KPMG

FEDERAL FINANCING BANK

Financial Statements

September 30, 2006 and 2005

(With Independent Auditors' Report Thereon)

FEDERAL FINANCING BANK

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September 30, 2006 and 2005

Introduction

The Federal Financing Bank (the Bank) is a government corporation under the general supervision and direction of the Secretary of the Treasury. It was created by the Congress in 1973, at the request of the U.S. Department of the Treasury (Treasury). The Bank borrows primarily from Treasury and lends to Federal agencies and private borrowers that have Federal guarantees.

Mission

The mission of the Bank is to reduce the costs of Federal and federally assisted borrowings, to coordinate such borrowings with the Government's overall fiscal policy, and to ensure that such borrowings are done in ways that least disrupt private markets. To accomplish this mission, the Bank exercises its broad statutory authority to purchase obligations issued, sold, or guaranteed by Federal agencies.

Objectives

The Bank was formed to be the vehicle through which Federal agencies finance programs involving the sale or placement of credit market instruments, including agency securities, guaranteed obligations, participation agreements and the sale of assets. This principle is applied in the manner consistent with the Federal Financing Bank Act of 1973 (12 U.S.C. 2281 et seq.) and its legislative history. Guaranteed programs entailing large numbers of relatively small loans in which local origination and servicing are an integral part of the program are excluded.

The Bank makes funds available to Federal agencies and to guaranteed borrowers in accordance with program requirements. The Bank is capable of providing a lending rate for any amount required and for nearly any maturity. The rate charged by the Bank for terms such as prepayment provisions, forward interest rate commitments, and pass-through of service charges are applied consistently for all borrowers.

The lending policy of the Bank is flexible enough to preclude the need for any accumulation of pools of funds by agencies. This does not exclude the maintenance of liquidity reserves for those agencies that have such a need. In no case will funds provided by the Bank be invested in private credit instruments or be used to speculate in the market for public securities.

Organizational Structure

The Bank is subject to the general supervision and direction of the Secretary of the Treasury. The Board of Directors is comprised of the incumbents of the following Treasury offices: The Secretary of the Treasury, who, as provided by law, is the Chairman; the Deputy Secretary; the Under Secretary for Domestic Finance; the General Counsel; and the Fiscal Assistant Secretary.

The officers are incumbents of the following Treasury offices (corresponding Bank positions are in parentheses): the Under Secretary for Domestic Finance (President); the General Counsel (General Counsel); the Assistant Secretary for Financial Markets (Vice President); the Fiscal Assistant Secretary (Vice President); the Deputy Assistant Secretary for Government Financial Policy (Vice President and Treasurer); and the Director, Office of Federal Lending (Secretary and Chief Financial Officer).

A delegation by the Bank President authorizes any Bank Vice President, in consultation with any other Bank officer, to exercise the powers of the Presidency.

The staff of the Bank is organized into two units headed by the Bank manager and the Accounting manager, respectively, who report to the Bank Secretary and Chief Financial Officer. The Bank manager is responsible for the administrative unit which includes the duties and responsibilities associated with credit analysis, loan origination, loan structuring and customer service. The Bank manager also acts as the organization's CIO with responsibility for a team of information systems professionals who conduct in-house software development and maintain the Bank's Oracle-based mission critical enterprise application. That application provides systems support for the loan administration and accounting functions. The Accounting manager heads a team of professionals responsible for loan disbursements, accounting for loan repayments, and financial reporting.

Ongoing Issues

Under a provision in the 1987 enabling legislation for the U.S. Department of Agriculture's Rural Utilities Service (RUS) Cushion of Credit Payments Program ("cushion of credit"), the Bank receives considerably less interest each year on certain loans that it holds than it is contractually entitled to receive. This provision, however, does not reduce the amount of interest the Bank owes on its corresponding loans from Treasury. The shortfall in interest received by the Bank has resulted in substantial deficits in the past and has the possibility of resulting in deficits in the future. The cumulative losses from interest credits taken by the RUS, beyond losses that were extinguished by appropriation in a previous year, totaled $1.0 billion through September 30, 2006. The interest shortfall is recorded on the statement of operations and changes in net position as legislatively-mandated expense.

