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 X 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 X

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

The Registrant 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)

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

	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	Three months ended August 31, 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.

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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.

Activity in the loan loss allowance account is summarized below:

	August 31,		May 31,
(in thousands)	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:

	For the three months ended August 31,	
(in thousands)	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:

	For the three months ended August 31,	
(in thousands)	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

(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:

	For the three months ended August 31,	
(in thousands)	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:

	August 31, 2006		May 31, 2006	
(in thousands)	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

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

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

	August 31, 2006		May 31, 2006	
(in thousands)	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			
Total by loan program:	Secured	%	Unsecured	%	Secured	%	Unsecured	%
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%	-	-

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%

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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:

	Three months ended August 31,		Year ended
(in thousands)	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%

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.

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

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

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:

	Notional Amounts Outstanding	
(in thousands)	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

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				
Agreements that qualify for hedge accounting:				
Interest expense	$	-	$	(2,011)
Agreements that do not qualify for hedge accounting:				
Derivative cash settlements		12,180		17,409
Derivative forward value		(54,325)		(30,136)
Total loss on interest rate exchange agreements	$	(42,145)	$	(14,738)
Comprehensive Income Impact				
Agreements that qualify for hedge accounting:				
Unrealized loss on derivatives	$	-	$	(591)
Amortization of transition adjustment		(251)		220
Total comprehensive loss	$	(251)	$	(371)

Cash settlements includes income of $12 million and $16 million during the three months ended August 31, 2006 and 2005, respectively, related to the periodic amounts that were paid and received related to its interest rate exchange agreements. During the three months ended August 31, 2005, cash settlements also includes $1 million of fees received from counterparties for the Company's termination of agreements. These agreements were terminated due to the prepayment of RTFC loans during the three months ended August 31, 2005, the proceeds of which were used to pay down the underlying debt for the terminated interest rate exchange agreements.

For the three months ended August 31, 2006 and 2005, the derivative forward value also includes amortization to income of $0.2 million and to expense of $0.3 million, respectively, related to the transition adjustment recorded as an other comprehensive loss on June 1, 2001, the date the Company implemented SFAS 133. The transition adjustment will be amortized into earnings over the remaining life of the related interest rate exchange agreements. Approximately $0.8 million is expected to be amortized to income over the next twelve months related to the transition adjustment and will continue through April 2029.

Cross Currency and Cross Currency Interest Rate Exchange Agreements
Generally, the Company's cross currency and cross currency interest rate exchange agreements do not qualify for hedge accounting under SFAS 133. At August 31, 2005, cross currency exchange agreements with a total notional amount of $390 million were designated as and qualified as effective cash flow hedges and were accounted for using hedge accounting. Those cross currency exchange agreements matured in February 2006.

At August 31, 2006 and May 31, 2006, the Company was a party to the following cross currency and cross currency interest rate exchange agreements, none of which were accounted for using hedge accounting:

(Currency amounts in thousands)		Notional Principal Amount			
	Original	U.S. Dollars (5)		Foreign Currency	
	Exchange	August 31,	May 31,	August 31,	May 31,
Maturity Date	Rate	2006	2006	2006	2006
July 7, 2006	1.506	$ -	$166,000(3)	- AUD (2)	250,000 AUD (2)
July 7, 2006	1.506	-	116,200(4)	- AUD (2)	175,000 AUD (2)
March 14, 2007	1.153	433,500(4)	433,500(4)	500,000 EU (1)	500,000 EU (1)
Total		$433,500	$715,700	500,000	925,000

(1) EU - Euros
(2) AUD - Australian dollars
(3) These agreements also change the interest rate from a foreign denominated variable rate to a U.S. dollar denominated variable rate.
(4) These agreements also change the interest rate from a foreign denominated fixed rate to a U.S. dollar denominated variable rate.
(5) Amounts in the chart represent the U.S. dollar value at the initiation of the exchange agreement. At August 31, 2006 and May 31, 2006, one U. S. dollar was the equivalent of 0.779 and 0.780 Euros, respectively. One U.S. dollar was the equivalent of 1.329 Australian dollars at May 31, 2006.

The Company entered into the cross currency and cross currency interest rate exchange agreements related to the issuance of medium-term notes denominated in Euros and Australian dollars. In addition to foreign currency exchange, the agreements that do not qualify for hedge accounting also synthetically change the interest rate from a fixed rate on the foreign denominated debt to variable rate U.S. denominated debt or from a variable rate on the foreign denominated debt to a different variable rate. Since the agreements synthetically change both the interest rate and the currency exchange rate in one agreement, the criteria to qualify for effectiveness specifies that the change in fair value of the debt when divided by the change in the fair value of the derivative must be within a range of 80% to 125%. Under this criteria, the agreements do not qualify for hedge treatment, therefore all changes in fair value are recorded in the consolidated statements of operations.

Cross currency and cross currency 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		
Agreements that qualify for hedge accounting:		
Interest expense	$ -	$ 705
Agreements that do not qualify for hedge accounting:		
Derivative cash settlements	(474)	2,791
Derivative forward value	(6,129)	(4,753)
Total loss on cross currency exchange agreements	$ (6,603)	$ (1,257)
Comprehensive Income Impact		
Agreements that qualify for hedge accounting:		
Unrealized loss on derivatives	$ -	$ (968)

Rating Triggers

The Company has certain interest rate, cross currency and cross currency interest rate exchange agreements that contain a provision called a rating trigger. Under a rating trigger, if the credit rating for either counterparty falls to the level specified in the agreement, the other counterparty may, but is not obligated to, terminate the agreement. If either counterparty terminates the agreement, a net payment may be due from one counterparty to the other based on the fair value of the underlying derivative instrument. Rating triggers are not separate financial instruments and are not separate derivatives under SFAS 133. The rating triggers contained in certain of the Company's derivative contracts are based on its senior unsecured credit rating from Standard & Poor's Corporation and Moody's Investors Service (see chart on page 43).

At August 31, 2006, the Company has the following notional amount and fair values associated with exchange agreements that contain rating triggers. For the purpose of the presentation, the Company has grouped the rating triggers into two categories, (1) ratings from Moody's Investors Service falls to Baa1 or from Standard & Poor's Corporation falls to BBB+ and (2) ratings from Moody's Investors Service falls below Baa1 or from Standard & Poor's Corporation falls below BBB+.

(in thousands) Rating Level:	Notional Amount	Required Company Payment	Amount Company Would Collect	Net Total
Fall to Baa1/BBB+	$ 1,113,989	$ (2,064)	$ 39,065	$ 37,001
Fall below Baa1/BBB+	8,546,770	(54,134)	278,912	224,778
Total	$ 9,660,759	$ (56,198)	$ 317,977	$ 261,779

(8) Members' Subordinated Certificates

CFC's members are required to purchase membership certificates as a condition of membership. Such certificates are interest-bearing unsecured, subordinated debt of CFC. New members are required to purchase membership certificates based on an amount calculated as a percentage of the difference between revenue and the cost of power for a period of 15 years. New members purchase the certificates over time as a percentage of the amount they borrow from CFC. RTFC and NCSC members are not required to purchase membership certificates as a condition of membership. CFC membership certificates typically have an original maturity of 100 years and pay interest at 5%. The weighted average maturity for all membership subordinated certificates outstanding at August 31, 2006 and May 31, 2006 was 70 years.

