

NATIONAL RURAL UTILITIES COOPERATIVE FINANCE CORP /DC/
Form 10-Q
October 13, 2006

FORM 10-Q

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

X QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934
For the Quarterly Period Ended August 31, 2006

OR

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

Commission File Number 1-7102

NATIONAL RURAL UTILITIES COOPERATIVE FINANCE CORPORATION
(Exact name of registrant as specified in its charter)

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

52-0891669
(I.R.S. Employer
Identification No.)

Woodland Park, 2201 Cooperative Way, Herndon, VA 20171-3025
(Address of principal executive offices)

Registrant's telephone number, including the area code (703) 709-6700

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

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

Large accelerated filer Accelerated filer Non-accelerated filer

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

The Registrant has no outstanding stock.

PART 1. FINANCIAL INFORMATION

Item 1. Financial Statements.

NATIONAL RURAL UTILITIES COOPERATIVE FINANCE CORPORATION

CONSOLIDATED BALANCE SHEETS
(UNAUDITED)
(in thousands)

A S S E T S

	August 31, 2006	May 31, 2006
Cash and cash equivalents	\$ 141,310	\$ 260,338
Loans to members	18,337,840	18,360,905
Less: Allowance for loan losses	(611,418)	(611,443)
Loans to members, net	17,726,422	17,749,462
Accrued interest and other receivables	343,606	313,796
Fixed assets, net	5,886	6,146
Debt service reserve funds	80,159	80,159
Bond issuance costs, net	44,953	51,064
Foreclosed assets	96,987	120,889
Derivative assets	472,725	579,237
Other assets	19,602	18,530
	\$ 18,931,650	\$ 19,179,621

See accompanying notes.

NATIONAL RURAL UTILITIES COOPERATIVE FINANCE CORPORATION

CONSOLIDATED BALANCE SHEETS
(UNAUDITED)
(in thousands)

LIABILITIES AND EQUITY

	August 31, 2006	May 31, 2006
Short-term debt	\$ 5,208,686	\$ 5,343,824
Accrued interest payable	383,036	299,391
Long-term debt	10,590,306	10,642,028
Deferred income	34,198	40,086
Guarantee liability	15,445	16,750
Other liabilities	31,552	28,074
Derivative liabilities	72,904	85,198
Subordinated deferrable debt	486,440	486,440
Members' subordinated certificates:		
Membership subordinated certificates	650,871	650,799
Loan and guarantee subordinated certificates	773,508	777,161
Total members' subordinated certificates	1,424,379	1,427,960
Commitments and contingencies		
Minority interest	21,671	21,894
Equity:		
Retained equity	650,076	774,768
Accumulated other comprehensive income	12,957	13,208
Total equity	663,033	787,976
	\$ 18,931,650	\$ 19,179,621

See accompanying notes.

NATIONAL RURAL UTILITIES COOPERATIVE FINANCE CORPORATION

CONSOLIDATED STATEMENTS OF OPERATIONS
(UNAUDITED)
(in thousands)

For the three months ended August 31, 2006 and 2005

	Three months ended August 31,	
	2006	2005
Interest income	\$ 264,689	\$ 249,877
Interest expense	(252,455)	(235,277)
Net interest income	12,234	14,600
Recovery of guarantee losses	1,400	3,300
Net interest income after recovery of guarantee losses	13,634	17,900
Non-interest income and expense:		
General and administrative expenses	(12,728)	(12,117)
Rental and other income	317	1,462
Results of operations of foreclosed assets	3,002	4,692
Total non-interest income and expense	(9,409)	(5,963)
Derivative and foreign currency adjustments:		
Derivative cash settlements	11,706	20,200
Derivative forward value	(60,454)	(34,889)
Foreign currency adjustments	3,321	(1,260)
Total loss on derivative and foreign currency adjustments	(45,427)	(15,949)
Loss prior to income taxes and minority interest	(41,202)	(4,012)
Income tax benefit (expense)	714	(199)
Loss prior to minority interest	(40,488)	(4,211)
Minority interest	366	(1,106)
Net loss	\$ (40,122)	\$ (5,317)

See accompanying notes.

NATIONAL RURAL UTILITIES COOPERATIVE FINANCE CORPORATION

CONSOLIDATED STATEMENTS OF CHANGES IN EQUITY

(UNAUDITED)

(in thousands)