The Balanced Budget and Emergency Deficit Control Act of 1985, commonly known as Gramm-Rudman-Hollings, Consolidated Omnibus Budget Reconciliation Act of 1985 and the Federal Credit Reform Act of 1990 include provisions that have acted as prohibitions and disincentives against Bank financing of certain loans that are 100 percent guaranteed by Federal agencies. The result has been a long-term reduction in the Bank loan portfolio and a more than corresponding increase in government guaranteed loans funded in the private markets. Both of these trends are expected to continue unabated without legislation to remove these statutory prohibitions against Bank financing.

Operations and Changes in Net Position Highlights

The following is a synopsis of the financial performance of the Bank for the fiscal year ended September 30, 2006. Interest on loans of $1.94 billion for the fiscal year ended September 30, 2006 was relatively flat compared to the interest on loans for the fiscal year ended September 30, 2005. Though the loan portfolio has actually increased since the prior year, new loans were funded relatively late in the year and had yet to make up the reduction in revenue as a result of the $1.6 billion reduction in loans receivable from fiscal year 2004 to fiscal year 2005. Revenue from servicing loans of $2.4 million was down $1.0 million comparatively. Servicing revenue continues to shrink as pre-credit reform loans mature.

Interest on borrowings of $1.2 billion for the fiscal year ended September 30, 2006 continued to be in line with expectations. After the bi-annual legislatively-mandated expense of $234.3 million and administrative expenses of $4.0 million, net income of $533.2 million for the fiscal year ended September 30, 2006 represents a $22.8 million reduction from the net income for the fiscal year ended September 30, 2005. Legislatively-mandated expenses are related to "cushion of credit" Rural Utilities Service loans.

Statement of Financial Position Highlights

Funds with U.S. Treasury (cash equivalent) of $901.5 million at September 30, 2006 continue to accumulate year-to-year, balanced by significant semi-annual interest payments on outstanding Office of Personnel Management (OPM) securities during the year ($651.2 million for fiscal year ended September 30, 2006). The Bank retains higher cash balances compared to previous years in order to ensure payment of interest on OPM related securities and make prepayments of debt held by the Secretary of the Treasury, when deemed appropriate.

The loan portfolio (loans receivable) increased $4.0 billion from $27.8 billion at September 30, 2005 to $31.8 billion at September 30, 2006. The increase is primarily the result of $2.0 billion in new financing to the National Rural Utilities Cooperative Finance Corporation and a $2.1 billion short-term loan to the United States Postal Service. The Bank's net position increased to over $1.7 billion at September 30, 2006 as a result of steady positive earnings.

All of the loans in the Bank's portfolio are federally guaranteed except for those of the United States Postal Service. The Bank does not maintain a reserve for loan losses as no future credit related losses are expected.

During fiscal year 2006, the Bank processed 441 new loan requests. The interest rate was set or reset on 1,082 loans in fiscal year 2006. This includes new loans and maturity extensions. In addition, the Bank received 142 prepayments and processed 19,487 loan payments in fiscal year 2006.

Management Controls

The Bank completed an in-depth testing of its internal accounting and administrative control procedures in accordance with OMB Circular No. A-123, *Management Accountability and Control,* in June 2006. In addition, a private contractor performed a certification and accreditation of the Bank's enterprise management system, known as the Loan Management Control System, in July of 2006.

Accordingly, we believe that the Bank's systems of internal accounting and administrative controls fully comply with the requirements for agency internal accounting and administrative control systems, providing reasonable assurance that they are achieving the intended objectives.

KPMG LLP
2001 M Street, NW
Washington, DC 20036

Independent Auditors' Report on Financial Statements

Inspector General, U.S. Department of the Treasury and the
Fiscal Assistant Secretary of the U.S. Department of the Treasury:

We have audited the accompanying statements of financial position of the Federal Financing Bank (the Bank) as of September 30, 2006 and 2005, and the related statements of operations and changes in net position and cash flows for the years then ended. These financial statements are the responsibility of the Bank's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and applicable provisions of Office of Management and Budget (OMB) Bulletin No. 06-03, *Audit Requirements for Federal Financial Statements*. Those standards and OMB Bulletin No. 06-03 require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Bank's internal control over financial reporting. Accordingly, we express no such opinion. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Federal Financing Bank, as of September 30, 2006 and 2005, and the results of its operations, changes in net position, and cash flows for the years then ended, in conformity with U.S. generally accepted accounting principles.

