under streamlined regulation, which allow for the resetting of rates within the guidelines of an established formula. State public utility commissions regulate the remaining 10% of the RECs, which limit their flexibility and can create regulatory lag.

OUTSTANDING CREDIT QUALITY OF CFC'S LOAN PORTFOLIO, INCLUDING ITS LOAN LOSS HISTORY, AND ITS STRONG COLLATERAL POSITION ON 91% OF ITS LOANS

CFC has an excellent loan loss experience. Only $117 million in cumulative net losses have been taken in the company's 37 year operating history, and in the past five years, $35 million in cumulative net losses have been recorded. The low write-off loan history demonstrates the historically high credit quality of CFC's portfolio, the strength of the collateral typically pledged to CFC, and the ability of the CFC to take a long-term view concerning debt restructuring due to its unique relationship with its customer base and the fact that CFC is a not-for-profit organization.

As depicted below, about 91% of CFC's loan portfolio is secured. Loans are typically secured on a parity with other secured lenders (primarily RUS), if any, by all assets and revenues with certain exceptions typical for utility mortgages. This strong collateral position has helped to provide high recovery values for CFC in past problem loan debt restructurings and often enables CFC to receive the payment of interest and principal while a borrower is operating in bankruptcy. The majority of CFC's unsecured loans relate to short-term lines of credit with RECs.

($ Amounts in Millions)	At August 31, 2006				At May 31, 2005			
Total Loans by Segment	Secured	%	Unsecured	%	Secured	%	Unsecured	%
CFC	$14,587.9	92%	$1,321.9	8%	$14,316.9	92%	$1,188.2	8%
RTFC	$1,797.5	88%	$236.9	12%	2,747.9	92%	244.4	8%
NCSC	$304.8	77%	$88.7	23%	391.1	82%	83.6	18%
Total Loans	$16,690.2	91%	$1,647.6	9%	$17,455.9	92%	$1,516.2	8%

INCREASE IN LOAN LOSS RESERVE PROVIDES A CUSHION FOR MANAGING PROBLEM CREDITS

Since fiscal year 2000, CFC has materially increased it loan loss reserve. At August 31, 2006, the loan loss reserve stood at $611 million, an increase of $398 million over that timeframe. CFC has also established a $13 million reserve for guarantees issued by CFC of members' debt.

LOAN LOSS RESERVE	LTM Q1 2007	2006	2005	2004	2003	2002	2001	2000
2006								
Loan Loss Reserve (Millions)*	611	611	590	574	511	478	317	213
Loan Loss Reserve / Loans (%)	3.33%	3.33%	3.11%	2.80%	2.62%	2.38%	1.61%	1.28%

**Excludes loss reserves for guarantee portfolio of $13 million, $15 million, $16 million, $19 million, $54 million, $28 million, and $15 million for Q1 2007, 2006, 2005, 2004, 2003, 2002, and 2001 respectively.*

During 2006, CFC increased in loan loss reserve by $21 million reflecting a higher provision for impaired loans principally offset by a decline in high risk loans and all other loans due in part to a reduction in total loan outstandings to the telecommunication sector. CFC's ability to consistently meet its financial target of an adjusted TIER of 1.10x while increasing the loan loss reserve over this timeframe, a period when several large obligors were on a non-accrual status, demonstrates the degree of pricing flexibility afforded to CFC. At August 31, 2006, CFC's loan loss reserve represents 3.33% of total loans, representing a significant improvement from 2000 levels of 1.28% of total loans.

At August 31, 2006, non-performing loans totaled $538 million and restructured loans totaled $624 million. CFC's classifies non-performing loans and restructured loans as being impaired loans pursuant to SFAS 114. Of the $611 million of loan loss reserves at August 31, 2006, approximately $451 million was dedicated to the impaired loan category. In light of the size of the impaired loan portfolio and the concentration that exists among non-performing loans and restructured loans, Moody's does not expect CFC to materially lower its loan loss reserve in the near term.

Since 2003, CFC has implemented a more objective loan loss methodology to determine the loan loss allowance for the general portfolio. Factors impacting the methodology include 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. Additionally, CFC allocates additional reserve for entities with large exposures.

MANAGEMENT HAS A STRONG TRACK RECORD OF BEING ABLE TO EFFECTIVELY MANAGE DIFFICULT CREDIT RESTRUCTURINGS

CFC 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 CFC's loans. Additionally, its status as a not-for-profit cooperative 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 resolution of problems, relative to other financial institutions.