For the three months ended August 31, 2006 and 2005

	Total	Accumulated Other Comprehensive Income (Loss)	Subtotal Retained Equity	Membership Fees	Unallocated Net Margin	Education Fund	Members' Capital Reserve	Patronage Capital Allocated General Reserve Fund	Other
Quarter ended August 31, 2006:									
Balance as of May 31, 2006	\$ 787,976	\$ 13,208	\$ 774,768	\$ 994	\$ 229,417	\$ 1,281	\$ 156,844	\$ 497	\$385,735
Patronage capital retirement	(84,247)	-	(84,247)	-	-	-	-	-	(84,247)
Loss prior to income taxes and minority interest	(41,202)	-	(41,202)	-	(41,202)	-	-	-	-
Accumulated other comprehensive loss	(251)	(251)	-	-	-	-	-	-	-
Income tax benefit	714	-	714	-	714	-	-	-	-
Minority interest	366	-	366	-	366	-	-	-	-
Other	(323)	-	(323)	-	-	(323)	-	-	-
Balance as of August 31, 2006	\$ 663,033	\$ 12,957	\$ 650,076	\$ 994	\$ 189,295	\$ 958	\$ 156,844	\$ 497	\$301,488
Quarter ended August 31, 2005:									
Balance as of May 31, 2005	\$ 768,761	\$ 16,129	\$ 752,632	\$ 993	\$ 229,049	\$ 1,200	\$ 164,067	\$ 497	\$356,826
Patronage capital retirement	(72,912)	-	(72,912)	-	-	-	-	-	(72,912)
Loss prior to income taxes and minority interest	(4,012)	-	(4,012)	-	(4,012)	-	-	-	-
Accumulated other comprehensive loss	(1,339)	(1,339)	-	-	-	-	-	-	-
Income tax expense	(199)	-	(199)	-	(199)	-	-	-	-
Minority interest	(1,106)	-	(1,106)	-	(1,106)	-	-	-	-
Other	(274)	-	(274)	-	-	(274)	-	-	-
Balance as of August 31, 2005	\$ 688,919	\$ 14,790	\$ 674,129	\$ 993	\$ 223,732	\$ 926	\$ 164,067	\$ 497	\$283,914

See accompanying notes.

NATIONAL RURAL UTILITIES COOPERATIVE FINANCE CORPORATION

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

For the three months ended August 31, 2006 and 2005

	2006	2005
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net loss	\$ (40,122)	\$ (5,317)
Add (deduct):		
Amortization of deferred income	(5,339)	(3,683)
Amortization of bond issuance costs and deferred charges	7,167	2,659
Depreciation	557	784
Recovery of guarantee losses	(1,400)	(3,300)
Results of operations of foreclosed assets	(3,002)	(4,692)
Derivative forward value	60,454	34,889
Foreign currency adjustments	(3,321)	1,260
Changes in operating assets and liabilities:		
Accrued interest and other receivables	(30,747)	(75,735)
Accrued interest payable	83,645	142,790
Other	(8,915)	(11,749)
Net cash provided by operating activities	58,977	77,906
CASH FLOWS FROM INVESTING ACTIVITIES:		
Advances made on loans	(1,818,262)	(1,405,049)
Principal collected on loans	1,841,302	2,170,964
Net investment in fixed assets	(297)	(1,466)
Net cash provided by (invested in) foreclosed assets	26,417	(346)
Net proceeds from sale of foreclosed assets	487	28,254
Net cash provided by investing activities	49,647	792,357
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from issuance (repayments) of short-term debt, net	258,585	(1,408,543)
Proceeds from issuance of long-term debt, net	72,833	586,805
Payments for retirement of long-term debt	(332,332)	(55,683)
Payment for retirement of subordinated deferrable debt	(150,000)	-
Proceeds from issuance of members' subordinated certificates	11,684	15,270
Payments for retirement of members' subordinated certificates	(14,328)	(50,816)
Payments for retirement of patronage capital	(74,094)	(57,328)
Net cash used in financing activities	(227,652)	(970,295)
NET DECREASE IN CASH AND CASH EQUIVALENTS	(119,028)	(100,032)
BEGINNING CASH AND CASH EQUIVALENTS	260,338	418,514
ENDING CASH AND CASH EQUIVALENTS	\$ 141,310	\$ 318,482

See accompanying notes.

NATIONAL RURAL UTILITIES COOPERATIVE FINANCE CORPORATION

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

For the three months ended August 31, 2006 and 2005

	2006	2005
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:		
Cash paid for interest	\$ 161,643	\$ 99,138
Non-cash financing and investing activities:		
Patronage capital applied against loan balances	\$ -	\$ 1,829
Minority interest patronage capital applied against loan balances	-	1,689

See accompanying notes.

NATIONAL RURAL UTILITIES COOPERATIVE FINANCE CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)

(1) **General Information and Accounting Policies**

(a) **General Information**

National Rural Utilities Cooperative Finance Corporation ("CFC" or "the Company") is a private, not-for-profit cooperative association incorporated under the laws of the District of Columbia in April 1969. The principal purpose of CFC is to provide its members with a source of financing to supplement the loan programs of the Rural Utilities Service ("RUS") of the United States Department of Agriculture. CFC makes loans to its rural utility system members ("utility members") to enable them to acquire, construct and operate electric distribution, generation, transmission and related facilities. CFC also provides its members with credit enhancements in the form of letters of credit and guarantees of debt obligations. CFC is exempt from payment of federal income taxes under the provisions of Section 501(c)(4) of the Internal Revenue Code. CFC is a not-for-profit member-owned finance cooperative, thus its objective is not to maximize its net margins, but to offer its members the lowest cost financial products and services consistent with sound financial management.