The information in the Management's Discussion and Analysis section is presented for the purpose of additional analysis and is not a required part of the financial statements. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of this information. However, we did not audit this information and, accordingly, we express no opinion on it.

Our audits were conducted for the purpose of forming an opinion on the financial statements taken as a whole. The other supplementary information included in Schedule 1 is presented for purposes of additional analysis and is not a required part of the financial statements. Such information has not been subjected to the auditing procedures applied in the audits of the basic financial statements and, accordingly, we express no opinion on it.

In accordance with *Government Auditing Standards*, we have also issued reports dated November 10, 2006, on our consideration of the Bank's internal control over financial reporting and its compliance with certain provisions of laws, regulations, contracts, and other matters. The purpose of those reports is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on its compliance with laws, regulations, contracts, and other matters. Those reports are an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audits.

KPMG LLP

November 10, 2006

FEDERAL FINANCING BANK

Statements of Financial Position

September 30, 2006 and 2005

(Dollars in thousands)

		2006	2005
Assets:			
Funds with U.S. Treasury	$	901,480	361,469
Loans receivable (notes 2 and 4)		31,843,573	27,774,344
Advances to others		283	152
Accrued interest receivable		445,699	182,972
Total assets	$	33,191,035	28,318,937
Liabilities:			
Borrowings:			
Principal amount	$	30,709,045	26,426,618
Plus unamortized premium		405,702	474,640
Total borrowings (note 3)		31,114,747	26,901,258
Accrued interest payable		322,330	197,036
Other liabilities		129	—
Total liabilities		31,437,206	27,098,294
Net position (note 5)		1,753,829	1,220,643
Total liabilities and net position	$	33,191,035	28,318,937

See accompanying notes to financial statements.

FEDERAL FINANCING BANK

Statements of Operations and Changes in Net Position

Years ended September 30, 2006 and 2005

(Dollars in thousands)

		2006	2005
Revenue and financing sources:			
Interest on loans	$	1,944,655	1,939,428
Revenue from servicing loans		2,431	3,436
Total revenue		1,947,086	1,942,864
Expenses:			
Interest on borrowings		1,175,643	1,139,535
Legislatively-mandated expense		234,266	244,420
Administrative expenses		3,991	2,945
Total expenses		1,413,900	1,386,900
Net income		533,186	555,964
Net position:			
Beginning of year		1,220,643	612,986
Net income		533,186	555,964
Gain on extinguishment of borrowings treated as capital transaction (note 6)		—	51,693
End of year (note 5)	$	1,753,829	1,220,643

See accompanying notes to financial statements.

FEDERAL FINANCING BANK

Statements of Cash Flows

Years ended September 30, 2006 and 2005

(Dollars in thousands)

		2006	2005
Cash flows from operations:			
Net income	$	533,186	555,964
Adjustments to reconcile net income to net cash provided by operations:			
Amortization of premium on loans		(68,938)	(32,973)
Capitalization of interest receivable		(527)	—
Capitalization of interest payable		88,628	—
(Increase) decrease in accrued interest receivable		(262,727)	66,337
Increase in accrued interest payable		125,294	108,316
Increase in advances to others		(131)	(120)
Increase (decrease) in other liabilities		129	(4)
Net cash provided by operations		414,914	697,520
Cash flows from investing activities:			
Loan disbursements		(5,729,852)	(4,373,603)
Loan collections		1,661,150	5,925,163
Note receivable collection		—	246,221
Net cash (used in) provided by investing activities		(4,068,702)	1,797,781
Cash flows from financing activities:			
Borrowings		5,730,270	4,373,603
Repayments of borrowings		(1,536,471)	(6,957,306)
Net cash provided by (used in) financing activities		4,193,799	(2,583,703)
Net increase (decrease) in cash		540,011	(88,402)
Funds with U.S. Treasury – beginning of the period		361,469	449,871
Funds with U.S. Treasury – end of the period	$	901,480	361,469
Supplemental disclosures of cash flow information:			
Interest paid (net of amount capitalized)	$	1,031,821	1,066,269
Supplemental schedule of noncash investing and financing activities:			
Decrease in loans for capitalized interest receivable	$	—	10,837
Increase in borrowings for capitalized interest payable	$	—	4,303
Gain on early extinguishment of borrowings treated as capital transactions. (note 6)	$	—	51,693

The Bank issued borrowings of $14,246,221 and a related premium of $507,613 in exchange for an investment and related interest receivable totaling $14,753,834. (note 6)

The Bank extinguished borrowings of $14,447,217 using an investment and related interest receivable totaling $14,753,834. In addition, the Bank received a note receivable for $246,221 that was due on December 31, 2004. (note 6)

See accompanying notes to financial statements.