COSERV LOAN RESTRUCTURING AND CFC'S FORECLOSED ASSET PORTFOLIO BOTH CONTINUE TO MEET PERFORMANCE EXPECTATIONS

At August 31, 2006, approximately $563 million of CFC's restructured loans were to CoServ, a large electric distribution cooperative located in Denton, Texas. While all loans with CoServ are on a non-accrual status since January 1, 2001, CoServ continues to makes scheduled quarterly payments to CFC under the terms of the bankruptcy settlement agreement. Such payments will continue to be applied to principal reduction. Moody's believes that CFC will continue to account for this loan as a restructured asset for the foreseeable future.

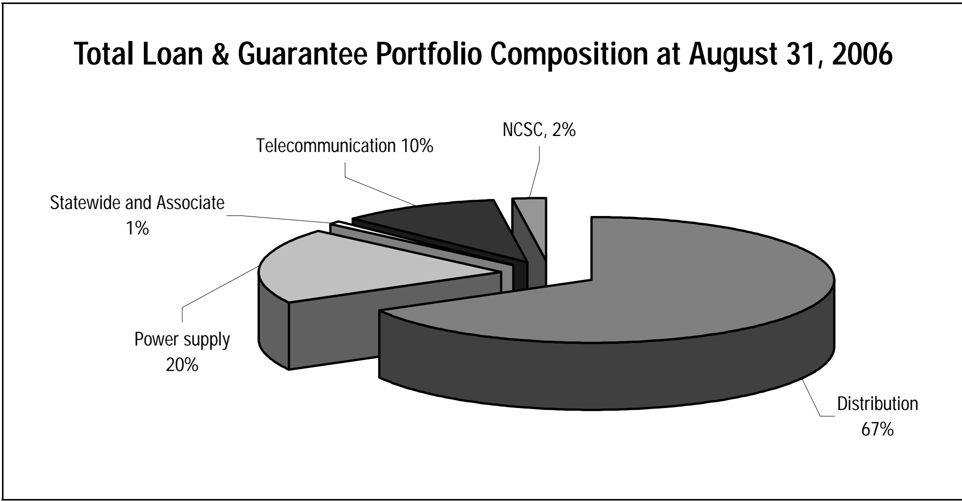
As part of the CoServ restructuring, entities controlled by CFC took possession of $325 million of notes receivable from real estate developers, limited partnership interests in certain real estate developments and partnership interests in certain real estate assets. Additionally, as part of CoServ's bankruptcy restructuring, CoServ transferred its telecommunications assets to an entity designated by CFC. During fiscal year 2004, CFC sold the telecommunications subsidiary for $31 million. Also, during the past three fiscal years, CFC received approximately $246 million in net cash proceeds from the liquidation of real estate notes through asset sales or repayment of the notes. As such, foreclosed assets, which include both the real estate notes and telecom assets, have substantially reduced by $248 million to $121 million at May 31, 2006 from $369 million in 2002. Subsequent to fiscal year-end 2006, CFC received partial or full pay down by two limited real estate partnerships resulting in a further reduction in the level of foreclosed assets by $24 million.

LOAN AND GUARANTEE PORTFOLIO DECLINES DUE TO A SUBSTANTIAL REDUCTION IN LOANS TO THE TELECOMMUNICATIONS SECTOR

At August 31, 2006, CFC's total loans to members stood at $18.3 billion versus almost $19 billion at fiscal year end 2005, a decline of around $630 million or almost 3.3%, due primarily to several large prepayments of loans with telecommunication borrowers. Specifically, loans to telecommunication borrowers declined by $960 million during fiscal year 2006 as several of the borrowers utilized the capital markets to refinance their RTFC loans allowing RTFC to substantially reduce exposure to this sector and to several large telecommunication borrowers. Loans to power supply REC borrowers increased by $248 million while loans to distribution RECs increased by $167 million to almost $12.9 billion.

CFC's off-balance sheet commitments, principally in the form of guarantees, continue the downward trend that began in the late 1990's. The vast majority of these off-balance commitments remain associated with the power supply segment of CFC's business with a large component of these off-balance commitments representing CFC's guarantee of a member's pollution control bond obligation. At August 31, 2006, total guarantees and other off-balance sheet commitments were $1.08 billion, a decline of $78 million from fiscal year-end 2005, and a decline of around $1.1 billion from year-end 2001.

