FEDERAL FINANCING BANK

Financial Statements

September 30, 2012 and 2011

(With Independent Auditors' Report Thereon)

FEDERAL FINANCING BANK

Table of Contents

FEDERAL FINANCING BANK

Management's Discussion and Analysis

September 30, 2012 and 2011

Introduction

The Federal Financing Bank (the Bank) is a government corporation under the general supervision and direction of the Secretary of the Treasury. The Congress created the Bank in 1973, at the request of the U.S. Department of the Treasury (Treasury). The Bank actively borrows from Treasury and lends to Federal agencies and private borrowers that have Federal guarantees. The Bank also has a debt obligation to the Civil Service Retirement and Disability Fund.

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 a 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 rates charged by the Bank for terms such as prepayment provisions 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 three units: loan administration, loan accounting, and computer support. The loan administration and accounting managers and the Chief Information Officer (CIO) report to the Chief Financial Officer (CFO). The loan administration manager is responsible for the loan administration unit, which includes the duties and responsibilities associated with credit analysis, loan origination, loan structuring, and customer service. The loan accounting manager heads a team of professionals responsible for loan disbursements, repayments, accounting, and financial reporting. The CIO is responsible for a team of information systems professionals and contractors that 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.

Loan Programs Activity

Under a provision in the 1987 enabling legislation for the U.S. Department of Agriculture's Rural Utilities Services (RUS) Cushion of Credit Payments Program (cushion of credit), the Bank receives considerably less interest each year on certain RUS loans that it holds than it is contractually entitled to receive. The shortfall in interest received by the Bank has resulted in substantial deficits in the past. The cumulative losses from interest credits taken by the RUS, beyond losses that were extinguished by appropriation in a previous year, totaled $2,080,431 thousand through September 30, 2012. The interest shortfall is recorded on the statement of operations and changes in net position as a legislatively mandated interest credit (contra-revenue to interest on loans).

The Balanced Budget and Emergency Deficit Control Act of 1985, commonly known as Gramm-Rudman-Hollings Act, the Consolidated Omnibus Budget Reconciliation Act of 1985, and the Federal Credit Reform Act of 1990 included provisions that have acted as prohibitions and disincentives against the Bank financing certain loans that are 100 percent guaranteed by Federal agencies.

Section 6102 of the Food, Conservation, and Energy Act of 2008 reinstated the direct loan program for the RUS Electric Program, eliminating the borrower's right to have loans financed by the Bank. Eventually, RUS anticipates financing new electric loans through a direct loan program instead of financing the loans through the Bank.

Impact of Economic Conditions

Current economic conditions have had an impact on programs that borrow from the Bank. Certain borrowers have repaid their loans with the Bank early, while other borrowers have increased their borrowing activities with the Bank.

All FFB assets are, or have a commitment to be, full faith and credit obligations of the U.S. Government and economic conditions do not affect repayments to the Bank. Loans backed by the full faith and credit of the U.S. Government are the credit equivalent of Treasury securities. The Bank does not expect to suffer any credit losses from loans backed by the full faith and credit of the U.S. Government.

United States Postal Service

The United States Postal Service (USPS) is an independent establishment of the executive branch of the U.S. Government, which borrows from the Bank to finance its capital improvements and defray operating expenses. The USPS is limited by statute to net annual debt increases of $3 billion with a total borrowing authority of $15 billion. USPS borrowed up to the maximum debt ceiling on September 28, 2012. USPS repaid $1.5 billion of the outstanding amount on October 1, 2012. The outstanding balance was further reduced to $11.8 billion on October 11, 2012. USPS can be expected to borrow up to the ceiling amount at different times in the coming year.

The USPS had a fiscal year 2012 deficit due to a decline in mail volume. As a result, the USPS was unable to make payments for legislatively mandated prefunding of retiree health benefits. However, relieving USPS of the obligation to prefund retiree health benefits will not, in and of itself, resolve the current and long-term financial issues of the USPS. The Administration, Congress, and other stakeholders are aware of the current and long-term financial issues of USPS. Congress is considering legislative solutions that it believes will return the USPS to financial stability if enacted.

The Bank has not incurred any credit-related losses on its loans as of the date of these statements, and as stated above, all Bank assets are, or have a commitment to be, full faith and credit obligations of the U.S. Government.