FEDERAL FINANCING BANK

Notes to Financial Statements

September 30, 2006 and 2005

(Dollars in thousands)

(1) Summary of Significant Accounting Policies

The Federal Financing Bank (the Bank) was created by the Federal Financing Bank Act of 1973 (12 USC 2281, the Act) as an instrumentality of the U.S. Government and a body corporate under the general supervision of the Secretary of the Treasury (the Secretary). The budget and audit provisions of the Government Corporation Control Act are applicable to the Bank in the same manner as they are applied to other wholly owned government corporations.

The Bank was established by Congress at the request of the U.S. Department of the Treasury (Treasury), in order "to assure coordination of federal and federally assisted borrowing programs with the overall economic and fiscal policies of the U.S. Government, to reduce the cost of federal and federally assisted borrowing from the public, and to assure that such borrowings are financed in a manner least disruptive of private financial markets and institutions." The Bank was given broad statutory authority to finance obligations issued, sold, or guaranteed by federal agencies so that the Bank could meet these debt management objectives.

The Bank is authorized, with the approval of the Secretary, to issue obligations to the public in amounts not to exceed $15,000,000. Additionally, the Bank is authorized to issue obligations in unlimited amounts to the Secretary and, at the discretion of the Secretary, may agree to purchase any such obligations.

(a) Basis of Presentation

The Bank has historically prepared its financial statements in accordance with accounting principles generally accepted in the United States of America (GAAP), based on standards issued by the Financial Accounting Standards Board (FASB), the private-sector standards-setting body. In October 1999, the American Institute of Certified Public Accountants (AICPA) designated the Federal Accounting Standards Advisory Board (FASAB) as the standards-setting body for the financial statements of federal government entities, with respect to the establishment of accounting principles generally accepted in the United States of America. The FASAB has indicated that financial statements prepared based upon standards promulgated by the FASB may also be regarded as in accordance with GAAP for those federal entities, such as the Bank, that have issued financial statements based upon FASB standards in the past. Accordingly, consistent with historical reporting, the Bank's financial statements are presented in accordance with accounting and financial reporting standards promulgated by the FASB.

(b) Basis of Accounting

The financial statements are presented on the accrual basis of accounting. The Bank recognizes loans when they are issued and related repayments when they are received. The Bank recognizes borrowings when they are received and repayments when they are made. In addition, the Bank recognizes interest on loans and revenue from servicing loans when they are earned and recognizes interest on borrowings and expenses when they are incurred.

(c) ***Funds with U.S. Treasury***

As a government corporation, the Bank maintains a Fund Balance with Treasury (fund account 20X4521) and does not hold cash. For the purposes of the statement of cash flows, the funds with Treasury are considered cash.

(d) ***Loans Receivable***

The Bank issues loans to federal agencies for their own use or to issue loans to private sector borrowers, whose loans are guaranteed by the federal agencies. When a federal agency has to honor its guarantee because a private sector borrower defaults, the federal agency must obtain an appropriation or use other resources to pay the Bank. Loan principal and interest are backed by the full faith and credit of the U.S. Government, except for loans to the U.S. Postal Service. The Bank has not incurred and does not expect to incur any credit-related losses on its loans.

(e) ***Interest on Loans***

The Bank's general policy is to capture the liquidity premium between Treasury securities and the private sector lending rates, and to charge a rate that reflects the risk inherent in a borrower or transaction, when such a rate will accomplish a broader goal. Under the 1997 amendments to the Federal Credit Reform Act while the Bank continues to be permitted to charge a spread on new lending arrangements with government-guaranteed borrowers, the margin may no longer be retained by the Bank, but rather is credited to and retained by the loan guarantor. Since the Bank is not collecting income from the interest spread, there is a possibility that the Bank may not be able to fund its administrative expenses related to these loans. The 1997 amendments to the Federal Credit Reform Act allow the Bank to require reimbursements to cover the administrative expenses related to these loans from loan guarantors who have retained the margin.