Members obtaining long-term loans, certain intermediate-term loans or guarantees are generally required to purchase additional loan or guarantee subordinated certificates with each such loan or guarantee based on the members' CFC debt to equity ratio. These certificates are unsecured, subordinated debt of the Company.

Certificates currently purchased in conjunction with long-term loans are generally non-interest bearing. CFC's policy regarding the purchase of loan subordinated certificates requires members with a CFC debt to equity ratio in excess of the limit in the policy to purchase a non-amortizing/non-interest bearing subordinated certificate in the amount of 2% for distribution systems and 7% for power supply systems. CFC associates and RTFC members are required to purchase loan subordinated certificates of 10% of each long-term loan advance. For non-standard credit facilities, the borrower is required to purchase interest bearing certificates in amounts determined appropriate by CFC based on the circumstances of the transaction.

The maturity dates and the interest rates payable on guarantee subordinated certificates purchased in conjunction with CFC's guarantee program vary in accordance with applicable CFC policy. Members may be required to purchase non-interest-bearing debt service reserve subordinated certificates in connection with CFC's guarantee of long-term tax-exempt bonds (see Note 11). CFC pledges proceeds from the sale of such certificates to the debt service reserve fund established in connection with the bond issue and any earnings from the investments of the fund inure solely to the benefit of the members for whom the bonds are issued. These certificates have varying maturities not exceeding the longest maturity of the guaranteed obligation.

(9) Minority Interest

At August 31, 2006 and May 31, 2006, the Company reported minority interests of $22 million on the consolidated balance sheets. Minority interest represents the 100% interest that RTFC and NCSC members have in their respective organizations. The members of RTFC and NCSC own or control 100% of the interest in the respective company.

During the three months ended August 31, 2006, the balance of minority interest decreased by less than $1 million of minority interest net loss for the three months ended August 31, 2006.

(10) Equity

CFC is required by the District of Columbia cooperative law to have a methodology to allocate its net margin to its members. CFC maintains the current year net margin as unallocated through the end of its fiscal year. At that time, CFC's board of directors allocates its net margin to members in the form of patronage capital and to board approved reserves. Currently, CFC has two such board approved reserves, the education fund and the members' capital reserve. CFC allocates a small portion, less than 1%, of net margin annually to the education fund. The allocation to the education fund must be at least 0.25% of net margin as required by CFC's bylaws. Funds from the education fund are disbursed annually to fund cooperative education among employees and directors of cooperatives in the service territories of each state. The board of directors determines the amount of net margin that is allocated to the members' capital reserve, if any. The members' capital reserve represents margins that are held by CFC to increase equity retention. The margins held in the members' capital reserve have not been allocated to any member, but may be allocated to individual members in the future as patronage capital if authorized by CFC's board of directors. All remaining net margin is allocated to CFC's members in the form of patronage capital. CFC bases the amount of net margin allocated to each member on the members' patronage of the CFC lending programs in the year that the net margin was earned. There is no impact on CFC's total equity as a result of allocating margins to members in the form of patronage capital or to board approved reserves. CFC's board of directors has annually voted to retire a portion of the patronage capital allocated to members in prior years. CFC's total equity is reduced by the amount of patronage capital retired to members and by amounts disbursed from board approved reserves. CFC adjusts the net margin it allocates to members and board approved reserves to exclude the non-cash impacts of SFAS 133 and 52.

In July 2006, CFC's board of directors authorized the allocation of the fiscal year 2006 adjusted net margin as follows: $0.8 million to the education fund and $95 million to members in the form of patronage capital. The board of directors also authorized the allocation of $7 million from the members' capital reserve. In July 2006, CFC's board of directors authorized the retirement of

allocated margins totaling $84 million, representing 70% of the fiscal year 2006 allocation and one-ninth of the fiscal years 1991, 1992 and 1993 allocated margins. This amount was returned to members in cash in August and September 2006. Future allocations and retirements of margins will be made annually as determined by CFC's board of directors with due regard for CFC's financial condition. The board of directors for CFC has the authority to change the policy for allocating and retiring net margins at any time, subject to applicable cooperative law.

At August 31, 2006 and May 31, 2006, equity included the following components:

(in thousands)	August 31, 2006	May 31, 2006
Membership fees	$ 994	$ 994
Education fund	958	1,281
Members' capital reserve	156,844	156,844
Allocated net margin	301,985	386,232
Unallocated net margin	15,309	-
Total members' equity	476,090	545,351
Prior years cumulative derivative forward value and foreign currency adjustments	229,417	229,049
Current period derivative forward value (1)	(58,752)	22,962
Current period foreign currency adjustments	3,321	(22,594)
Total retained equity	650,076	774,768
Accumulated other comprehensive income	12,957	13,208
Total equity	$ 663,033	$ 787,976

(1) Represents the derivative forward value (loss) gain recorded by CFC for the period.

(11) Guarantees

The Company guarantees certain contractual obligations of its members so that they may obtain various forms of financing. With the exception of letters of credit, the underlying obligations may not be accelerated so long as the Company performs under its guarantee. At August 31, 2006 and May 31, 2006, the Company had recorded a guarantee liability totaling $15 million and $17 million, respectively, which represents the contingent and non-contingent exposure related to guarantees of members' debt obligations. The contingent guarantee liability at August 31, 2006 and May 31, 2006 totaled $13 million and $15 million, respectively, based on management's estimate of exposure to losses within the guarantee portfolio. The Company uses factors such as internal risk rating, remaining term of guarantee, corporate bond default probabilities and estimated recovery rates in estimating its contingent exposure. The remaining balance of the total guarantee liability of $2 million at August 31, 2006 and May 31, 2006 relates to the Company's non-contingent obligation to stand ready to perform over the term of its guarantees that it has entered into or modified since January 1, 2003 in accordance with FIN No. 45, Guarantor's Accounting and Disclosure Requirement for Guarantees, Including Indirect Guarantees of Indebtedness of Others (an interpretation of FASB Statements No. 5, 57, and 107 and rescission of FASB Interpretation No. 34). The non-contingent obligation is estimated based on guarantee fees received. The fees are deferred and amortized on the straight-line method into interest income over the term of the guarantees. The Company deferred fees of $0.6 million and $0.1 million for the three months ended August 31, 2006 and 2005, respectively, related to new guarantees issued during the periods. Activity in the guarantee liability account is summarized below:

	For the three months ended August 31,		Year ended May 31,
	2006	2005	2006
Beginning balance	$ 16,750	$ 16,094	$ 16,094
Net change in non-contingent liability	95	(25)	1,356
Recovery of guarantee losses	(1,400)	(3,300)	(700)
Ending balance	$ 15,445	$ 12,769	$ 16,750

Liability as percentage of total guarantees	1.43%	1.22%	1.55%

The following chart summarizes total guarantees by type and segment:

(in thousands)	August 31, 2006	May 31, 2006
Total by type:		
Long-term tax exempt bonds (1)	$ 599,130	$ 607,655
Indemnifications of tax benefit transfers (2)	120,154	123,544
Letters of credit (3)	287,396	272,450
Other guarantees (4)	73,417	75,331
Total	$ 1,080,097	$ 1,078,980
Total by segment:		
CFC:		
Distribution	$ 86,601	$ 70,166
Power supply	908,784	921,930
Statewide and associate	25,436	32,873
CFC total	1,020,821	1,024,969
RTFC	50	-
NCSC	59,226	54,011
Total	$ 1,080,097	$ 1,078,980

(1) The maturities for this type of guarantee run through 2026. CFC has guaranteed debt issued in connection with the construction or acquisition of pollution control, solid waste disposal, industrial development and electric distribution facilities. CFC has unconditionally guaranteed to the holders or to trustees for the benefit of holders of these bonds the full principal, premium, if any, and interest on each bond when due. In addition, CFC has agreed to make up, at certain times, deficiencies in the debt service reserve funds for certain of these issues of bonds. In the event of default by a system for non-payment of debt service, CFC is obligated to pay any required amounts under its guarantees, which will prevent the acceleration of the bond issue. The system is required to repay, on demand, any amount advanced by CFC and interest thereon pursuant to the documents evidencing the system's reimbursement obligation.

Of the amounts shown above, $566 million and $572 million as of August 31, 2006 and May 31, 2006, respectively, are adjustable or floating/fixed rate bonds. The floating interest rate on such bonds may be converted to a fixed rate as specified in the indenture for each bond offering. During the variable rate period (including at the time of conversion to a fixed rate), CFC has unconditionally agreed to purchase bonds tendered or called for redemption if the remarketing agents have not previously sold such bonds to other purchasers. CFC's maximum potential exposure includes guaranteed principal and interest related to the bonds. CFC is unable to determine the maximum amount of interest that it could be required to pay related to the floating rate bonds. As of August 31, 2006, CFC's maximum potential exposure for the $33 million of fixed rate tax-exempt bonds is $43 million. Many of these bonds have a call provision that in the event of a default would allow CFC to trigger the call provision. This would limit CFC's exposure to future interest payments on these bonds. CFC's maximum potential exposure is secured by a mortgage lien on all of the system's assets and future revenues. However, if the debt is accelerated because of a determination that the interest thereon is not tax-exempt, the system's obligation to reimburse CFC for any guarantee payments will be treated as a long-term loan.

(2) The maturities for this type of guarantee run through 2015. CFC has unconditionally guaranteed to lessors certain indemnity payments, which may be required to be made by the lessees in connection with tax benefit transfers. In the event of default by a system for non-payment of indemnity payments, CFC is obligated to pay any required amounts under its guarantees, which will prevent the acceleration of the indemnity payments. The member is required to repay any amount advanced by CFC and interest thereon pursuant to the documents evidencing the system's reimbursement obligation. The amounts shown represent CFC's maximum potential exposure for guaranteed indemnity payments. A member's obligation to reimburse CFC for any guarantee payments would be treated as a long-term loan to the extent of any cash received by the member at the outset of the transaction. This amount is secured by a mortgage lien on all of the system's assets and future revenues. The remainder would be treated as an intermediate-term loan secured by a subordinated mortgage on substantially all of the member's property. Due to changes in federal tax law, no further guarantees of this nature are anticipated.

(3) The maturities for this type of guarantee run through 2017. Additionally, letters of credit totaling $9 million at August 31, 2006 have a term of one year and automatically extend for a period of one year unless the Company cancels the agreement within 120 days of maturity (in which case, the beneficiary may draw on the letter of credit). The Company issues irrevocable letters of credit to support members' obligations to energy marketers and other third parties and to the Rural Business and Cooperative Development Service with issuance fees as may be determined from time to time. Each letter of credit issued is supported by a reimbursement agreement with the member on whose behalf the letter of credit was issued. In the event a beneficiary draws on a letter of credit, the agreement generally requires the member to reimburse the Company within one year from the date of the draw. Interest would accrue from the date of the draw at the line of credit variable rate of interest in effect on such date. The agreement also requires the member to pay, as applicable, a late payment charge and all costs of collection, including reasonable attorneys' fees. As of August 31, 2006, the Company's maximum potential exposure is $287 million, of which $198 million is secured. Additionally, in the event of default for $26 million of secured NCSC letters of credit, NCSC is only liable for 40% of the amount guaranteed due to a reimbursement obligation agreement for the remaining 60%. Security provisions include a mortgage lien on all of the system's assets, future revenues, and the system's commercial paper

invested at the Company. In addition to the letters of credit listed in the table, under master letter of credit facilities, the Company may be required to issue up to an additional $329 million in letters of credit to third parties for the benefit of its members at August 31, 2006. At May 31, 2006, this amount was $217 million.

(4) The maturities for this type of guarantee run through 2025. CFC provides other guarantees for its members. In the event of default by a system for non-payment of the obligation, CFC must pay any required amounts under its guarantees, which will prevent the acceleration of the obligation. Such guarantees may be made on a secured or unsecured basis with guarantee fees set to cover CFC's general and administrative expenses, a provision for losses and a reasonable margin. The member is required to repay any amount advanced by CFC and interest thereon pursuant to the documents evidencing the system's reimbursement obligation. Of CFC's maximum potential exposure for guaranteed principal and interest totaling $73 million at May 31, 2006, $3 million is secured by a mortgage lien on all of the system's assets and future revenues and the remaining $70 million is unsecured.

CFC uses the same credit policies and monitoring procedures in providing guarantees as it does for loans and commitments.

At August 31, 2006 and May 31, 2006, CFC had a total of $160 million and $144 million of guarantees, representing 15% and 13% of total guarantees, respectively, under which its right of recovery from its members was not secured.

(12) Contingencies

The Company had the following loans classified as non-performing and restructured at:

(in thousands)		August 31, 2006		May 31, 2006		August 31, 2005
Non-performing loans	$	538,082	$	577,869	$	560,578
Restructured loans		623,840		630,354		594,680
Total	$	1,161,922	$	1,208,223	$	1,155,258

(a) At August 31, 2006, May 31, 2006 and August 31, 2005, all loans classified as non-performing were on a non-accrual status with respect to the recognition of interest income. At August 31, 2006 and May 31, 2006, $563 million and $569 million, respectively, of restructured loans were on non-accrual status with respect to the recognition of interest income. At August 31, 2005, there were $587 million of restructured loans on non-accrual status. A total of $0.9 million and $0.1 million of interest income was accrued on restructured loans during the three months ended August 31, 2006 and 2005, respectively.