Financial Highlights

Statements of 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, 2012. Interest on loans of $2,642,121 thousand for the fiscal year ended September 30, 2012 increased compared to the interest on loans of $2,319,867 thousand for the fiscal year ended September 30, 2011, due to the increase in the total loans receivable balance primarily due to the increase in borrowing by the Department of Energy (DOE) and RUS. The legislatively mandated interest credits reduced interest income by $158,794 thousand and $249,813 thousand for the fiscal years ended September 30, 2012 and 2011, respectively, and are related to RUS "cushion of credit" loans. Revenue from servicing loans of $1,493 thousand for the fiscal year ended September 30, 2012 decreased from $2,120 thousand for the fiscal year ended September 30, 2011 due to the maturity of the loans being serviced.

Interest on borrowings of $2,176,933 thousand for the fiscal year ended September 30, 2012 increased from the interest on borrowings of $1,860,498 thousand for the fiscal year ended September 30, 2011 primarily due to the change in repayment structure resulting from the borrowing agreement with the Secretary of the Treasury. After administrative expenses of $5,387 thousand, net income of $302,788 thousand for the fiscal year ended September 30, 2012 increased from the net income of $206,769 thousand for the fiscal year ended September 30, 2011.

Statements of Financial Position Highlights

Funds with U.S. Treasury (cash equivalents) amounted to $716,258 thousand at September 30, 2012, which represents a decrease from the September 30, 2011 balance of $841,853 thousand. The cash balance declined due to timing of repayments.

The loan portfolio (loans receivable) increased $10,774,717 thousand from $57,087,892 thousand at September 30, 2011 to $67,862,609 thousand at September 30, 2012. The change is primarily the result of a $3,572,023 thousand increase in loan activity to RUS, $5,242,027 thousand increase in new loans to DOE, $1,999,600 thousand increase in new loans to the USPS and other loan activity. The Bank's net position increased to $4,302,103 thousand at September 30, 2012 from $3,999,315 thousand at September 30, 2011 primarily as a result of positive earnings.

All of the loans in the Bank's portfolio are federally guaranteed or have a commitment to be full faith and credit obligations of the United States. The Bank's borrowings increased by $10,490,827 thousand due to increased lending activities.

Performance Highlights

During fiscal year 2012, the Bank processed 1,552 new loan requests. The interest rate was set or reset on 2,941 loans in fiscal year 2012 for new loans and maturity extensions. The Bank processed 78 prepayments and 26,704 loan payments in fiscal year 2012.

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's Responsibility for Internal Control*, as of June 2012. Additionally, in fiscal year 2009, a private contractor performed a certification and accreditation of the Bank's enterprise management system, known as the Loan Management Control System (LMCS), which is effective for three years. Future LMCS certifications will be included with Treasury's certifications.

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.

FEDERAL FINANCING BANK

Statements of Financial Position

September 30, 2012 and 2011

(Dollars in thousands)

Assets		**2012**	**2011**
Funds with U.S. Treasury	$	716,258	841,853
Investments held-to-maturity (fair value of $493,404 and $493,194, notes 3 and 6)		493,446	493,254
Loans receivable (notes 4, 6, and 9)		67,862,609	57,087,892
Accrued interest receivable		466,149	151,227
Advances to others		55	66
Total assets	$	69,538,517	58,574,292
Liabilities and Net Position			
Liabilities:			
Borrowings:			
Principal amount	$	64,776,632	54,250,478
Plus unamortized premium		102,454	137,781
Total borrowings (notes 5, 6, 8, and 9)		64,879,086	54,388,259
Accrued interest payable		357,163	186,291
Other liabilities		165	427
Total liabilities		65,236,414	54,574,977
Loan and interest credit commitments (notes 10 and 1(j))			
Net position (note 7)		4,302,103	3,999,315
Total liabilities and net position	$	69,538,517	58,574,292

See accompanying notes to financial statements.