(f) ***Capitalized Interest***

In accordance with loan agreements with the Bank, the General Services Administration (GSA), Historically Black Colleges and Universities (HBCU), and Veteran Administration Transitional Housing (VATH) program have the option of deferring payments of interest on their loans until future periods. When GSA, HBCU, or VATH elect, in advance, to defer interest payments, the accrued interest is recorded as capitalized interest receivable and added to the respective loan balance by the Bank. The Bank correspondingly capitalizes the interest payable on its related borrowings.

(g) ***Premium on Borrowings***

The Bank amortizes the premium on borrowings using the effective interest method. The amortization is recorded as part of interest on borrowings on the statement of operations and changes in net position.

(h) ***Revenue from Servicing Loans***

The Bank charges certain Rural Utilities Services (RUS) borrowers a loan service fee that is reported as revenue from servicing loans on the statements of operations and changes in net position. The

Bank's loan servicing fee is equal to one-eighth of one percent more than the contractual interest rate with Treasury.

(i) ***Legislatively-mandated Expense***

In prior years, the Bank purchased certificates of beneficial ownership (i.e., loans reported as loans receivable on the statement of financial position) from RUS, a component of the U.S. Department of Agriculture. RUS used the funds received from the Bank to issue loans to non-federal entities, specifically private utility companies. In 1987, Congress passed legislation (i.e., 7 USC Sec. 940c – Cushion of Credit Payments Program) that required RUS to develop and promote a program to encourage private utility companies to voluntarily make deposits into cushion of credit accounts established within RUS. The legislation also indicated that a private utility company may reduce the balance of its cushion of credit account only if the reduction is used to make scheduled payments on loans received from RUS. In accordance with the legislation, the private utility companies earn interest at the higher of 5% or the weighted average rate of the certificates of beneficial ownership on cash deposited into the cushion of credit accounts with RUS. The legislation also indicated that RUS shall receive an interest credit from the Bank equal to the amount of interest RUS pays to the private utility companies. The Bank records the interest credit in the period the cost is incurred as a legislatively-mandated expense in the statement of operations and changes in net position.

(j) ***Administrative Expenses***

The Bank is subject to the general supervision and direction of the Secretary. As provided by law, the Secretary acts as Chairman of the board of directors. Employees of Treasury's Departmental Offices perform the Bank's management and accounting functions; its legal counsel is the General Counsel of the Treasury. The Bank reimburses Treasury for the facilities and services it provides. The amount of such reimbursements for the years ended September 30, 2006 and 2005, was $3,991 and $2,945, respectively, and is included as administrative expenses in the statement of operations and changes in net position.

(k) ***Net Position***

The Bank can borrow from Treasury to meet its immediate cash needs and can also seek appropriations from Congress to make up for accumulated losses that will not be met by income.

(l) ***Management's Use of Estimates***

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of income and expenses during the reporting period. Actual results could differ from those estimates.

(m) ***Tax-Exempt Status***

The Bank is exempt from tax in accordance with Section 11(a) of the Federal Financing Bank Act of 1973 (12 USC 2281).

(n) Related Parties

The Bank conducts most of its financial transactions with other federal entities and therefore the financial statement balances that represent transactions with other federal entities include all assets, liabilities except borrowings from the public of $10 as of September 30, 2006 and 2005, revenues, and expenses.

(o) Future Accounting Standards

In March 2006, the FASB issued SFAS No. 156, *Accounting for Servicing of Financial Assets – an Amendment of FASB Statement No. 140* (SFAS No. 156). SFAS No. 156 requires entities to recognize a servicing asset or liability each time it undertakes an obligation to service a financial asset by entering into a servicing contract in certain situations. This statement also requires all separately recognized servicing assets and servicing liabilities to be initially measured at fair value and permits a choice of either the amortization or fair value measurement method for subsequent measurement. SFAS No. 156 is effective for all financial instruments acquired or issued after the beginning of an entity's first fiscal year that begins after September 15, 2006. The Bank has not completed the process of evaluating the impact that will result from adopting SFAS No. 156.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* (SFAS No. 157). SFAS No. 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles (GAAP), and expands disclosures about fair value measurements. SFAS No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007. The Bank has not completed the process of evaluating the impact that will result from adopting SFAS No. 157.