Rural Telephone Finance Cooperative ("RTFC") was incorporated as a private cooperative association in the state of South Dakota in September 1987. In February 2005, RTFC reincorporated as a not-for-profit cooperative association in the District of Columbia. The principal purpose of RTFC is to provide and arrange financing for its rural telecommunications members and their affiliates. RTFC's results of operations and financial condition are consolidated with those of CFC in the accompanying financial statements. RTFC is headquartered with CFC in Herndon, Virginia. RTFC is a taxable cooperative that pays income tax based on its net margins, excluding net margins allocated to its members, as allowed by law under Subchapter T of the Internal Revenue Code.

National Cooperative Services Corporation ("NCSC") was incorporated in 1981 in the District of Columbia as a private cooperative association. The principal purpose of NCSC is to provide financing to the for-profit or non-profit entities that are owned, operated or controlled by or provide substantial benefit to, members of CFC. NCSC also markets, through its cooperative members, a consumer loan program for home improvements and an affinity credit card program. NCSC's membership consists of CFC and distribution systems that are members of CFC or are eligible for such membership. NCSC's results of operations and financial condition are consolidated with those of CFC in the accompanying financial statements. NCSC is headquartered with CFC in Herndon, Virginia. NCSC is a taxable corporation that pays income tax based on its net margins for the period.

The Company's consolidated membership was 1,546 as of August 31, 2006 including 898 utility members, the majority of which are consumer-owned electric cooperatives, 514 telecommunications members, 66 service members and 68 associates in 49 states, the District of Columbia and two U.S. territories. The utility members included 829 distribution systems and 69 generation and transmission ("power supply") systems. Memberships among CFC, RTFC and NCSC have been eliminated in consolidation. All references to members within this document include members and associates.

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

The notes to the consolidated financial statements for the years ended May 31, 2006 and 2005 should be read in conjunction with the accompanying financial statements. (See the Company's Form 10-K for the year ended May 31, 2006.)

The preparation of financial statements in conformity with accounting principles generally accepted in the United States ("GAAP") requires management to make estimates and assumptions that affect the assets, liabilities, revenues and expenses reported in the financial statements, as well as amounts included in the notes thereto, including discussion and disclosure of contingent liabilities. While the Company uses its best estimates and judgments based on the known facts at the date of the financial statements, actual results could differ from these estimates as future events occur.

The Company does not believe it is vulnerable to the risk of a near term severe impact as a result of any concentrations of its activities.

(b)

Principles of Consolidation

The accompanying financial statements include the consolidated accounts of CFC, RTFC and NCSC and certain entities controlled by CFC and created to hold foreclosed assets, after elimination of all material intercompany accounts and transactions. Financial Accounting Standards Board ("FASB") Interpretation No. ("FIN") 46(R), Consolidation of Variable Interest Entities, an interpretation of Accounting Research Bulletin No. 51, requires CFC to consolidate the financial results of RTFC and NCSC. CFC is the primary beneficiary of variable interests in RTFC and NCSC due to its exposure to absorbing the majority of expected losses.

CFC is the sole lender to and manages the lending and financial affairs of RTFC through a long-term management agreement. Under a guarantee agreement, RTFC pays CFC a fee in exchange for which CFC reimburses RTFC for loan losses. Six members of the CFC board serve as a lender advisory council to the RTFC board. All loans that require RTFC board approval also require the approval of the CFC lender advisory council. CFC is not a member of RTFC and does not elect directors to the RTFC board. RTFC is an associate member of CFC.

CFC is the primary source of funding to and manages the lending and financial affairs of NCSC through a management agreement which is automatically renewable on an annual basis unless terminated by either party. NCSC funds its programs either through loans from CFC or commercial paper and long-term notes issued by NCSC and guaranteed by CFC. In connection with these guarantees, NCSC must pay a guarantee fee and purchase from CFC interest-bearing subordinated term certificates in proportion to the related guarantee. Under a guarantee agreement, NCSC pays CFC a fee in exchange for which CFC reimburses NCSC for loan losses, excluding losses in the consumer loan program. CFC does not control the election of directors to the NCSC board. NCSC is a service organization member of CFC.

RTFC and NCSC creditors have no recourse against CFC in the event of default by RTFC and NCSC, unless there is a guarantee agreement under which CFC has guaranteed NCSC and RTFC debt obligations to a third party. At August 31, 2006, CFC had guaranteed \$211 million of NCSC debt with third parties. These guarantees are not included in Note 11 at August 31, 2006 as the debt that CFC had guaranteed is reported as debt of the Company. At August 31, 2006, CFC had no guarantees of RTFC debt to third party creditors. All CFC loans to RTFC and NCSC are secured by all assets and revenues of RTFC and NCSC. At August 31, 2006, RTFC had total assets of \$2,258 million including loans outstanding to members of \$2,035 million and NCSC had total assets of \$428 million including loans outstanding of \$394 million. At August 31, 2006 and May 31, 2006, CFC had committed to lend RTFC up to \$10 billion, of which \$2,030 million was outstanding at August 31, 2006. As of August 31, 2006 and May 31, 2006, CFC had committed to provide credit to NCSC of up to \$1 billion. At August 31, 2006, CFC had provided a total of \$416 million of credit to NCSC, representing \$205 million of outstanding loans and \$211 million of credit enhancements.