As depicted below, 87% of CFC's loans and guarantees at August 31, 2006 were with RECs with 67% of the loans and guarantees being extended to distribution RECs and 20% with power supply RECs. Loans and guarantees exposure to the rural telecommunication sector accounted for 10% of CFC's total loans and guarantees at August 31, 2006, representing a substantial decline from year-end 2003 when loans and guarantees exposure to the rural telecommunication sector was 23% of CFC's total loans and guarantees. As discussed in greater detail below, 85% of CFC's exposure in the rural telecommunication portfolio is to rural local exchange carriers (RLECs). Moody's views this shift in the portfolio towards RECs and away from the rural telecommunication sector as being supportive to CFC's overall credit quality and to the quality of the loan portfolio.



CFC expects loan portfolio growth to remain relatively flat due to additional prepayments expected from telecommunication borrowers balanced against some growth from REC borrowers. CFC anticipates that the majority of its electric loan growth will come from distribution system borrowers that have fully prepaid their RUS loans and choose not to return to the government loan program, from distribution borrowers who view CFC as a more timely and efficient source of capital when compared to the government loan program, and from power supply systems.

HIGH CONCENTRATION ACROSS TWO INDUSTRY SECTORS

As mentioned, at August 31, 2006, approximately 87% of the company's loans and guarantees were made to RECs. As such, trends in the rural electric utility's aggregate credit quality directly impacts CFC. The uncertainty caused by deregulation and technological advances, both of which could impact RECs, remain long-term challenges for CFC. To date, however, the vast majority of the electric cooperatives have opted out of competition either by choice or by legislative action.

A more near-term challenge for RECs is the higher cost of operating their business given the continued increase in fuel prices, particularly natural gas, as well as increased in other operating expenses, including pension related obligations. Additionally, many of the REC systems are experiencing higher than average customer growth in their respective service territory. While higher customer growth enables RECs to more efficiently spread any incremental costs across more customers, it also results in higher capital expenditures for generation, transmission, and distribution investments, all of which will need to be recovered from the RECs customers. 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 RECs.

About 10% of CFC's loans and guarantees are with rural telecommunication companies. As discussed above, CFC has made great strides in reducing its exposure to this industry segment, particularly since 2004, through debt prepayments that occurred at a number of CFC's largest telecommunication borrowers. Over that timeframe, exposure to this sector declined by more than $2.6 billion representing a 57% decline in actual loans and guarantees to this sector, While exposure to the rural telecommunication sector has declined measurably, CFC's exposure to this sector remains meaningful as total loans and guarantees at August 31, 2006 stood at slightly more than $2.0 billion. Moody's expects exposure to the rural telecommunications sector to continue a declining trend over the next several years.

As depicted below, loan and guarantee exposure with RLECs remains the largest component of CFC's rural telecommunication exposure. While the degree of competition experienced by RLECs is less intense than other sectors of the telecommunication space, the degree of competition for borrowers in this portfolio is far greater than what has occurred within the electric side of the business. Additionally, uncertainty exists surrounding the future of universal service funds (USF) and intercarrier access fees, both of which are important revenue streams for RLECs. While CFC 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, CFC does not believe that any changes would materially impact the credit quality of its telecommunication loan portfolio.

RTFC Segment Loans and Guarantees

(Dollar amounts in millions)	Q1 2007		2006		2005		2004	
Rural local exchange carriers	1,733	85%	1,815	84%	2,358	79%	3,615	78%
Cable television providers	178	9%	179	8%	169	6%	176	4%
Long distance carriers	49	2%	89	4%	135	5%	340	7%
Fiber optic network providers	42	2%	41	2%	67	2%	168	4%
Competitive local exchange carriers	24	1%	28	1%	45	2%	62	1%
Wireless providers	3	0%	5	0%	211	7%	267	6%
Other	5	0%	5	0%	7	0%	15	0%
	2,034	100%	2,162	100%	2,992	100%	4,643	100%