(2) Loans Receivable

Loans receivable represent the outstanding balances for loans to agencies. The Bank has the ability and intends to hold loans receivable until maturity or payoff. At September 30, 2006, the Bank had outstanding loans receivable of $31,843,573 with interest rates ranging from 2.037% to 16.183%, and maturity dates from October 1, 2006 to July 17, 2045. At September 30, 2005, the Bank had loans receivable of $27,774,344 with interest rates ranging from 1.617% to 16.183%, and maturing dates ranging from October 1, 2005 to January 3, 2040.

FEDERAL FINANCING BANK

Notes to Financial Statements

September 30, 2006 and 2005

(Dollars in thousands)

Loans receivable at September 30, 2006 and 2005, consist of the following:

Agency		2006	2005
Rural Utilities Service, Department of Agriculture	$	21,366,837	18,535,948
Rural Utilities Service, Department of Agriculture (CBO) certificates of beneficial ownership		3,916,573	4,270,207
General Services Administration		2,191,603	2,201,455
U.S. Postal Service		2,100,000	—
Foreign Military Sales, Department of Defense		1,023,946	1,244,459
Low Rent Public Housing, Department of Housing and Urban Development		883,966	971,927
Veteran Administration Transitional Housing Program		2,478	—
Ship Leasing, Department of Defense, Navy		170,586	375,712
Historically Black Colleges and Universities, Department of Education		155,347	126,500
Small Business Administration		26,510	39,705
Virgin Islands, Department of the Interior		3,239	5,523
Federal Railroad Administration, Department of Transportation		2,488	2,694
Community Development Block Grants, Department of Housing and Urban Development		—	214
Total loans receivable	$	31,843,573	27,774,344

The loans receivable due within one year is $4,892,767 and $1,061,045 as of September 30, 2006 and 2005, respectively.

(3) Borrowings

Under the FFB Act, the Bank may, with the approval of the Secretary of the Treasury, borrow without limit from the Treasury. Repayments on Treasury borrowings match the terms and conditions of corresponding loans made by the Bank and bear interest at the respective rate as determined by the Secretary of the Treasury. The Bank's borrowings are repayable on demand. At September 30, 2006, the Bank had Treasury borrowings of $16,709,035 with interest rates ranging from 1.502% to 16.050%, and maturity dates from October 1, 2006 to July 17, 2045. At September 30, 2005, the Bank had Treasury borrowings of $12,426,608, with interest rates ranging from 1.448% to 16.050%, and maturity dates from October 1, 2005 to January 3, 2040.

Additionally, at September 30, 2006 and 2005 the Bank had borrowings of $14.0 billion and an associated unamortized premium of $405,702 and $474,640 at September 30, 2006 and 2005, respectively (also see note 6 for details of transaction) from the Civil Service Retirement and Disability Fund (CSR&DF), which is administered by the Office of Personnel Management (OPM). These borrowings are at stated interest rates ranging from 4.625% to 5.625%, effective interest rate of 4.125%, and with maturity dates ranging from June 30, 2009 to June 30, 2019. The principal amounts, maturity dates, and interest rates on the debt to OPM are the same as the obligations previously issued by Treasury's Bureau of the Public Debt to OPM as investments.

(Dollars in thousands)

Borrowings from the public amounted to $10 at September 30, 2006 and 2005.

The scheduled principal repayments below reflect maturities of the Bank's borrowings and do not necessarily match the maturities of assets in the Bank's loan portfolio. Scheduled principal repayments of borrowings as of September 30, 2006, are as follows:

Fiscal Year		
2007	$	4,758,894
2008		1,801,954
2009		2,530,058
2010		1,966,083
2011		2,745,151
2012 and thereafter		16,906,905
Total principal payments		30,709,045
Plus unamortized premium		405,702
Total borrowings	$	31,114,747

(4) Fair Value of Financial Instruments

(a) Funds with U.S. Treasury

The carrying amount approximates fair value because of the liquid nature of the funds with Treasury.