CFC established limited liability corporations and partnerships to hold foreclosed assets. CFC has full ownership and control of all such companies and thus consolidates their financial results. CFC presents these companies in one line on the consolidated balance sheets and the consolidated statements of operations.

Unless stated otherwise, references to the Company relate to the consolidation of CFC, RTFC, NCSC and certain entities controlled by CFC and created to hold foreclosed assets.

(c) Allowance for Loan Losses

The Company maintains an allowance for loan losses at a level estimated by management to adequately provide for probable losses inherent in the loan portfolio, which are estimated based upon a review of the loan portfolio, past loss experience, specific problem loans, economic conditions and other pertinent factors which, in management's judgment, deserve current recognition in estimating loan losses. On a quarterly basis, the Company prepares an analysis of the adequacy of the loan loss allowance and makes adjustments to the allowance as necessary. The allowance is based on estimates and, accordingly, actual loan losses may differ from the allowance amount.

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

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Activity in the loan loss allowance account is summarized below:

(in thousands)	August 31,		May 31,
	2006	2005	2006
Balance at beginning of period	\$ 611,443	\$ 589,749	\$589,749
Provision for loan losses	-	-	23,240
Write-offs	(138)	(238)	(2,197)
Recoveries	113	188	651
Balance at end of period	\$ 611,418	\$ 589,699	\$611,443

(d) *Interest Income*

Interest income includes the following:

(in thousands)	For the three months ended August 31,	
	2006	2005
Loan interest income (1)	\$ 255,251	\$ 238,957
Investment income (2)	2,028	2,172
Conversion fees (3)	2,512	3,683
Make-whole and prepayment fees (4)	443	3,409
Commitment and guarantee fees (5)	4,209	1,599
Other fees (6)	246	57
Total interest income	\$ 264,689	\$ 249,877

(1) Represents interest income on loans to members.

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

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

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

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

(6) Other fees include late payment fees charged on late loan payments and recognized when collected and other fees associated with syndication of loans that are deferred and amortized using the straight-line method. Additionally, other fees include loan origination fees that are deferred and amortized over the life of the facility as an addition to interest income using the straight-line method which approximates the interest method.

Deferred income on the consolidated balance sheets is comprised primarily of deferred conversion fees totaling \$32 million and \$37 million at August 31, 2006 and May 31, 2006, respectively.

(e) *Interest Expense*

Interest expense includes the following:

(in thousands)	For the three months ended August 31,	
	2006	2005
Debt interest expense (1)	\$ 240,275	\$ 229,322
Debt issuance costs (2)	7,049	2,148
Derivative cash settlements, net (3)	-	1,307

Commitment and guarantee fees (4)	3,927	1,634
Other fees (5)	1,204	866
Total interest expense	\$ 252,455	\$ 235,277

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- (1) Represents interest expense and the amortization of discounts on all debt securities including members' subordinated certificates.
- (2) Includes amortization of all deferred charges related to debt issuance, principally underwriter's fees, legal fees, printing costs and comfort letter fees. Amortization is calculated on the effective interest method. Also includes issuance costs related to dealer commercial paper and debt issuance costs fully amortized as part of the early retirement of debt.
- (3) Represents the net cost related to swaps that qualify for hedge accounting treatment plus the accrual from the date of the last settlement to the current period end.
- (4) Includes various fees related to funding activities, including fees paid to banks participating in the Company's revolving credit agreements and fees paid under bond guarantee agreements with RUS as part of the Rural Economic Development Loan and Grant ("REDLG") program. Fees are recognized as incurred or amortized on a straight-line basis over the life of the respective agreement.
- (5) Represents fees associated with NCSC's consumer loan program and other fees.

The Company does not include indirect costs, if any, related to funding activities in interest expense.

(f) *Comprehensive Income*

Comprehensive income includes the Company's net margin, as well as other comprehensive income related to derivatives. Comprehensive income is calculated as follows:

(in thousands)	For the three months ended August 31,	
	2006	2005
Net loss	\$ (40,122)	\$ (5,317)
Other comprehensive income:		
Unrealized loss on derivatives	-	(1,559)
Reclassification adjustment for realized (gain) loss on derivatives	(251)	220
Comprehensive loss	\$ (40,373)	\$ (6,656)

(g) *Reclassifications*

Certain reclassifications of prior period amounts have been made to conform to the current reporting format.