FEDERAL FINANCING BANK

Statements of Operations and Changes in Net Position

Years ended September 30, 2012 and 2011

(Dollars in thousands)

		2012	2011
Revenue and financing sources:			
Interest on loans	$	2,642,121	2,319,867
Less legislatively mandated interest credit		(158,794)	(249,813)
Net interest on loans		2,483,327	2,070,054
Interest on investments		288	492
Revenue from servicing loans		1,493	2,120
Total revenue		2,485,108	2,072,666
Expenses:			
Interest on borrowings		2,176,933	1,860,498
Administrative expenses		5,387	5,399
Total expenses		2,182,320	1,865,897
Net income	$	302,788	206,769
Net position:			
Beginning of year	$	3,999,315	3,793,194
Net income		302,788	206,769
Loss on extinguishment of borrowings treated as capital transactions (note 8)			(648)
End of year (note 7)	$	4,302,103	3,999,315

See accompanying notes to financial statements.

FEDERAL FINANCING BANK

Statements of Cash Flows

Years ended September 30, 2012 and 2011

(Dollars in thousands)

	2012	2011
Cash flows from operating activities:		
Net income	$ 302,788	206,769
Adjustments to reconcile net income to net cash provided by operations:		
Amortization of premium on borrowings	(35,327)	(42,226)
Capitalization of interest receivable	(58,345)	(9,332)
Capitalization of interest payable	129,344	184,037
(Increase) Decrease in accrued interest receivable	(314,922)	4,462
Decrease in advances to others	11	40
Increase (Decrease) in accrued interest payable	170,872	(27,984)
(Decrease) Increase in other liabilities	(262)	220
Net cash provided by operating activities	194,159	315,986
Cash flows from investing activities:		
Investment purchases	(192)	(640)
Loan disbursements	(654,980,692)	(594,804,927)
Loan collections	644,264,320	597,034,658
Net cash (used in) provided by investing activities	(10,716,564)	2,229,091
Cash flows from financing activities:		
Borrowings	654,980,885	594,805,568
Repayments of borrowings	(644,584,075)	(598,179,887)
Net cash provided by (used in) financing activities	10,396,810	(3,374,319)
Net decrease in cash	(125,595)	(829,242)
Funds with U.S. Treasury – beginning of the period	841,853	1,671,095
Funds with U.S. Treasury – end of the period	$ 716,258	841,853
Supplemental disclosures of cash flow information:		
Interest paid (net of amount capitalized)	$ 1,876,620	1,730,674
Supplemental schedule of noncash investing and financing activities:		
Loss on early extinguishment of borrowings treated as capital transactions (note 8)	$ —	(648)

See accompanying notes to financial statements.

(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) 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 to issue obligations to the public in amounts not to exceed $15,000,000 with the approval of the Secretary. 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. The Federal Accounting Standards Advisory Board (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 investments when they are made and investment redemptions when the proceeds are received. The Bank recognizes borrowings when they are received and repayments when they are made. In addition, the Bank recognizes interest on loans, interest on investments, 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 and does not hold cash. For the purposes of the statements of cash flows, the funds with Treasury are considered cash.

(Continued)

(d) Investments

The Bank's investments consist of investments in U.S. Treasury securities for the Home Ownership Preservation Entity (HOPE) Fund. The securities are categorized as held to maturity, because the Bank has the ability and intent to hold the securities until maturity. The securities are recorded at par value.

(e) Loans Receivable

The Bank issues loans to Federal agencies for their own use or to private sector borrowers whose loans are guaranteed by a Federal agency. When a Federal agency has to honor a guarantee because a private sector borrower defaults, the Federal agency must obtain an appropriation or use other resources to pay the Bank. All Bank assets are, or have a commitment to be, full faith and credit obligations of the U.S. Government. Accordingly, the Bank has not recorded a reserve for default on any loans receivable.

The Bank has not incurred any credit-related losses on its loans as of the date of these statements.

(f) 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. The income resulting from the interest spread covers the administrative expenses of the Bank. Under amendments to the Federal Credit Reform Act (FCRA), effective October 1, 1998, while the Bank is permitted to charge a spread on new lending arrangements with government-guaranteed borrowers, the margin is not retained by the Bank, but rather is retained by the loan guarantor. In the event that this results in the Bank being unable to fund its administrative expenses related to these loans, the FCRA, as amended, states that the Bank may require reimbursement from loan guarantors.

(g) Capitalized Interest

In accordance with their loan agreements with the Bank, the General Services Administration (GSA), Historically Black Colleges and Universities (HBCU), Veteran Administration Transitional Housing (VATH), and Department of Energy (DOE) have the option of deferring payments of interest on their loans until future periods. When GSA, HBCU, VATH, or DOE 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 non-FCRA borrowings.