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

	For the three months ended August 31,			
(in thousands)		2006		2005
Non-performing loans	$	10,474	$	10,624
Restructured loans		9,840		8,202
Total	$	20,314	$	18,826

(b) The Company classified $1,155 million and $1,201 million of loans as impaired pursuant to the provisions of SFAS 114, Accounting by Creditors for Impairment of a Loan - an Amendment of SFAS 5 and SFAS 15, as amended, at August 31, 2006 and May 31, 2006, respectively. The Company reserved $451 million and $447 million of the loan loss allowance for such impaired loans at August 31, 2006 and May 31, 2006, respectively. The amount included in the loan loss allowance for such loans was based on a comparison of the present value of the expected future cash flow associated with the loan discounted at the original contract interest rate and/or the estimated fair value of the collateral securing the loan to the recorded investment in the loan. Impaired loans may be on accrual or non-accrual status with respect to the recognition of interest income based on a review of the terms of the restructure agreement and borrower performance. The Company accrued a total of $0.8 million of interest income on impaired loans for the three months ended August 31, 2006. The Company did not accrue interest income on loans classified as impaired during the three months ended August 31, 2005. The average recorded investment in impaired loans for the three months ended August 31, 2006 and 2005 was $1,301 million and $1,177 million, respectively.

The Company updates impairment calculations on a quarterly basis. Since a borrower's original contract rate may include a variable rate component, calculated impairment could vary with changes to the Company's variable rate, independent of a borrower's underlying financial performance or condition. In addition, the calculated impairment for a borrower will fluctuate based on changes to certain assumptions. Changes to assumptions include, but are not limited to the following:

* court rulings,
* changes to collateral values, and
* changes to expected future cash flows both as to timing and amount.

(c) At August 31, 2006 and May 31, 2006, CFC had a total of $563 million and $569 million, respectively, of loans outstanding to Denton County Electric Cooperative, d/b/a CoServ Electric ("CoServ"), a large electric distribution cooperative located in Denton County, Texas, that provides retail electric service to residential and business customers. All loans have been on non-accrual status since January 1, 2001. Total loans to CoServ at August 31, 2006 and May 31, 2006 represented 2.9% of the Company's total loans and guarantees outstanding.

Under the terms of a bankruptcy settlement, CFC restructured its loans to CoServ. CoServ is scheduled to make quarterly payments to CFC through December 2037. As part of the restructuring, CFC may be obligated to provide up to $200 million of senior secured capital expenditure loans to CoServ for electric distribution infrastructure through December 2012. If CoServ requests capital expenditure loans from CFC, these loans will be provided at the standard terms offered to all borrowers and will require debt service payments in addition to the quarterly payments that CoServ is required to make to CFC. As of August 31, 2006, no amounts have been advanced to CoServ under this loan facility. To date, CoServ has made all payments required under the restructure agreement. Under the terms of the restructure agreement, CoServ has the option to prepay the loan for $415 million plus an interest payment true up on or after December 13, 2007 and for $405 million plus an interest payment true up on or after December 13, 2008.

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

Based on its analysis, the Company believes that it is adequately reserved for its exposure to CoServ at August 31, 2006.

(d) VarTec Telecom, Inc. ("VarTec") is a telecommunications company and RTFC borrower located in Dallas, Texas. RTFC is VarTec's principal senior secured creditor. At August 31, 2006 and May 31, 2006, RTFC had a total of $49 million and $90 million, respectively, of loans outstanding to VarTec. At August 31, 2006 and May 31, 2006, all loans to VarTec were on non-accrual status, resulting in the application of all payments received against principal.

VarTec and 16 of its U.S.-based affiliates, which were guarantors of VarTec's debt to RTFC, filed voluntary petitions under Chapter 11 of the United States Bankruptcy Code on November 1, 2004 in Dallas, Texas. On July 29, 2005, the court approved a sale of VarTec's remaining operating assets (the "Domestic Assets Sale"). Final proceeds from the closing of the Domestic Assets Sale were received in June 2006 totaling $40 million. Pursuant to court order, all net proceeds of asset sales, including the Domestic Assets Sale, have been provisionally applied to RTFC's secured debt. The application is subject to third parties' rights, if any, superior to RTFC's rights and liens, and to further court order to require the return of such funds for use as cash collateral under the Bankruptcy Code. 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.

On June 10, 2005, the Official Committee of Unsecured Creditors (the "UCC") initiated an adversary proceeding against RTFC in the United States Bankruptcy Court for the Northern District of Texas, Dallas Division. As a result of the conversion of the proceedings to Chapter 7, the UCC has been dissolved and the Chapter 7 trustee is now the plaintiff in the adversary proceedings. The adversary proceeding asserts the following claims: (i) that RTFC may have engaged in wrongful activities prior to the filing of the bankruptcy proceeding (e.g., RTFC had "control" over VarTec's affairs, RTFC exerted "financial leverage" over VarTec and is liable for VarTec's "deepening insolvency"); (ii) that RTFC's claims against VarTec should be equitably subordinated to the claims of other creditors because of the alleged wrongful activities; and (iii) that certain payments made by VarTec to RTFC and certain liens granted to RTFC are avoidable as preferences or fraudulent transfers or should otherwise be avoided and re-distributed for the benefit of VarTec's bankruptcy estates. The adversary proceeding identifies payments made by VarTec to RTFC of approximately $141 million, but does not specify damages sought. On December 16, 2005, the Court issued an order dismissing the "deepening insolvency" claim against RTFC. Trial, if necessary, on the merits of the remaining claims is currently scheduled for March 5, 2007. The trial date is subject to change.

On October 14, 2005, the Bankruptcy Court approved an administrative debtor-in-possession ("DIP") facility from RTFC in the amount of $9 million, of which $9 million was outstanding as of August 31, 2006. The DIP facility was extended on March 17, 2006, but RTFC has no obligation to fund beyond those budgeted expenses which accrued prior to June 15, 2006. However, RTFC may consider providing the estate with further DIP funding to pursue the collection of various claims.

Based on its analysis, the Company believes that it is adequately reserved for its exposure to VarTec at August 31, 2006.

(e) Innovative Communication Corporation ("ICC") is a diversified telecommunications company and RTFC borrower headquartered in St. Croix, United States Virgin Islands ("USVI"). In the USVI, through its subsidiary Virgin Islands Telephone Corporation d/b/a Innovative Telephone ("Vitelco"), ICC provides wire line local and long-distance telephone services. Cable television service and/or wireless telephone service is provided to subscribers in the USVI and a number of other islands located in the eastern and southern Caribbean and mainland France. ICC also owns a local newspaper based in St. Thomas, USVI and operates a public access television station that serves the USVI.