(2) **Loans and Commitments**

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

(in thousands)	August 31, 2006		May 31, 2006	
	Loans outstanding	Unadvanced (1) commitments	Loans outstanding	Unadvanced (1) commitments
Total by loan type:				
Long-term fixed rate loans	\$ 14,507,813	\$ -	\$ 14,546,850	\$ -
Long-term variable rate loans	2,432,583	6,124,668	2,524,722	6,146,618
Loans guaranteed by RUS	260,419	591	261,330	591
Intermediate-term loans	5,658	21,719	5,605	21,741
Line of credit loans	1,131,367	6,700,131	1,022,398	6,610,963
Total loans	18,337,840	12,847,109	18,360,905	12,779,913
Less: Allowance for loan losses	(611,418)	-	(611,443)	-
Net loans	\$ 17,726,422	\$ 12,847,109	\$ 17,749,462	\$ 12,779,913
Total by segment:				
CFC:				
Distribution	\$ 12,896,484	\$ 9,007,538	\$ 12,859,076	\$ 8,905,434
Power supply	2,888,941	2,600,174	2,810,663	2,635,502

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Statewide and associate	124,357	122,077	124,633	110,839
CFC Total	15,909,782	11,729,789	15,794,372	11,651,775
RTFC	2,034,521	544,792	2,162,464	550,990
NCSC	393,537	572,528	404,069	577,148
Total	\$ 18,337,840	\$ 12,847,109	\$ 18,360,905	\$ 12,779,913

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The following table summarizes non-performing and restructured loans outstanding and unadvanced commitments to those borrowers by segment and by loan program:

(in thousands)	August 31, 2006		May 31, 2006	
	Loans outstanding	Unadvanced (1) commitments	Loans outstanding	Unadvanced (1) commitments
Non-performing loans:				
RTFC:				
Long-term fixed rate loans	\$ 212,984	\$ -	\$ 212,984	\$ -
Long-term variable rate loans	273,959	-	314,987	-
Line of credit loans	51,077	403	49,817	296
Total RTFC loans	538,020	403	577,788	296
NCSC:				
Long-term fixed rate loans	62	-	81	-
Total non-performing loans	\$ 538,082	\$ 403	\$ 577,869	\$ 296
Restructured loans:				
CFC:				
Long-term fixed rate loans	\$ 53,170	\$ 15,500	\$ 51,670	\$ 15,242
Long-term variable rate loans	564,030	200,000	571,640	200,000
Line of credit loans	-	-	258	-
Total CFC loans	617,200	215,500	623,568	215,242
RTFC:				
Long-term fixed rate loans	6,640	-	6,786	-
Total restructured loans	\$ 623,840	\$ 215,500	\$ 630,354	\$ 215,242

(1) Unadvanced commitments include loans for which loan contracts have been approved and executed, but funds have not been advanced. Additional information may be required to assure that all conditions for advance of funds have been fully met and that there has been no material change in the member's condition as represented in the supporting documents. Since commitments may expire without being fully drawn upon and a significant amount of the commitments are for standby liquidity purposes, the total unadvanced loan commitments do not necessarily represent future cash requirements. Collateral and security requirements for advances on commitments are identical to those on initial loan approval. As the interest rate on unadvanced commitments is not set, long-term unadvanced commitments have been classified in this chart as variable rate unadvanced commitments. However, at the time of the advance, the borrower may select a fixed or variable rate.

Loan origination costs are deferred and amortized using the straight-line method, which approximates the interest method, over the life of the loan as a reduction to interest income. At August 31, 2006 and May 31, 2006, the balance for deferred loan origination costs related to loans outstanding totaled \$3 million.

Loan Security

The Company evaluates each borrower's creditworthiness on a case-by-case basis. It is generally the Company's policy to require collateral for long-term loans. Such collateral usually consists of a first mortgage lien on the borrower's total system, including plant and equipment, and a pledge of future revenues. The loan and security documents also contain various provisions with respect to the mortgaging of the borrower's property and debt service coverage ratios, maintenance of adequate insurance coverage as well as certain other restrictive covenants.

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

(Dollar amounts in thousands)	August 31, 2006				May 31, 2006			
	Secured	%	Unsecured	%	Secured	%	Unsecured	%
Total by loan program:								
Long-term fixed rate loans	\$ 13,953,354	96%	\$ 554,459	4%	\$ 13,984,404	96%	\$ 562,446	4%
Long-term variable rate loans	2,310,595	95%	121,988	5%	2,414,737	96%	109,985	4%
Loans guaranteed by RUS	260,419	100%	-	-	261,330	100%	-	-

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Intermediate-term loans	811	14%	4,847	86%	897	16%	4,708	84%
Line of credit loans	165,067	15%	966,300	85%	145,938	14%	876,460	86%
Total loans	\$ 16,690,246	91%	\$ 1,647,594	9%	\$ 16,807,306	92%	\$ 1,553,599	8%
Total by segment:								
CFC	\$ 14,587,883	92%	\$ 1,321,899	8%	\$ 14,575,691	92%	\$ 1,218,681	8%
RTFC	1,797,534	88%	236,987	12%	1,921,635	89%	240,829	11%
NCSC	304,829	77%	88,708	23%	309,980	77%	94,089	23%
Total loans	\$ 16,690,246	91%	\$ 1,647,594	9%	\$ 16,807,306	92%	\$ 1,553,599	8%

Pledging of Loans

As of August 31, 2006 and May 31, 2006, distribution system mortgage notes related to outstanding long-term loans totaling \$5,433 million and \$5,472 million, respectively, and RUS guaranteed loans qualifying as permitted investments totaling \$222 million and \$223 million, respectively, were pledged as collateral to secure CFC's collateral trust bonds under the 1994 indenture. In addition, \$2 million of cash was pledged under the 1972 indenture at August 31, 2006 and May 31, 2006.