The loans receivable due within a year for September 30, 2011 was revised to include capitalized interest for comparative purpose in Note 4.

(h) 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 statements of operations and changes in net position.

(i) Interest on Borrowings from Treasury to Fund Amounts Treated as Lending to Financing Accounts

The interest on borrowings from Treasury is based on the daily Treasury New Issue Curve (TNIC) for all borrowings, except for borrowings used to fund certain guaranteed loans that require the guaranteeing federal agencies to comply with the FCRA (2U.S.C. 661(d)(3)). The interest rate, interest payable, and interest expense for borrowings from Treasury that are used to fund certain guaranteed loans subject to FCRA are determined annually by the borrowing agencies using the FCRA and Office of Management and Budget guidelines.

(j) Legislatively Mandated Interest Credit

In prior years, the Bank purchased certificates of beneficial ownership (i.e., loans reported as loans receivable on the statement of financial position) from the U.S. Department of Agriculture's Rural Utilities Services (RUS). RUS used the funds received from the Bank to issue loans to nonfederal 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 private utility companies may reduce the balance of their 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 accrue interest at the higher of 5% per annum 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 interest credit (contra-revenue to interest on loans) in the statements of operations and changes in net position.

(k) Revenue from Servicing Loans

The Bank charges certain 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.

(l) 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, and its legal counsel is the General Counsel of the Treasury. The Bank reimburses Treasury for the facilities and services it provides. The amounts of such reimbursements are reported as administrative expenses in the statements of operations and changes in net position.

(m) 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.

(n) Loan Commitments

The Bank recognizes loan commitments when the Bank and the other parties fully execute the promissory notes and reduces loan commitments when the Bank issues loans or when the commitments expire. Most obligations of the Bank give a borrower the contractual right to a loan or loans immediately or at some point in the future. The Bank limits the time available for a loan under an obligation, where applicable.

(o) 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. The significant estimates made by management are the fair value calculations. Actual results could differ from those estimates.

(p) 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).

(q) 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; revenues; and expenses.

(2) Accounting Pronouncement

On May 17, 2011, FASB issued ASU No. 2011-04, FASB ASC 820, Fair Value Measurement and Disclosures *(precodification FASB SFAS No. 157,* Fair Value Measurements, *as amended).* The ASU explains how to measure fair value. The disclosures are effective for reporting periods beginning after December 15, 2011. The Bank adopted the applicable provisions of FASB ASU No. 2011-04 in fiscal year 2012. The adoption did not have an effect on the financial statements.

(3) Investments Held to Maturity (the HOPE Bond Transaction)

The Secretary is authorized to issue up to $300,000,000 HOPE bonds under the HOPE for Homeowners Act of 2008, and the Bank will purchase the HOPE bonds issued by the Secretary. The HOPE bonds purchased by the Bank are reported as investments held-to-maturity, and the related interest receivable is reported as accrued interest receivable in the Bank's statements of financial position. The interest rate is 0.103% and 0.010% as of September 30, 2012 and 2011, respectively, with floating interest rates reset quarterly. The bonds have 30-year maturity dates starting on August 27, 2038 and ending on July 15, 2042.

(Dollars in thousands)

The carrying amount, unrealized holding losses, and fair value of the HOPE bonds at September 30, 2012 and 2011 were as follows:

September 30, 2012		**Carrying amount**	**Unrealized holding losses**	**Fair value**
Investments held to maturity:				
U.S. Treasury Nonmarketable Securities – HOPE Bonds	$	493,446	(42)	493,404
Total	$	493,446	(42)	493,404

September 30, 2011		**Carrying amount**	**Unrealized holding losses**	**Fair value**
Investments held to maturity:				
U.S. Treasury Nonmarketable Securities – HOPE Bonds	$	493,254	(60)	493,194
Total	$	493,254	(60)	493,194

The Bank borrowed funds from Treasury at the same terms to purchase the HOPE bonds.