As of August 31, 2006 and May 31, 2006, RTFC had $489 million and $488 million, respectively, in loans outstanding to ICC. All loans to ICC have been on non-accrual status since February 1, 2005. ICC has not made debt service payments to the Company since June 2005.

RTFC is the primary secured lender to ICC. 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 ICC's USVI local exchange carrier subsidiary, Vitelco, (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 certain of its parent entities, including ICC's immediate parent, Emerging Communication, Inc., a Delaware corporation ("Emcom") and Emcom's parent, Innovative Communication Company LLC, a Delaware limited liability company ("ICC-LLC"), and (iv) a personal guaranty of the loans from ICC's indirect majority shareholder and chairman, Jeffrey Prosser ("Prosser").

Beginning on June 1, 2004, RTFC filed a series of lawsuits against ICC, Prosser and others for failure to comply with the terms of ICC's loan agreement with RTFC dated August 27, 2001 as amended on April 4, 2003 (hereinafter, the "RTFC Lawsuits"). In response to the RTFC Lawsuits, ICC, Vitelco and Prosser denied liability and asserted claims, by way of counterclaim and by filing its own lawsuits against RTFC, CFC and certain of RTFC's officers, seeking various remedies, including reformation of the loan agreement, injunctive relief, and damages. The remedies were based on various theories including a claim that RTFC breached an alleged funding obligation for the settlement of litigation brought by Emcom shareholders (the "Greenlight Entities") against ICC-LLC, ICC and some of ICC's directors, and a claim that Emcom and ICC-LLC were entitled to contribution from RTFC and CFC in connection with judgments that the Greenlight Entities had been awarded (the "ICC Claims," together with the RTFC Lawsuits, the "Loan Litigation"). Venue of the Loan Litigation ultimately was fixed in the District Court for the District of the Virgin Islands.

On February 10, 2006, Greenlight filed petitions for involuntary bankruptcy against Prosser, Emcom and ICC-LLC in the United States Bankruptcy Court for the District of Delaware. RTFC has appeared in the proceedings as a party-in-interest in accordance with the provisions of the United States Bankruptcy Code. The alleged debtors have filed motions seeking change of venue and dismissal of the involuntary petitions. RTFC has filed responses seeking denial of all such motions.

On April 26, 2006, RTFC reached a settlement of the Loan Litigation with ICC, Vitelco, ICC-LLC, Emcom, their directors and Prosser, individually. Under the settlement, RTFC obtained entry of judgments in the District Court for the District of the Virgin Islands against ICC for approximately $525 million and Prosser for approximately $100 million. RTFC also obtained dismissals with prejudice of all counterclaims, affirmative defenses and other lawsuits alleging wrongful acts by RTFC, certain of its officers, and CFC. Various parties also reached agreement for ICC to satisfy the RTFC judgments in the third quarter of calendar year 2006, subject to certain terms and conditions, however, on July 31, 2006, certain of the parties obligated to satisfy the RTFC judgments under the agreement filed voluntary bankruptcy proceedings, as described below, in order to obtain additional time to satisfy the judgments.

On July 31, 2006, ICC-LLC, and Emcom each filed a voluntary petition under Chapter 11 of the United States Bankruptcy Code in the United States District Court for the Virgin Islands, Division of St. Thomas and St. John, Bankruptcy Division, and Prosser, individually, filed a voluntary petition under Chapter 11 of the United States Bankruptcy Code in the United States Bankruptcy Court for the District of Virgin Islands. Prosser's case has been transferred to the United States District Court for the Virgin Islands, Division of St. Thomas and St. John, Bankruptcy Division. Each of the debtors is obligated to RTFC, for certain obligations of ICC, including court judgments. On September 25, 2006, ICC-LLC, Emcom and Prosser jointly filed a motion in the voluntary bankruptcy proceedings seeking court authority to assume the agreement under which each is obligated to satisfy the RTFC judgments. The bankruptcy court has entered an order scheduling a hearing on the motion for November 27, 2006. RTFC has not yet responded to the motion.

Based on its analysis, the Company believes that it is adequately reserved for its exposure to ICC at August 31, 2006.

(f) Pioneer Electric Cooperative, Inc. ("Pioneer") is an electric distribution cooperative located in Greenville, Alabama. Pioneer had also invested in a propane gas operation, which it recently sold. Pioneer has experienced deterioration in its financial condition as a result of losses in the gas operation. At August 31, 2006 and May 31, 2006, CFC had a total of $54 million in loans outstanding to Pioneer. Pioneer was current with respect to all debt service payments at August 31, 2006. All loans to Pioneer remain on accrual status with respect to the recognition of interest income. CFC is the principal creditor to Pioneer.

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

Based on its analysis, the Company believes that it is adequately reserved for its exposure to Pioneer at August 31, 2006.

(13) Segment Information

The Company's consolidated financial statements include the financial results of CFC, RTFC and NCSC. Full financial statements are produced for each of the three companies and are the primary reports that management reviews in evaluating performance. The segment presentation for the quarters ended August 31, 2006 and 2005 reflect the operating results of each of the three companies as a separate segment.

As stated elsewhere in the consolidated financial statements, CFC is the sole lender to RTFC and the primary source of funding for NCSC. NCSC also obtains funding from third parties with a CFC guarantee. Thus, CFC takes all of the risk related to the funding of the loans to RTFC and NCSC, and in return, CFC earns net interest income on the loans to RTFC and NCSC.

Pursuant to guarantee agreements, CFC has agreed to indemnify RTFC and NCSC for loan losses, with the exception of the NCSC consumer loan program. Thus, CFC maintains the majority of the total consolidated loan loss allowance. A small loan loss allowance is maintained by NCSC to cover its consumer loan exposure.

The following chart contains consolidated statement of operations for the three months ended August 31, 2006 and consolidated balance sheet information as of August 31, 2006.

(in thousands)	CFC	RTFC	NCSC	Consolidated
Statement of Operations:				
Interest income	$ 228,992	$ 28,113	$ 7,584	$ 264,689
Interest expense	(219,195)	(26,508)	(6,752)	(252,455)
Net interest income	9,797	1,605	832	12,234
Recovery of guarantee losses	1,400	-	-	1,400
Net interest income after recovery of guarantee losses	11,197	1,605	832	13,634
Non-interest income and expense:				
General and administrative expenses	(10,646)	(1,326)	(756)	(12,728)
Rental and other income	153	-	164	317
Results of operations of foreclosed assets	3,002	-	-	3,002
Total non-interest income and expense	(7,491)	(1,326)	(592)	(9,409)
Derivative cash settlements	11,603	-	103	11,706
Derivative forward value	(58,752)	-	(1,702)	(60,454)
Foreign currency adjustments	3,321	-	-	3,321
Total loss on derivative and foreign currency adjustments	(43,828)	-	(1,599)	(45,427)
Loss prior to income taxes and minority interest	(40,122)	279	(1,359)	(41,202)
Income tax benefit	-	198	516	714
Net (loss) income per segment reporting	$ (40,122)	$ 477	$ (843)	$ (40,488)
Reconciliation of net loss:				
Net loss per segment reporting				$ (40,488)
Minority interest				366
Net loss per consolidated statement of operations				$ (40,122)
Assets:				
Loans to members	$ 15,909,782	$ 2,034,521	$ 393,537	$ 18,337,840
Less: Allowance for loan losses	(610,671)	-	(747)	(611,418)

Loans to members, net	15,299,111	2,034,521	392,790	17,726,422
Other assets	946,121	223,420	35,687	1,205,228
Total assets	$16,245,232	$2,257,941	$428,477	$ 18,931,650

The following chart contains the consolidated statement of operations for the three months ended August 31, 2005 and consolidated balance sheet information at August 31, 2005.