(b) Loans Receivable and Borrowings

The fair value of loans receivable and borrowings is calculated using discounted cash flow analyses based on contractual repayment terms. The discount rates used in the loans receivable analysis are based on interest rates currently being offered by the Bank on loans of similar maturity and other characteristics. The discount rates used in the borrowings analysis are based on interest rates of current borrowings from Treasury using similar maturity and other characteristics. The fair value of loans receivable at September 30, 2006 and 2005, was $34,957,860 and $31,759,870, respectively. The fair value of borrowings at September 30, 2006 and 2005, was $31,028,820 and $27,195,570, respectively.

(c) Advances to Others, Accrued Interest Receivable, Accrued Interest Payable, and Other Liabilities

The carrying amount of advances to others, accrued interest receivable, accrued interest payable, and other liabilities approximate fair value as they represent the amounts expected to be realized or paid and are current assets and liabilities.

FEDERAL FINANCING BANK

Notes to Financial Statements

September 30, 2006 and 2005

(Dollars in thousands)

(5) Net Position

At September 30, 2006 and 2005, the net position includes the following:

		2006	2005
Transfers to Treasury	$	(1,682,847)	(1,682,847)
Cumulative results of operations and gains/losses on extinguishment of borrowings treated as capital transactions		3,436,676	2,903,490
Net position	$	1,753,829	1,220,643

Included in the net position activity is income the Bank earned prior to fiscal year 2000 that the Bank transferred to Treasury.

(6) Capital Transactions

On November 15, 2004 the Bank issued debt obligations of $14,000,000 with interest rates ranging from 4.625% to 5.625% and maturity dates ranging from June 30, 2009 to June 30, 2019, a related premium of $507,613 and a debt obligation of $246,221 with a maturity date of December 31, 2004, to CSR&DF and received in exchange $14,000,000 of investments at par value "Specified Treasury Specials," issued by Treasury with interest rates ranging from 4.625% to 5.625%, and maturity dates ranging from June 30, 2009 to June 30, 2019, related purchased accrued interest receivable of $246,221, and related purchased premium of $507,613.

On November 15, 2004, the Bank used the "Specified Treasury Specials" received from the CSR&DF of $14,000,000; related premium of $507,613; and related interest receivable of $246,221 to extinguish $14,447,217 of borrowings from the Treasury, related capitalized interest of $15,064; and related interest payable of $82,473. In addition, the Bank received a note receivable from the Treasury of approximately $246,221 that was due on December 31, 2004.

These transactions resulted in the Bank owing debt to the CSR&DF instead of owing debt to the Treasury and resulted in a gain of $37,141, which represents a capital transaction with Treasury.

In June and September 2005, the Bank made early repayments to the Treasury totaling $969,240 resulting in a net gain of $14,552, which represents a capital transaction with Treasury.

(7) Capitalized Interest

Capitalized interest receivable was approximately $45,155 and $58,687, and the related capitalized interest payable was $90,255 and $13,860 as of September 30, 2006 and 2005, respectively. Capitalized interest receivable and payable are reported as part of the loans receivable and borrowing balances, respectively, on the statement of financial position.

FEDERAL FINANCING BANK

Other Supplementary Information – Schedule 1

Unaudited – See Accompanying Independent Auditors' Report

September 30, 2006 and 2005

(Dollars in thousands)

In prior years, the Federal Financing Bank (Bank) purchased certificates of beneficial ownership (i.e., loans reported as loans receivable on the statement of financial position) from the Rural Utilities Service (RUS), a component of the U.S. Department of Agriculture. RUS used the funds received from the Bank to issue loans to non-federal entities, specifically private utility companies. In 1987, Congress passed legislation (i.e., 7 USC Sec. 940c – Cushion of Credit Payments Program) that required RUS to develop and promote a program to encourage private utility companies to voluntarily make deposits into cushion of credit accounts established within RUS. The legislation also specified that private utility companies may reduce the balance of its cushion of credit account only if the reduction is used to make scheduled payments on loans from RUS. In accordance with the legislation, the private utility companies accrue interest at a rate of 5% per annum on cash deposited into the cushion of credit accounts with RUS. The legislation also specified that RUS shall receive an interest credit from the Bank equal to the amount of interest RUS pays to the private utility companies. The Bank records the interest credit in the period the cost is incurred as a legislatively mandated expense. As of September 30, 2006, the outstanding principal balance of the 17 RUS loans totaled $3,916,573, with interest rates ranging from 7.755% to 15.325%, and maturity dates ranging from 2008 to 2021. In October 1998, the Bank received an appropriation that off-set the RUS-CBO interest credits by $917,699.