(4) Loans Receivable

Loans receivable represent the outstanding balances being treated as loans to agencies. The Bank has the ability and intends to hold loans receivable until maturity or payoff. At September 30, 2012, the Bank had outstanding loans receivable of $67,862,609. Certain of these loans were funded using FCRA borrowing procedures. The outstanding amount of loans funded using FCRA borrowing procedures was $17,184,592 with interest rates ranging from .095% to 4.707% and maturity dates ranging from October 1, 2012 to December 31, 2046. The remaining non-FCRA loans receivable of $50,678,017 had interest rates ranging from .095% to 12.405% and maturity dates ranging from October 1, 2012 to July 17, 2045.

At September 30, 2011, the Bank had outstanding loans receivable of $57,087,892. The outstanding amount of loans funded using FCRA borrowing procedures was $9,237,969 with interest rates ranging from .011% to 4.707% and maturity dates ranging from January 03, 2012 to January 02, 2046. The remaining non-FCRA loans receivable of $47,849,923 had interest rates ranging from 0.010% to 13.935% and maturity dates ranging from October 1, 2011 to July 17, 2045.

(Dollars in thousands)

Loans receivable at September 30, 2012 and 2011, consist of the following:

Agency		2012	2011
Rural Utilities Service, Department of Agriculture	$	36,603,840	32,503,417
U.S. Postal Service		14,999,600	13,000,000
Department of Energy		12,170,688	6,928,661
Rural Utilities Service, Department of Agriculture certificates of beneficial ownership		1,146,500	1,674,900
General Services Administration		1,819,153	1,898,140
Historically Black Colleges and Universities, Department of Education		928,712	781,750
Foreign Military Sales, Department of Defense		188,397	294,429
Veterans Administration Transitional Housing Program		4,723	4,780
Small Business Administration		60	578
Federal Railroad Administration, Department of Transportation		936	1,237
Total loans receivable	$	67,862,609	57,087,892

The loans receivable due within one year are $16,040,021 and $12,558,280 as of September 30, 2012 and 2011, respectively. The loans receivable due within a year for September 30, 2011 was revised to include capitalized interest for comparative purpose.

(5) Borrowings

Under the FFB Act, the Bank may, with the approval of the Secretary, borrow without limit from the Treasury.

For certain borrowings used to fund certain guaranteed loans based on FCRA, the interest rate is determined annually by the borrowing agencies using FCRA and Office of Management and Budget guidelines. At September 30, 2012, the Bank had $17,121,965 of Treasury borrowings used to fund guaranteed loans based on FCRA with interest rates ranging from 1.000% to 4.723%, and a maturity date of September 30, 2050. Under FCRA borrowing procedures, borrowings from Treasury do not capitalize interest.

For the Bank's non-FCRA borrowings, repayments on Treasury borrowings generally match the terms and conditions of corresponding loans made by the Bank and bear interest at the respective rate, as determined by the Secretary, and are repayable at any time, except for loans with fixed-price call options in the no-call period. In November 2004, certain borrowings from Treasury were refinanced under a debt limit transaction. At September 30, 2012, the Bank had $40,543,098 of Treasury borrowings for non-FCRA related loans, with interest rates ranging from .051% to 8.961%, and maturity dates from October 1, 2012 to December 31, 2046.

(Dollars in thousands)

At September 30, 2011, the Bank had $9,230,123 of Treasury borrowings used to fund guaranteed loans based on FCRA with interest rates ranging from 1.600% to 4.723% and a maturity date of September 30, 2050. Treasury borrowings for non-FCRA related loans of $36,578,875, with interest rates ranging from 0.000% to 8.961%, and maturity dates from October 3, 2011 to January 2, 2046.

Finally, at September 30, 2012 and 2011, the Bank had borrowings of $7,111,559 and $8,441,480, respectively, and an associated unamortized premium of $102,454 and $137,781, respectively, from the Civil Service Retirement and Disability Fund, which is administered by the Office of Personnel Management. At September 30, 2012, these borrowings were at a stated interest rate of 4.625%, effective interest rate of 4.625%, and with maturity dates ranging from June 30, 2013 to June 30, 2019. At September 30, 2011, these borrowings were at stated interest rates 4.625%, effective interest rate of 4.625%, and with maturity dates ranging from June 30, 2012 to June 30, 2019. Borrowing from the public amounted to $10 at September 30, 2012 and 2011.