(in thousands)	CFC	RTFC	NCSC	Consolidated
Statement of Operations:				
Interest income	$ 202,741	$ 39,654	$ 7,482	$ 249,877
Interest expense	(191,453)	(37,741)	(6,083)	(235,277)
Net interest income	11,288	1,913	1,399	14,600
Recovery of guarantee losses	3,300	-	-	3,300
Net interest income after recovery of guarantee losses	14,588	1,913	1,399	17,900
Non-interest income and expense:				
General and administrative expenses	(10,521)	(1,132)	(464)	(12,117)
Rental and other income	1,462	-	-	1,462
Results of operations of foreclosed assets	4,692	-	-	4,692
Total non-interest income and expense	(4,367)	(1,132)	(464)	(5,963)
Derivative cash settlements	20,651	-	(451)	20,200
Derivative forward value	(34,929)	-	40	(34,889)
Foreign currency adjustments	(1,260)	-	-	(1,260)
Total loss on derivative and foreign currency adjustments	(15,538)	-	(411)	(15,949)
(Loss) margin prior to income taxes	(5,317)	781	524	(4,012)
Income tax expense	-	-	(199)	(199)
Net (loss) margin per segment reporting	$ (5,317)	$ 781	$ 325	$ (4,211)
Reconciliation of net loss:				
Net loss per segment reporting				$ (4,211)
Minority interest				(1,106)
Net loss per consolidated statement of operations				$ (5,317)
Assets:				
Loans to members	$ 15,462,713	$ 2,301,263	$ 438,609	$ 18,202,585
Less: Allowance for loan losses	(588,418)	-	(1,281)	(589,699)
Loans to members, net	14,874,295	2,301,263	437,328	17,612,886
Other assets	1,314,831	220,583	39,288	1,574,702
Total assets	$ 16,189,126	$ 2,521,846	$ 476,616	$ 19,187,588

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

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

This Form 10-Q contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Exchange Act of 1934, as amended, and as such may involve known and unknown risks, uncertainties and other factors that may cause our actual results, performance or achievements to be materially different from future results, performance or achievements expressed or implied by these forward-looking statements. Forward-looking statements, which are based on certain assumptions and describe our future plans, strategies and expectations, are generally identified by our use of words such as "intend," "plan," "may," "should," "will," "project," "estimate," "anticipate," "believe," "expect," "continue," "potential," "opportunity," and similar expressions, whether in the negative or affirmative. Our ability to predict results is inherently uncertain. Although we believe that the expectations reflected in such forward-looking statements are based on reasonable assumptions, actual results and performance could differ materially from those set forth in the forward-looking statements. All statements that address expectations or projections about the future, including statements about loan growth, the adequacy of the loan loss allowance, net margin growth, leverage and debt to equity ratios, and borrower financial performance are forward-looking statements. All forward-looking statements speak only to events as of the date on which the statements are made. All subsequent written and oral forward-looking statements attributable to us or any person acting on our behalf are qualified by the cautionary statements in this section. Except as required by law, we undertake no obligation to update or publicly release any revisions to forward-looking statements to reflect events, circumstances or changes in expectations after the date on which the statement is made.

The information contained in this section should be read in conjunction with our consolidated financial statements and related notes and the information contained elsewhere in this Form 10-Q, in addition to Part I, Item 1A, Risk Factors in the Company's Form 10-K for the year ended May 31, 2006.

Overview

In this report the Company will provide analysis on its results of operations, financial condition, liquidity and market risk. The Company will also provide analysis of trends and significant transactions completed in the period covered by the report.

The Company provides financial products to its rural electric and telecommunications members at the lowest cost in relation to the financial performance and strength required to maintain strong credit ratings. The Company's access to the capital markets at levels that allow it to keep cost to the members low is dependent on maintaining strong credit ratings. See page 43 for detail on the current ratings for the Company's public debt.

Financial Overview

Results of Operations

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

For the quarter ended August 31, 2006, the Company reported a net loss of $40 million compared to a net loss of $5 million for the prior year period, thus the TIER calculation for both periods results in a value below 1.00. For the quarter ended August 31, 2006, the Company reported an adjusted net margin of $17 million and adjusted TIER of 1.07, compared to an adjusted net margin of $32 million and adjusted TIER of 1.15 for the prior year period. See "Non-GAAP Financial Measures" for more information on the adjustments the Company makes to its financial results for the purposes of its own analysis and covenant compliance.

During the quarter ended August 31, 2006, earnings were impacted by a $29 million decrease in derivative and foreign currency adjustments and a $3 million decrease in net interest income, both of which were primarily impacted by the rise in interest rates.

Over the remainder of fiscal year 2007, the Company anticipates that the net interest income yield will remain at about the current level, as it is anticipated that the increases to the federal funds interest rate are nearing an end. The level of loans on non-accrual is expected to continue to be a significant drag on earnings for fiscal year 2007.

Financial Condition

During the quarter ended August 31, 2006, the Company's total loans outstanding decreased by $23 million or less than 1%. RTFC loans outstanding decreased by $128 million and NCSC loans outstanding decreased by $10 million, while CFC loans increased by $115 million.

The Company expects that the balance of the loan portfolio will remain relatively stable during the remainder of fiscal year 2007. Loans from the Federal Financing Bank ("FFB"), an agency of the U.S. Treasury Department, with a Rural Utilities Service ("RUS") guarantee, represent a lower cost option for rural electric utilities compared to the Company. The Company anticipates that the majority of its electric loan growth will come from distribution system borrowers that have fully prepaid their RUS loans and choose not to return to the government loan program, from distribution system borrowers that do not want to wait the 12 to 24 months it may take RUS to process and fund the loan and from power supply systems. The Company anticipates that the RTFC loan balance will continue to decline due to long-term loan amortization and lower levels of capital expenditure requirements and asset acquisitions in the rural telecommunications marketplace.

During the quarter ended August 31, 2006, short-term debt decreased by $135 million and long-term debt decreased by $52 million. Short-term debt decreased due to the redemption of $150 million of subordinated deferrable debt and the maturity of medium-term notes denominated in Australian dollars valued at $320 million at May 31, 2006, offset by an increase in commercial paper. There was no significant change to long-term debt.