SINGLE OBLIGOR RISK CONTINUES TO BE ONGOING CONCERN

CFC's market dominance has resulted in a loan portfolio that covers the majority of the RECs; and in a large number of cases, CFC is the principal source of financing for these entities. Furthermore, CFC's electric loan portfolio is long dated and the assets are not very liquid. Historically, all of CFC's loans were not syndicated or distributed to other potential lenders, which was not surprising, givens its dominant market position, the unique nature of its business, and the low rates that it charges its customers. Although these issues have existed at CFC since its inception, Moody's considers these characteristics as higher risk factors in recent times, particularly given the amount of leverage on CFC's balance sheet and CFC's reliance on the capital markets to fund its business. Within the last several years, CFC has sought to increase its internal syndication ability for several of its largest loan exposures and taken numerous steps to improve the liquidity across the asset side of the balance sheet. Over the past year, CFC has lead four syndicated deals totaling $1.7 billion. Moody's views positively CFC's syndication efforts though increased loan syndication serves to reduce CFC's historically dominant position in a restructuring given its role as the primary lender.

Additionally, CFC has established a whole loan sale program with a third party which is intended to sell all or portion of its loans from individual RECs. While the established program is just evolving and sales of existing loans are expected to be modest relative to the size of CFC's REC loan portfolio, the existence of the program indicates an ongoing effort by CFC to reduce single obligor risk and signals a continuing shift to improve portfolio management diversification measures across the portfolio.

Also, CFC has established portfolio and credit guidelines to address this ongoing concern. Industry and borrower limits have been established, and the credit risk arising from higher credit exposure may be addressed by additional requirements for subordinate certificate purchases, thereby increasing members' equity and partially mitigating CFC's exposure. CFC also maintains additional reserves in its loan loss reserve for large single obligor exposures. CFC has actively worked down several of its large single obligor exposures following the refinancing of telecommunications loans resulting in substantial loan prepayments for RTFC loans. For example, at August 31, 2006, CFC's top ten largest borrowers had total loan outstanding of $3.5 billion representing 18% of CFC's total loan portfolio. By comparison, at May 31, 2004, CFC's top ten largest borrowers had total loan outstanding of $4.7 billion representing 21% of CFC's total loan portfolio

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 16% of total loans at May 31, 2006. In Texas, CFC's largest state exposure, the loans are spread among 111 cooperatives, with the largest being the $569 million exposure to CoServ. In addition, cooperatives largely serve residential customers, thereby adding diversity to the ultimate source of cash flow.

CFC IS RELIANT ON THE SHORT-TERM AND LONG-TERM CAPITAL MARKETS FOR FUNDING ITS BUSINESS AND FOR REFINANCING MATURING DEBT

Like most finance companies, CFC is highly reliant upon access to the short-term and long-term capital markets for funding its business and for refunding debt maturities. In addition to operating cash flow, investments from CFC members provide about $3.68 billion of capital for CFC representing 19% of total assets at May 31, 2006. Of the $3.68 billion, $1.64 billion represented short-term debt funding through $1.36 billion in members' commercial paper and $276 million in members' contributions to the daily liquidity fund, both funding sources that Moody's considers to be "core funding".

CFC funds the remainder of its capital needs through the issuance of short-term debt consisting of dealer commercial paper and bank bid notes. Longer-term needs are satisfied through the issuance of secured collateral trust bonds, unsecured medium term notes, and subordinated deferrable debt. At August 31, 2006, the company had effective registration statements covering $1.075 billion of collateral trust bonds, $3.875 billion of medium-term notes and $165 million of subordinated deferrable debt. The company has Board authorization to issue up to $1.0 billion of commercial paper and $4.0 billion of medium-term notes in the European market and $1.5 billion of medium-term notes in the Australian market.

Subsequent to fiscal year 2005, CFC executed two agreements which provide sizeable and highly reliable sources of capital for the company for the next few years. In June 2005, CFC entered into a bond purchase agreement with the Federal Financing Bank (FFB) and a bond guarantee agreement with RUS resulting in a $2.5 billion loan facility under the Rural Electric Development Loan and Guarantee (REDLG) program. Under this program, CFC is eligible to borrow up to the amount of the outstanding loans that it has issued concurrent with RUS loans. At August 31, 2006, CFC had a total of $2.5 billion outstanding on loans issued concurrently with RUS. Under the program, CFC will pay a fee of 30 basis points per annum to RUS for the guarantee of principal and interest payments to FFB. At August 2006, CFC had $2 billion outstanding under the REDLG program. In a separate transaction, in July 2005, CFC sold $500 million of 4.656% notes due in 2008 to the Federal Agricultural Mortgage Corporation (Farmer Mac) and secured by the pledge of CFC mortgage notes.