As of August 31, 2006 and May 31, 2006, distribution system mortgage notes related to outstanding long-term loans totaling \$569 million and \$574 million, respectively were pledged as collateral to secure CFC's notes to Federal Agricultural Mortgage Corporation ("Farmer Mac").

In addition to the loans pledged as collateral at August 31, 2006 and May 31, 2006, CFC had \$2,292 million and \$2,302 million, respectively, of mortgage notes on deposit with the trustee for the \$2 billion of notes payable to the Federal Financing Bank ("FFB") of the United States Treasury (see Note 5).

The \$2 billion of notes payable to the FFB contain a rating trigger related to the Company's senior secured credit ratings from Standard & Poor's Corporation, Moody's Investors Service and Fitch Ratings (see chart on page 43). A rating trigger event exists if the Company's senior secured debt does not have at least two of the following ratings: (i) A- or higher from Standard & Poor's Corporation, (ii) A3 or higher from Moody's Investors Service, (iii) A- or higher from Fitch Ratings and (iv) an equivalent rating from a successor rating agency to any of the above rating agencies. If the Company's senior secured credit ratings fall below the levels listed above, the total \$2,292 million of mortgage notes would be pledged as collateral rather than held on deposit.

A total of \$1 billion of the same notes payable to the FFB has a second rating trigger related to the appointment of a financial expert to the Company's board of directors. A rating trigger event will exist if CFC does not have a financial expert (as defined by Section 407 of the Sarbanes-Oxley Act of 2002) appointed to serve on the audit committee of its board of directors by thirty days after the CFC March 2007 annual meeting through the tenor of the bonds or if the financial expert position remains vacant for more than 90 consecutive days after the initial appointment. CFC's board has identified candidates to run for the financial expert position in the membership elections to be held in the fall of 2006. If the Company does not satisfy the financial expert rating trigger, \$1,167 million of mortgage notes would be pledged as collateral rather than held on deposit.

(3) Foreclosed Assets

Assets received in satisfaction of loan receivables are recorded at the lower of cost or market and identified on the consolidated balance sheets as foreclosed assets. At August 31, 2006 and May 31, 2006, the balance of foreclosed assets included real estate developer notes receivable and limited partnership interests in certain real estate developments.

The activity for foreclosed assets is summarized below:

(in thousands)	Three months ended August 31,		Year ended
	2006	2005	May 31, 2006
Beginning balance	\$ 120,889	\$ 140,950	\$ 140,950
Results of operations	3,002	4,692	15,492
Net cash (provided by) invested in	(26,417)	346	(6,401)
Sale of foreclosed assets	(487)	(28,254)	(29,152)
Ending balance of foreclosed assets	\$ 96,987	\$ 117,734	\$ 120,889

Net cash provided by foreclosed assets increased significantly during the three months ended August 31, 2006 due to full and partial paydowns of notes primarily by two limited partnership interests in certain real estate developments. At May 31, 2005, the balance of foreclosed assets also included partnership interests in real estate properties. CFC operated the real estate properties before selling such properties in August 2005 for \$30 million. A gain of \$4 million was included in the results of operations of foreclosed assets during the year ended May 31, 2006, \$3 million of which was recognized during the three months ended August 31, 2005.

(4) Short-Term Debt and Credit Arrangements

The following is a summary of short-term debt at August 31, 2006 and May 31, 2006:

(in thousands)	August 31, 2006	May 31, 2006
Short-term debt:		
Commercial paper sold through dealers, net of discounts	\$ 1,732,768	\$ 1,658,222
Commercial paper sold directly to members, at par	1,360,318	1,184,030
Commercial paper sold directly to non-members, at par	144,654	146,294
Total commercial paper	3,237,740	2,988,546
Daily liquidity fund	276,055	266,664
Bank bid notes	100,000	100,000
Subtotal short-term debt	3,613,795	3,355,210
Long-term debt maturing within one year:		
Medium-term notes sold through dealers (1)	1,052,409	1,278,142
Medium-term notes sold through members	218,489	199,626
Foreign currency valuation account (1)	208,080	244,955
Secured collateral trust bonds	99,998	99,991
Subordinated deferrable debt (2)	-	150,000
Unsecured notes payable	15,915	15,900
Total long-term debt maturing within one year	1,594,891	1,988,614
Total short-term debt	\$ 5,208,686	\$ 5,343,824

(1) At August 31, 2006 and May 31, 2006, medium-term notes includes \$434 million of medium-term notes denominated in Euros and \$0 and \$282 million, respectively of medium-term notes denominated in Australian dollars. The foreign currency valuation account represents the change in the dollar value of foreign denominated debt due to changes in currency exchange rates from the date the debt was issued to the reporting date as required under Statement of Financial Accounting Standard ("SFAS") 52, Foreign Currency Translation.