Total equity decreased $125 million from May 31, 2006 to August 31, 2006 due to CFC's retirement of $84 million of patronage capital to its members and a net loss of $40 million for the quarter ended August 31, 2006. Under GAAP, the Company's reported equity balance fluctuates based on the impact of future expected changes to interest rates on the fair value of its interest rate exchange agreements and the impact of future expected currency exchange rates on its currency exchange agreements. As a result, it is difficult to predict the future changes in the Company's reported GAAP equity due to the uncertainty of the movement in future interest and currency exchange rates. In its internal analysis and for purposes of covenant compliance under its credit agreements, the Company adjusts equity to exclude the non-cash impacts of Statement of Financial Accounting Standards ("SFAS") 133, Accounting for Derivative Instruments and Hedging Activities, as amended and SFAS 52, Foreign Currency Translation.

Liquidity

At August 31, 2006, the Company had $3,614 million of commercial paper, daily liquidity fund and bank bid notes and $1,595 million of medium-term notes, collateral trust bonds and long-term notes payable scheduled to mature during the next twelve months. Members held commercial paper (including the daily liquidity fund) totaling $1,636 million or approximately 47% of the total commercial paper outstanding at August 31, 2006. Commercial paper issued through dealers and bank bid notes totaled $1,833 million and represented 10% of total debt outstanding at August 31, 2006. The Company intends to maintain the balance of dealer commercial paper and bank bid notes at 15% or less of total debt outstanding during fiscal year 2007. During the next twelve months, the Company plans to refinance the $1,595 million of medium-term notes, collateral trust bonds and long-term notes payable and fund new loan growth by issuing a combination of commercial paper, medium-term notes, collateral trust bonds and other debt.

CFC uses member loan repayments, capital market debt issuance, private debt issuance, member investments, and net margins to fund its operations. In addition, the Company maintains both short-term and long-term bank lines in the form of revolving credit agreements with its bank group. Members pay a small membership fee and are typically required to purchase subordinated certificates as a condition to receiving a long-term loan advance and as a condition of membership. CFC has a need for funding to make loan advances to its members, to make interest payments on its public and private debt and to make payments of principal on its maturing debt. To facilitate access to the capital markets, CFC is a regular issuer of debt in the capital markets, maintains strong credit ratings and has active shelf registrations on file with the Securities and Exchange Commission ("SEC") for each of its public debt instruments. CFC also has access to foreign debt markets with Euro medium-term note and commercial paper programs and an Australian medium-term note program.

The Company can borrow amounts from the FFB with a guarantee of repayment by the RUS as part of the funding mechanism for the Rural Economic Development Loan and Grant ("REDLG") program. As a result of the RUS guarantee, these funds represent a lower cost compared to the Company's other forms of debt securities. At August 31, 2006, the Company had RUS approval to borrow an additional $500 million under the REDLG program and the Company anticipates borrowing this amount prior to the expiration of the commitment in July 2009.

Margin Analysis

Results of Operations

Quarter ended August 31, 2006 versus August 31, 2005
The following chart presents the results of operations for the three months ended August 31, 2006 versus August 31, 2005.

	For the three months ended August 31,		Increase/
(Dollar amounts in millions)	2006	2005	(Decrease)
Interest income	$ 265	$ 250	$ 15
Interest expense	(253)	(235)	(18)
Net interest income	12	15	(3)
Recovery of guarantee losses	2	3	(1)
Net interest income after recovery of guarantee losses	14	18	(4)
Non-interest income and expense:			
General and administrative expenses	(13)	(12)	(1)
Rental and other income	-	1	(1)
Results of operations of foreclosed assets	3	5	(2)
Total non-interest income and expense	(10)	(6)	(4)
Derivative and foreign currency adjustments:			
Derivative cash settlements	12	20	(8)
Derivative forward value	(60)	(35)	(25)
Foreign currency adjustments	3	(1)	4
Total loss on derivative and foreign currency adjustments	(45)	(16)	(29)
Loss prior to income taxes and minority interest	(41)	(4)	(37)
Income tax benefit	1	-	1
Minority interest	-	(1)	1
Net loss	$ (40)	$ (5)	$ (35)
TIER (1)	-	-	
Adjusted TIER (2)	1.07	1.15	

(1) For the three months ended August 31, 2006 and 2005, the Company reported a net loss of $40 million and $5 million, respectively, thus the TIER calculation results in a value below 1.00.
(2) Adjusted to exclude the impact of the derivative forward value and foreign currency adjustments from net margin, to include minority interest in net margin and to include all derivative cash settlements in the interest expense. See "Non-GAAP Financial Measures" for further explanation and a reconciliation of these adjustments.

The following chart summarizes the Company's operating results expressed as an annualized percentage of average loans outstanding.

	For the three months ended August 31,		
	2006	2005	Change
Interest income	5.73%	5.31%	0.42%
Interest expense	(5.47)%	(4.99)%	(0.48)%
Net interest income	0.26%	0.32%	(0.06)%
Recovery of guarantee losses	0.04%	0.06%	(0.02)%
Net interest income after recovery of guarantee losses	0.30%	0.38%	(0.08)%
Non-interest income and expense:			
General and administrative expenses	(0.28)%	(0.25)%	(0.03)%
Rental and other income	-	0.02%	(0.02)%
Results of operations of foreclosed assets	0.06%	0.11%	(0.05)%
Total non-interest income and expense	(0.22)%	(0.12)%	(0.10)%
Derivative and foreign currency adjustments:			
Derivative cash settlements	0.26%	0.42%	(0.16)%
Derivative forward value	(1.30)%	(0.74)%	(0.56)%
Foreign currency adjustments	0.07%	(0.02)%	0.09%
Total loss on derivative and foreign currency adjustments	(0.97)%	(0.34)%	(0.63)%
Loss prior to income taxes and minority interest	(0.89)%	(0.08)%	(0.81)%
Income tax benefit	0.02%	-	0.02%
Minority interest	-	(0.03)%	0.03%
Net loss	(0.87)%	(0.11)%	(0.76)%
Adjusted net interest income (1)	0.52%	0.74%	(0.22)%
Adjusted margin prior to income taxes and minority interest (2)	0.34%	0.68%	(0.34)%

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

CFC's net interest income will increase or decrease due to changes in loan volume and the rate that it receives on its loans and pays on its sources of funding, respectively. CFC's loan volume substantially determines its funding needs. The following Volume Rate Variance Table provides a breakout of the change to interest income, interest expense and net interest income due to changes in loan volume versus changes to interest rates. The analysis is consistent with the August 31, 2006 and 2005 consolidated statements of operations. For comparability purposes, average daily loan volume is used as the denominator in calculating interest income yield, interest expense rates and net interest income yield.