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, 2012 are as follows:

Repayment date		Amount
2013	$	15,481,615
2014		4,083,913
2015		2,826,250
2016		3,349,178
2017		2,471,306
2018 and thereafter		36,564,370
Total principal payments		64,776,632
Plus unamortized premium		102,454
Total borrowings	$	64,879,086

(6) Fair Value of Financial Instruments and Interest Rate Volatility

(a) Fair Value Hierarchy

The accounting standards establish a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurements) and the lowest priority to measurements involving significant unobservable inputs (Level 3 measurements). The three levels of the fair value hierarchy are as follows:

- Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities that the Bank has the ability to access at the measurement date.
- Level 2 inputs are inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly.

(Dollars in thousands)

- Level 3 inputs are unobservable inputs for the asset or liability.

The level in the fair value hierarchy within which a fair value measurement in its entirety falls is based on the lowest level input that is significant to the fair value measurement in its entirety.

The Bank does not hold any financial instruments that are measured at fair market value on a recurring basis or for which the fair value option has been elected at September 30, 2012 and 2011.

All the fair values shown in this note are performed using Level 2 inputs at September 30, 2012 and 2011. The Bank's fair value measurements maximize the use of observable inputs and do not use unobservable inputs (Level 3).

The financial statements as of and for the year ended September 30, 2012 and 2011 do not include any nonrecurring fair value measurements relating to assets or liabilities for which the Bank has adopted the provisions of FASB ASC 820.

(b) Fair Value of Financial Instruments

The following table presents the carrying amounts and estimated fair values of the Bank's financial instruments at September 30, 2012 and 2011. The fair value of a financial instrument is the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

	2012		2011	
	Carrying amount	**Fair value (Level 2 inputs)**	**Carrying amount**	**Fair value (Level 2 inputs)**
Financial assets:				
Investments held to maturity	$ 493,446	493,404	493,254	493,194
Loans receivable	67,862,609	76,128,482	57,087,892	64,744,775
Financial liabilities:				
Borrowings	$ 64,879,086	73,351,618	54,388,259	60,595,936

The carrying amounts shown in the table are included in the statements of financial position under the indicated captions.

The fair values of the financial instruments shown in the above table as of September 30, 2012 and 2011 represent management's best estimates of the amounts that would be received to sell those assets or that would be paid to transfer those liabilities in an orderly transaction between market participants at that date. Those fair value measurements maximize the use of observable inputs.

The following methods and assumptions were used to estimate the fair value of each class of financial instruments:

Funds with U.S. Treasury: The carrying amount approximates fair value because of the liquid nature of the funds with Treasury.

Loans Receivable and Investments held-to-maturity: The fair value for the majority of the loan portfolio (approximately 99.7%) and investments held-to-maturity is determined using discounted cash flow analyses based on contractual repayment terms. The Bank's loans receivable, investments held-to-maturity, and interest are backed, or have a commitment to be backed, by the full faith and credit of the U.S. Government. As such, the Bank's assets are the equivalent of Treasury securities. The discount rates used in the loans receivable and investment analysis are based on interest rates currently being offered by the Bank on loans of similar maturity and other characteristics, plus 25 basis points added as a factor to account for the liquidity premium. The Bank obtains the discount rates from the daily TNIC, which is created daily with an interest rate for each day from 1 month to 30 years, based on the bid yields that day for Treasury securities traded in the public markets. The TNIC yields represent Treasury's best estimate of its own cost of borrowing for any given term on that business day.

For the rest of the loan portfolio (approximately 0.3%), the Bank's borrowers purchased a call option at the loan origination date. For the loans that have aged past the first available call date, the fair value is determined as the remaining balance plus the fixed call premium in effect at the time of valuation. For the loans with call options that have not reached the first call date, the fair value is determined by evaluating each loan through a call option model using the interest rates from the daily TNIC plus 25 basis points and the same terms in effect for a new comparable loan.

Borrowings: The fair value for all borrowings, except for borrowings used to fund certain guaranteed loans based on the FCRA, is determined using discounted cash flow analyses based on contractual repayment terms. The discount rates used in the borrowings analysis are based on interest rates of current borrowings from Treasury using similar maturity and other characteristics, plus 25 basis points added as a factor to account for the liquidity premium. The Bank obtains the discount rates from the daily TNIC.