(2) Redeemed in June 2006.

CFC issues commercial paper for periods of one to 270 days. CFC also enters into short-term bank bid note agreements, which are unsecured obligations of CFC and do not require backup bank lines for liquidity purposes. Bank bid note facilities are uncommitted lines of credit for which CFC does not pay a fee. The commitments are generally subject to termination at the discretion of the individual banks.

Foreign Denominated Short-Term Debt

Included in short-term debt at August 31, 2006 and May 31, 2006 are medium-term notes due within one year that are denominated in a foreign currency. At the time of issuance of short-term debt denominated in a foreign currency, CFC enters into a cross currency or cross currency interest rate exchange agreement to fix the exchange rate on all principal and interest payments through maturity. The foreign denominated short-term debt is revalued at each reporting date based on the current exchange rate. To the extent that the current exchange rate is different than the exchange rate at the time of issuance, there will be a change in the reported value of the foreign denominated short-term debt. The adjustment to the reported value of the short-term debt on the consolidated balance sheets is also reported on the consolidated statements of operations as foreign currency adjustments. As a result of entering cross currency and cross currency interest rate exchange agreements, the adjusted short-term debt value at the reporting date does not represent the amount that CFC will ultimately pay to retire the short-term debt, unless the counterparty to the exchange agreement does not perform as required under the agreement.

Revolving Credit Agreements

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

(Dollar amounts in thousands)	August 31, 2006	May 31, 2006	Termination Date	Facility fee per annum (1)
364-day agreement (2)	\$ 1,025,000	\$ 1,025,000	March 21, 2007	0.05 of 1%
Five-year agreement	1,025,000	1,025,000	March 22, 2011	0.06 of 1%

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Five-year agreement	1,975,000	1,975,000	March 23, 2010	0.09 of 1%
Total	\$ 4,025,000	\$ 4,025,000		

- (1) Facility fee determined by CFC's senior unsecured credit ratings based on the pricing schedules put in place at the initiation of the related agreement.
(2) Any amount outstanding under these agreements may be converted to a one-year term loan at the end of the revolving credit periods. If converted to a term loan, the fee on the outstanding principal amount of the term loan is 0.10 of 1% per annum.

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Up-front fees of between 0.05 and 0.13 of 1% were paid to the banks based on their commitment level to the five-year agreements in place at August 31, 2006, totaling in aggregate \$3 million, which will be amortized on a straight-line basis over the life of the agreements. No up-front fees were paid to the banks for their commitment to the 364-day facility. Each agreement contains a provision under which if borrowings exceed 50% of total commitments, a utilization fee must be paid on the outstanding balance. The utilization fees are 0.05 of 1% for the five-year agreement terminating on March 22, 2011 and the 364-day agreement terminating on March 21, 2007 and 0.10 of 1% for the five-year agreement terminating on March 23, 2010.

Effective August 31, 2006 and May 31, 2006, the Company was in compliance with all covenants and conditions under its revolving credit agreements in place at that time and there were no borrowings outstanding under such agreements.

For the purpose of calculating the required financial covenants contained in its revolving credit agreements, the Company adjusts net margin, senior debt and total equity to exclude the non-cash adjustments related to SFAS 133, Accounting for Derivative Instruments and Hedging Activities, as amended and SFAS 52. The adjusted times interest earned ratio ("TIER"), as defined by the agreements, represents the interest expense adjusted to include the derivative cash settlements, plus minority interest net margin, plus net margin prior to the cumulative effect of change in accounting principle and dividing that total by the interest expense adjusted to include the derivative cash settlements. In addition to the non-cash adjustments related to SFAS 133 and 52, senior debt also excludes RUS guaranteed loans, subordinated deferrable debt, members' subordinated certificates and minority interest. Total equity is adjusted to include subordinated deferrable debt, members' subordinated certificates and minority interest. Senior debt includes guarantees; however, it excludes:

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

The following represents the Company's required and actual financial ratios under the revolving credit agreements at or for the three months ended August 31, 2006 and the year ended May 31, 2006:

	Requirement	August 31, 2006	May 31, 2006
Minimum average adjusted TIER over the six most recent fiscal quarters	1.025	1.09	1.11
Minimum adjusted TIER at fiscal year end (1)	1.05	1.11	1.11
Maximum ratio of senior debt to total equity	10.00	6.87	6.26

(1) The Company must meet this requirement in order to retire patronage capital.

The revolving credit agreements do not contain a material adverse change clause or ratings triggers that limit the banks' obligations to fund under the terms of the agreements, but CFC must be in compliance with their other requirements, including financial ratios, in order to draw down on the facilities.