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

Volume Rate Variance Table
(Dollar amounts in millions)

	For the three months ended August 31, 2006			2005			Change due to		
	Average Loan Balance	Income / (Cost)	Rate	Average Loan Balance	Income / (Cost)	Rate	Volume (1)	Rate (2)	Total
Interest income									
CFC	$ 16,424	$ 229	5.53%	$ 16,096	$ 203	5.00%	$ 4	$ 22	$ 26
RTFC	1,535	28	7.26%	2,123	40	7.41%	(11)	(1)	(12)
NCSC	397	8	7.58%	453	7	6.56%	-	1	1
Total	$ 18,356	$ 265	5.73%	$ 18,672	$ 250	5.31%	$ (7)	$ 22	$ 15
Interest expense									
CFC	$ 16,424	$ (219)	(5.30)%	$ 16,096	$ (191)	(4.72)%	$ (4)	$ (24)	$ (28)
RTFC	1,535	(27)	(6.85)%	2,123	(38)	(7.05)%	10	1	11
NCSC	397	(7)	(6.75)%	453	(6)	(5.33)%	-	(1)	(1)
Total	$ 18,356	$ (253)	(5.47)%	$ 18,672	$ (235)	(4.99)%	$ 6	$ (24)	$ (18)
Net interest income									
CFC	$ 16,424	$ 10	0.23%	$ 16,096	$ 12	0.28%	$ -	$ (2)	$ (2)
RTFC	1,535	1	0.41%	2,123	2	0.36%	(1)	-	(1)
NCSC	397	1	0.83%	453	1	1.23%	-	-	-
Total	$ 18,356	$ 12	0.26%	$ 18,672	$ 15	0.32%	$ (1)	$ (2)	$ (3)
Derivative cash settlements (3)									
CFC	$ 12,444	$ 12	0.37%	$ 15,031	$ 21	0.55%	$ (3)	$ (6)	$ (9)
NCSC	97	-	-	117	(1)	(1.53)%	-	1	1
Total	$ 12,541	$ 12	0.37%	$ 15,148	$ 20	0.53%	$ (3)	$ (5)	$ (8)
Adjusted interest expense (4)									
Total	$ 18,356	$ (241)	(5.21)%	$ 18,672	$ (215)	(4.57)%	$ 3	$ (29)	$ (26)

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

Interest Income

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

(Dollar amounts in millions)	For the three months ended August 31, 2006		2005		Increase/ (Decrease)
	Amount	Rate	Amount	Rate	
Loan interest income (1)	$ 255	5.51 %	$ 239	5.08%	$ 16
Investment income (2)	2	0.04 %	2	0.04%	-

Conversion fees (3)		3	0.07 %		4	0.09%		(1)
Make-whole and prepayment fees (4)		1	0.02 %		3	0.06%		(2)
Commitment and guarantee fees (5)		4	0.09 %		2	0.04%		2
Total interest income	$	265	5.73 %	$	250	5.31%	$	15

(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.

Total interest income for the quarter ended August 31, 2006 represented an increase of $15 million or 6% from the prior year period. The increase to interest income was due to the increase to CFC loan interest rates in the markets offset by lower loan volume. Since August 31, 2005, the Company raised variable interest rates by between approximately 165 basis points and 170 basis points depending on the loan program, while fixed interest rates remained relatively stable. For the quarter ended August 31, 2006, the Company had a reduction to interest income of $20 million due to non-accrual loans compared to a reduction of $19 million for the prior year period. The decrease in loan volume is due to the further reduction of RTFC loans during the quarter ended August 31, 2006.

The $26 million increase in CFC interest income was due to the increase in interest rates partly offset by the impact of non-accrual loans. The impact on CFC interest income of non-accrual loans was a reduction of $10 million for the quarter ended August 31, 2006 as compared to $8 million for the prior year period. The impact of non-accrual loans on interest income is included in the rate variance in the chart above. The $12 million decrease in RTFC interest income was due to the reduction in the balance of RTFC loans outstanding. The impact on RTFC interest income of non-accrual loans was a reduction of $10 million for the quarter ended August 31, 2006 as compared to $11 million for the prior year period.

Interest Expense

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

	For the three months ended August 31,				
	2006		2005		
(Dollar amounts in millions)	Amount	Rate	Amount	Rate	Increase/ (Decrease)
Debt interest expense (1)	$ 240	5.19 %	$ 229	4.87%	$ 11
Debt issuance costs (2)	7	0.15 %	2	0.04%	5
Derivative cash settlements, net (3)	-	-	1	0.02%	(1)
Commitment and guarantee fees (4)	4	0.09 %	2	0.04%	2
Other fees (5)	2	0.04 %	1	0.02 %	1
Total interest expense	$ 253	5.47 %	$ 235	4.99%	$ 18

(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 treatment plus the accrual from the date of the last settlement to the current period end.
(4) Includes various fees related to funding activities, including fees paid to banks participating in the Company's revolving credit agreements and fees paid under bond guarantee agreements with RUS as part of the REDLG program. Fees are recognized as incurred or amortized on a straight line basis over the life of the respective agreement.
(5) Represents fees associated with NCSC's consumer loan program and other fees.

The $18 million increase to the total interest expense for the quarter ended August 31, 2006 as compared to the prior year period was due to the increase to interest rates in the markets and the $7 million increase to total fees expensed by the Company during the quarter ended August 31, 2006. The increase to fees expensed was primarily due to the $5 million loss representing the unamortized issuance costs on the early retirement of subordinated deferrable debt in June 2006. The increase to total interest expense was partly offset by the decrease due to lower loan volume.

The adjusted total interest expense, which includes all derivative cash settlements, for the quarter ended August 31, 2006 increased by $26 million compared to the prior year period due to the $18 million increase to interest expense noted above and the $8 million decrease in derivative cash settlements described below. See "Non-GAAP Financial Measures" for further explanation of the adjustment the Company makes in its financial analysis to include all derivative cash settlements in its interest expense.

Net Interest Income

The change in the line items described above resulted in a decrease in net interest income of $3 million for the quarter ended August 31, 2006 compared to the prior year period. The adjusted net interest income, which includes all derivative cash settlements, for the quarter ended August 31, 2006 was $24 million, a decrease of $11 million from the prior year period. See "Non-GAAP Financial Measures" for further explanation of the adjustment the Company makes in its financial analysis to include all derivative cash settlements in its interest expense, and therefore net interest income.

Results of Operations of Foreclosed Assets

Income from the operation of foreclosed assets decreased by $2 million for the quarter ended August 31, 2006 compared to the prior year period due to the gain of $3 million related to the sale of real estate assets in August 2005. At August 31, 2006, the remaining balance of foreclosed assets is comprised of notes receivable which the Company continues to service.

Derivative Cash Settlements

The $8 million decrease in cash settlements for the quarter ended August 31, 2006 compared to the prior year period is primarily due to an increase in variable interest rates which caused a decrease to the net rate earned by the Company on exchange agreements. In addition, there was a reducti