The REDLG and Farmer Mac transactions provide more than $2.5 billion of new capital for CFC from a new highly dependable investor base which helps to mitigate the ongoing refinancing risk associated with CFC's reliance on the short-term and long-term capital markets.

LEVERAGE REMAINS HIGH AND MUST BE MANAGED

Due to the nature of its composition, CFC does not have common stock in its capital structure. Instead, RECs, as a condition of CFC membership, are required to purchase deeply subordinated capital term certificates in the 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 CFC or obtain a guarantee, they may be required to purchase similar subordinated obligations (long-term certificates or subordinated term certificates) in amounts ranging from 2.0-13.5% of the credit exposure that match 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.

In fiscal year 2007, CFC called $150 million in hybrid preferred securities thus reversing a trend over the past several years of increasing the levels of hybrid preferred securities on its balance sheet. At August 31, 2006, subordinated deferrable debt represented $486 million (2.7%) of CFC's total capitalization adjusted for SFAS 133. All issues carry quarterly payments of interest that are deferrable for up to five years and have 49-year maturities, thereby providing a source of permanent long-term capital an the CFC's balance sheet. Moody's recognizes the value that these securities provide to CFC from a funding and financial flexibility standpoint, but does not view the security as equity.

CFC's equity, after increasing materially during fiscal year 2003, has declined somewhat during the last 3 fiscal years due to large repayments of existing loans. Total debt has also declined during 2006 reflecting the slowly improving trend in CFC's leverage during the past three years as depicted below. Moody's believes that CFC's longer term credit quality would benefit from lower levels of debt, particularly given the degree of liquidity that exists on the asset side of the balance sheet.

Capitalization Ratios	LTM Q1 '07	2006	2005	2004	2003	2002	2001	2000
Funded Debt/Adjusted Members' Equity *	7.93x	8.01x	8.19x	8.30x	7.91x	8.29x	8.77x	8.83x
Adjusted Funded Debt/Adjusted Members' Equity **	8.18x	8.26x	8.53x	8.55x	8.21x	8.58x	9.05x	9.07x
Adjusted Funded Debt (inc. Guarantees) / Adjusted Members' Equity (inc. Loss Reserve) ***	7.01x	6.85x	7.01x	7.20x	7.21x	7.69x	8.70x	9.07x

** Moody's defines the Funded Debt to Adjusted Members' Equity ratio as being the sum of the Notes Payable and Long Term Debt on CFC's balance sheet divided by the sum of the Members' Subordinate Certificates and Members' Equity adjusted for SFAS 133.*

*** 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 CFC's balance sheet divided by the sum of the Members' Subordinate Certificates and Members' Equity adjusted for SFAS 133.*

**** 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 CFC's financial statements divided by the sum of the Members' Subordinate Certificates, Members' Equity adjusted for SFAS 133, and the Loan and Guarantee Loss Reserve.*

PROBLEM LOANS TOTAL $538 MILLION AT 08/31/06 AND REPRESENT A KEY RATING CONSTRAINT

Two large non-performing loans with Innovative Communications Corporation (ICC) and VarTec Telecom (VarTec), which are both in bankruptcy, represent all of CFC's non-performing loans.

At August 31, 2006, total loan and guarantee exposure to VarTec stood at $49 million (down from $340 million at fiscal year end 05/31/04), while total loan exposure to ICC was $489 million. Uncertainty about the final outcomes of the ICC and to a lesser extent the VarTec workouts remain a key rating constraint.

ICC

ICC is a diversified telecommunications company headquartered in St. Croix, United States Virgin Islands (USVI). As of August 31, 2006, CFC, through RTFC, had $489 million in loans outstanding to ICC. Since February 1, 2005, CFC has treated this loan as non-performing.

RTFC's collateral for the loans includes (i) a series of mortgages, security agreements, financing statements, pledges and guaranties creating liens in favor of RTFC on substantially all of the assets and voting stock of ICC, (ii) a direct pledge of 100% of the voting stock of Vitelco, ICC's USVI local exchange carrier subsidiary, (iii) secured guaranties, mortgages and direct and indirect stock pledges encumbering the assets and ownership interests in substantially all of ICC's other operating subsidiaries, and (iv) a personal guaranty of the loans from ICC's indirect majority shareholder and chairman.