(5) Long-Term Debt

The following is a summary of long-term debt at August 31, 2006 and May 31, 2006:

(in thousands)	August 31, 2006	May 31, 2006
Unsecured long-term debt:		
Medium-term notes, sold through dealers	\$ 4,133,200	\$ 4,174,200
Medium-term notes, sold directly to members	50,273	55,052
Subtotal	4,183,473	4,229,252
Unamortized discount	(8,765)	(9,203)
Total unsecured medium-term notes	4,174,708	4,220,049
Unsecured notes payable	2,067,855	2,074,565

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Total unsecured long-term debt	6,242,563	6,294,614
Secured debt:		
Collateral trust bonds	3,851,981	3,851,981
Unamortized discount	(4,238)	(4,567)
Total secured collateral trust bonds	3,847,743	3,847,414
Secured notes payable	500,000	500,000
Total secured long-term debt	4,347,743	4,347,414
Total long-term debt	\$ 10,590,306	\$ 10,642,028

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Collateral trust bonds are secured by the pledge of mortgage notes or eligible securities in an amount at least equal to the principal balance of the bonds outstanding. See Note 2 for additional information on the collateral pledged to secure the Company's collateral trust bonds. Medium-term notes are unsecured obligations of CFC.

Unsecured Notes Payable

At August 31, 2006 and May 31, 2006, CFC had a total of \$2 billion under a bond purchase agreement with the FFB and a bond guarantee agreement with RUS as part of the funding mechanism for the REDLG program. As part of the REDLG 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. As part of the REDLG program, CFC will pay a fee of 30 basis points per annum on the total amount borrowed to RUS. The \$2 billion of unsecured notes payable issued as part of the REDLG program require CFC to place on deposit mortgage notes in an amount at least equal to the principal balance of the notes outstanding. See Note 2 for additional information on the mortgage notes held on deposit.

Secured Notes Payable

At August 31, 2006 and May 31, 2006, the Company had outstanding a total of \$500 million of 4.656% notes to Farmer Mac due in 2008. The \$500 million of secured notes payable sold to Farmer Mac are secured by the pledge of mortgage notes in an amount at least equal to the principal balance of the notes outstanding. See Note 2 for additional information on the collateral pledged to secure the Company's notes payable.

(6) Subordinated Deferrable Debt

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

(Dollar amounts in thousands)	August 31, 2006	May 31, 2006
6.75% due 2043	\$ 125,000	\$ 125,000
6.10% due 2044	88,201	88,201
5.95% due 2045	98,239	98,239
7.40% due 2050	175,000	175,000
Total	\$ 486,440	\$ 486,440

(7) Derivative Financial Instruments

The Company is neither a dealer nor a trader in derivative financial instruments. The Company uses interest rate, cross currency and cross currency interest rate exchange agreements to manage its interest rate risk and foreign currency exchange risk.

Interest Rate Exchange Agreements

Generally, the Company's interest rate exchange agreements do not qualify for hedge accounting under SFAS 133. At August 31, 2006 and May 31, 2006, the Company did not have any interest rate exchange agreements that were accounted for using hedge accounting. The majority of the Company's interest rate exchange agreements use a 30-day composite commercial paper index or LIBOR as either the pay or receive leg. The 30-day composite commercial paper index is the best match for the commercial paper that is the underlying debt used as the cost basis in setting the Company's variable interest rates. However, the correlation between movement in the 30-day composite commercial paper index or LIBOR and movement in the Company's commercial paper rates is not consistently high enough to qualify for hedge accounting. The Company's commercial paper rates are not indexed to the 30-day composite commercial paper index or LIBOR and the Company does not solely issue its commercial paper with maturities of 30 days. At August 31, 2005, interest rate exchange agreements with a total notional amount of \$200 million were designated as and qualified as effective cash flow hedges and were accounted for using hedge accounting. Those interest rate exchange agreements matured in February 2006.

The Company was a party to the following interest rate exchange agreements:

(in thousands)	Notional Amounts Outstanding	
	August 31, 2006	May 31, 2006
Pay fixed and receive variable	\$ 7,013,100	\$ 7,349,584
Pay variable and receive fixed	5,186,440	5,186,440
Total interest rate exchange agreements	\$ 12,199,540	\$ 12,536,024

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Consistent with SFAS 133, as amended, the Company records derivative instruments on the consolidated balance sheet as either an asset or liability measured at fair value. Changes in the fair value of derivative instruments are recognized in the derivative forward value line item of the consolidated statement of operations unless specific hedge accounting criteria are met. The change to the fair value is either recorded to other comprehensive income or interest expense, depending on whether the interest rate exchange agreement qualifies as an effective hedge. Net settlements paid and received for derivative instruments that qualify for hedge accounting are recorded in interest expense. Net settlements related to derivative instruments that do not qualify for hedge accounting are recorded as derivative cash settlements in the consolidated statement of operations. The Company formally documents, designates, and assesses the effectiveness of transactions that receive hedge accounting.

The Company has classified cash activity associated with derivatives as an operating activity in the consolidated statements of cash flows.

Interest rate exchange agreements had the following impact on the Company:

	For the three months ended August 31,	
(in thousands)	2006	2005
Statement of Operations Impact		