The interest credits that the Bank has provided RUS-CBO through September 30, 2006 are as follows:

		Interest credit
Fiscal Year		Interest Credit
1988–2002	$	1,220,516
2003		71,810
2004		150,134
2005		244,420
2006		234,266
Total interest credits		1,921,146
Less appropriation		(917,699)
Total	$	1,003,447

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Independent Auditors' Report on
Internal Control over Financial Reporting

Inspector General, U.S. Department of the Treasury, and the
Fiscal Assistant Secretary of the U.S. Department of the Treasury:

We have audited the statements of financial position of the Federal Financing Bank (the Bank) as of September 30, 2006 and 2005, and the related statements of operations and changes in net position and cash flows for the years then ended, and have issued our report thereon dated November 10, 2006. We conducted our audits in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and Office of Management and Budget (OMB) Bulletin No. 06-03, *Audit Requirements for Federal Financial Statements*. Those standards and OMB Bulletin No. 06-03 require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement.

The management of the Bank is responsible for establishing and maintaining effective internal control. In planning and performing our fiscal year 2006 audit, we considered the Bank's internal control over financial reporting by obtaining an understanding of the Bank's internal control, determining whether internal controls had been placed in operation, assessing control risk, and performing tests of controls in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements. We limited our internal control testing to those controls necessary to achieve the objectives described in *Government Auditing Standards* and OMB Bulletin No. 06-03. We did not test all internal controls relevant to operating objectives as broadly defined by the *Federal Managers' Financial Integrity Act of 1982*. The objective of our audit was not to provide an opinion on the Bank's internal control over financial reporting. Consequently, we do not provide an opinion thereon.

Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be material weaknesses under standards issued by the American Institute of Certified Public Accountants. Material weaknesses are reportable conditions in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Because of inherent limitations in internal control, misstatements due to error or fraud may nevertheless occur and not be detected. However, we noted no matters involving the internal control and its operation that we considered to be material weaknesses as defined above.

We noted certain matters that we reported to the management of the Bank in a separate letter dated November 10, 2006.

This report is intended solely for the information and use of the Bank's management, the U.S. Department of the Treasury's Office of Inspector General, the OMB, the U.S. Government Accountability Office, and the U.S. Congress and is not intended to be and should not be used by anyone other than these specified parties.

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November 10, 2006

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Independent Auditors' Report on Compliance and Other Matters

Inspector General, U.S. Department of the Treasury, and the
Fiscal Assistant Secretary of the U.S. Department of the Treasury:

We have audited the statements of financial position of the Federal Financing Bank (the Bank) as of September 30, 2006 and 2005, and the related statements of operations and changes in net position and cash flows for the years then ended, and have issued our report thereon dated November 10, 2006. We conducted our audits in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and applicable provisions of Office of Management and Budget (OMB) Bulletin No. 06-03, *Audit Requirements for Federal Financial Statements.* Those standards and OMB Bulletin No. 06-03 require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

The management of the Bank is responsible for complying with laws, regulations, and contracts applicable to the Bank. As part of obtaining reasonable assurance about whether the Bank's financial statements are free of material misstatement, we performed tests of the Bank's compliance with certain provisions of laws, regulations, and contracts, noncompliance with which could have a direct and material effect on the determination of the financial statement amounts, and certain provisions of other laws and regulations specified in OMB Bulletin No. 06-03. Our audit procedures were not designed to test the requirements of OMB Bulletin No. 06-03 relating to the *Federal Financial Management Improvement Act* (FFMIA) of 1996, which are not considered applicable at the Bank level. FFMIA requirements will be reviewed and reported on as part of the financial statement audit of the U.S. Department of the Treasury. We limited our tests of compliance to the provisions described in the preceding sentence, and we did not test compliance with all laws, regulations, and contracts applicable to the Bank. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion.

The results of our tests of compliance described in the preceding paragraph of this report disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards* or OMB Bulletin No. 06-03.

This report is intended solely for the information and use of the Bank's management, the U.S. Department of the Treasury's Office of Inspector General, the OMB, the U.S. Government Accountability Office, and the U.S. Congress and is not intended to be and should not be used by anyone other than these specified parties.

KPMG LLP

November 10, 2006