On June 1, 2004, RTFC filed a lawsuit in the Eastern District Court of Virginia against ICC for failure to comply with the terms of the loan agreement. Subsequent lawsuits were filed by both parties and RTFC reached a settlement with ICC in April 2006. Under the settlement, RTFC obtained entry of judgments against ICC for approximately $525 million and Prosser for approximately $100 million. On July 31, 2006, ICC filed for bankruptcy protection.

While uncertainty continues about the final disposition of the large exposure, CFC believes that it is adequately reserved for this exposure.

VARTEC

VarTec is telecommunication company headquartered in Dallas, Texas which filed for bankruptcy on November 1, 2005. RTFC is VarTec's primary senior secured creditor. During fiscal year 2005 and 2006, RTFC's loan balance was reduced to $90 million from $340 million in May 2004 by $250 million in payments, offsets of allocated but unretired patronage capital and subordinated capital certificates, and asset sales. All loans to VarTec are on non-accrual status, resulting in the application of all payments received against principal. As part of the bankruptcy proceeding and as consideration for the $20 million debtor-in-possession (DIP) financing provided to VarTec by RTFC, VarTec is

required to sweep all cash to RTFC on a daily basis for application first to the DIP financing and then to other RTFC secured debt. Subsequent to fiscal 2006, CFC further reduced its exposure to VarTec to $49 million primarily due to proceeds from the final closing of VarTec's operating assets (Domestic Assets Sale). .

On December 17, 2004, VarTec sold its European operations, and on March 21, 2005, the court approved the sale of certain real estate in Addison, Texas, and miscellaneous personal property. On May 5, 2005, VarTec sold its Canadian operations. On July 29, 2005, the court approved a sale of Domestic Assets Sale. In June 2006, RTFC received $40 million representing final payment of proceeds from the Domestic Assets Sale. On June 19, 2006, the Chapter 11 proceedings were converted to Chapter 7 proceedings and a Chapter 7 trustee was appointed for each of the estates.

As part of the court order approving the DIP financing, VarTec was allowed to continue to make interest payments on the secured RTFC debt and to make principal payments during periods in which no amount was outstanding under the DIP financing. At August 31, 2006, there was $9 million outstanding from RTFC to VarTec on the court approved DIP loan. RTFC may consider providing VarTec with further DIP funding to pursue the collection of various claims.

CFC believes that it is adequately reserved for this exposure.

LIQUIDITY DISCUSSION

As discussed above, CFC remains reliant on the capital markets as its funding source as CFC's internal cash flow contribution from its portfolio is very modest relative to its funding requirements.

At August 31, 2006, approximately $3.614 billion of CFC commercial paper, bank bid notes, and other short-term debt was outstanding and CFC had approximately $1.595 billion in collateral trust bonds, medium-term notes and long-term notes payable that mature within one year. Of the $3.614 billion of CFC commercial paper, bank bid notes and other short-term debt, about $1.733 billion was dealer commercial paper, $1.360 billion was commercial paper issued to CFC's members, $145 million was commercial paper issued to certain nonmembers, $100 million was bank bid notes, and $276 million was borrowings in the daily liquidity fund, the source of which is provided by CFC's members. Moody's considers the $1.64 billion in borrowings provided by commercial paper issued to CFC's members and the daily liquidity fund to be a source of core funding.

As discussed above, the establishment of the REDLG program provides more than $2.5 billion of new capital for CFC from a new highly dependable investor base which helps to mitigate the ongoing refinancing risk associated with CFC's reliance on the short-term and long-term capital markets.

CFC has established a goal of maintaining its dealer commercial paper and bank bid notes at no more than 15% of total debt. At August 31, 2006, dealer commercial paper and bank bid notes totaled 10% of total debt outstanding. CFC expects outstanding dealer commercial paper and bank bid notes to remain comfortably below 15% during fiscal year 2007, given the company's access to the REDLG program and expected loan repayments from CFC's portfolio.

CFC 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. CFC's bank facilities aggregate $4.025 billion and represent CFC's principal form of liquidity support. Of the $4.025 billion in committed bank facilities, nearly 75% of the credit facilities have a multi-year maturity. Approximately $1.975 billion of the facilities expire on March 23, 2010, and $1.025 billion of the facilities expire on March 22, 2011. The remaining $1.025 billion of these commitments expire within 364 days or by March 21, 2007, but any borrowings outstanding under the 364-day facility can be converted into a one-year term loan.

The credit facilities do not contain a MAC clause. The facilities 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 SFAS 133/52). CFC was comfortably in compliance with this covenant. CFC runs its business and sets margins to maintain an adjusted TIER of at least 1.10x (excluding any non-cash adjustments for SFAS 133/52). Additionally, the agreement requires the senior debt to equity ratio, as defined in the bank agreement, to not be more than 10x (excluding any non-cash adjustments for SFAS 133/52). CFC was comfortably in compliance, with a senior debt to equity ratio as defined by the bank agreement of 6.87x at August 31, 2006.

LOAN PORTFOLIO REMAINS MATCH FUNDED

CFC'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 CFC delays funding long-term fixed rate assets until enough have been accumulated to create economical transaction sizes. It is CFC's policy to match fund asset and liability repricing terms within a range of 3% of total assets excluding derivative assets. At August 31, 2006, fixed rate loans funded with variable rate debt were $217 million representing 1.18% of total assets excluding derivative assets. CFC 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. At August 31, 2006, outstanding notional principal on interest rate derivatives was $12.2 billion.

SFAS 133 CONTINUES TO IMPACT GAAP FINANCIAL RESULTS

On June 1, 2001, CFC implemented SFAS 133. At August 31, 2006, CFC had a derivative asset of $473 million, a derivative liability of $73 million and an accumulated other comprehensive income of $13 million. During fiscal 2006, CFC was required to recognize income of $6.4 million, representing the SFAS 133 forward value and amortization related to the transition adjustment and long-term debt valuation allowance, of $29 million, plus a negative $22.6 million relating to SFAS 52 foreign currency adjustment. By contrast during 2005, CFC was required to recognize a gain of $49.2 million, representing the SFAS 133 forward value and amortization related to the transition adjustment and long-term debt valuation allowance, of a gain $26.3 million, plus a negative $22.9 million relating to SFAS 52 foreign currency adjustment.

CFC enters into these exchange agreements as part of its risk management strategy. As interest rates and currency exchange rates in the capital markets increase or decrease, the fair value of these derivative instruments will change. As a result of implementing SFAS 133, CFC has experienced and will continue to experience increased volatility in reported GAAP net margin, other comprehensive income or loss and the total equity balance. CFC intends to hold all derivatives through maturity. Moody's evaluation of adjusted TIER, leverage, and cash flow eliminates all non-cash SFAS 133 adjustments.

RATING TRIGGERS

At August 31, 2006, there were rating triggers associated with $9.66 billion notional amount of interest rate and cross currency interest rate exchange agreements. The rating triggers are based on CFC's senior unsecured credit rating from Moody's and Standard & Poor's Corporation (S&P). If CFC'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 CFC's rating from Moody's falls to Baa1 or CFC's ratings from S&P falls to BBB+, the counterparty may terminate agreements with a total notional amount of $1.11 billion. If CFC's rating from Moody's falls below Baa1 or CFC's rating from S&P falls below BBB+, the counterparty may terminate the agreement on the remaining total notional amount of $8.55 billion.

At August 31, 2006, CFC had a derivative fair value of $37 million, comprised of $39 million that would be due to CFC and $2 million that CFC would have to pay if all interest rate, cross currency, and cross currency interest rate exchange agreements at the level of Baa1 or BBB+ and above were terminated, and a derivative fair value of $262 million comprised of $318 million that would be due to CFC and $56 million that CFC would have to pay if all interest rate and cross currency exchange agreements with a rating trigger below the level of Baa1 or BBB+ were to terminated.

CORPORATE GOVERNANCE DISCUSSION

CFC'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, CFC 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. This at-large position continues to be vacant and Moody's expects the position to be filled in 2007.

No member of CFC 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, CFC is not subject to regulation by any federal or state authorities as a bank would be.

Related Research

Credit Opinion:

National Rural Utilities Cooperative Finance Corporation, December 2006

Liquidity Risk Assessment:

National Rural Utilities Cooperative Finance Corporation, December 2006
National Cooperative Services Corporation, December 2006

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.

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