Fair value for borrowings used to fund certain guaranteed loans based on the FCRA is determined based on an asset-backed securities model, for which the Bank does not expect to exercise the embedded call option. The asset-backed securities model reflects the cash flow profile of the respective cohorts and is discounted using interest rates from the daily TNIC, plus 25 basis points added as a factor to account for the liquidity premium.

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.

(Dollars in thousands)

(c) Interest Rate Volatility

The fair value of the Bank's loans receivable, investments, and borrowings changes in response to the interest rate volatility that results from the current economic conditions, market perception, and expectations. However, because the interest rates and maturities of loans receivable, investments, and borrowings are very similar, the fair market values of both assets and liabilities increase or decrease in the same direction and in similar amounts.

(7) Net Position

At September 30, 2012 and 2011, the net position includes the following:

		2012	2011
Beginning of year	$	3,999,315	3,793,194
Net Income		302,788	206,769
Early extinguishment of borrowings treated as capital transactions		—	(648)
Net position	$	4,302,103	3,999,315

(8) Loss on Extinguishment of Borrowings Treated as Capital Transactions

In fiscal year 2012, the Bank did not make an early repayment of debt to the Secretary. In fiscal year 2011, the Bank made early repayments to the Treasury totaling $902,906, resulting in a net loss of $648. The repayment represents a capital transaction, and the loss with Treasury is reported as a loss on extinguishment of borrowings treated as capital transaction on the statements of operations and changes in net position.

(9) Capitalized Interest

Capitalized interest receivable was approximately $68,588 and $12,714, and the related capitalized interest payable was $530,176 and $551,370 as of September 30, 2012 and 2011, respectively. Capitalized interest receivable and payable are reported as part of the loans receivable and borrowing balances, respectively, on the statements of financial position. The large difference between capitalized interest receivable and capitalized interest payable is due to the effects of a debt limit transaction on November 15, 2004. This transaction altered the structure of existing debt and caused capitalized interest to accrue.

(Dollars in thousands)

(10) Loan Commitments

The Bank makes loan commitments to extend credit to Federal program agencies based on the loan agreements executed between the parties. The loan commitments are not reported on the statements of financial position and generally have fixed expiration dates or other termination clauses. Since many of the loan commitments are expected to expire without being completely drawn upon, the total loan commitment amounts do not necessarily represent future cash requirements. The Bank uses the same credit policies in making loan commitments as it does for loans receivable reported on the statements of financial position. The Bank funds the loan commitments with its borrowing authority from the Secretary. There is no exposure or credit risk related to these commitments.

The contract amounts and remaining loan commitments by program agency as of September 30, 2012, are as follows:

Agency	Contract amounts	Remaining loan commitments
Department of Education – FFEL Conduit	$ 60,000,000	60,000,000
National Credit Union Administration – CLF	10,000,000	10,000,000
Rural Utilities Service, Department of Agriculture	27,124,411	10,209,705
U.S. Postal Service	9,500,000	400
Department of Energy	17,054,180	5,756,663
Historically Black Colleges and Universities, Department of Education	396,865	210,205
General Services Administration	163,200	6,254
Total commitments	$ 124,238,656	86,183,227

(11) Subsequent Events

The Bank has evaluated subsequent events from the statements of financial position date through November 9, 2012, the date at which the financial statements were available to be issued, and determined there are no other items to disclose.

FEDERAL FINANCING BANK

Other Supplementary Information – Schedule 1

Unaudited – See Accompanying Independent Auditors' Report

September 30, 2012 and 2011

(Dollars in thousands)

In prior years, the Federal Financing Bank (the 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 nonfederal 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 accrue interest at a rate of 5% per annum 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 interest credit (contra-revenue to interest on loans) in the statements of operations and changes in net position. As of September 30, 2012, the outstanding principal balance of the seven RUS loans subject to the certificates of beneficial ownership (CBO) legislation totaled $1,146,500, with interest rates ranging from 7.755% to 12.405 %, and maturity dates ranging from 2013 to 2021. In October 1998, the Bank received an appropriation that offset the RUS-CBO interest credits by $917,699.

The interest credits that the Bank has provided RUS-CBO through September 30, 2012 are as follows:

Fiscal year		Interest credits
1988–2008	$	2,116,975
2009		201,087
2010		271,461
2011		249,813
2012		158,794
Total interest credits		2,998,130
Less appropriation		(917,699)
Total	$	2,080,431

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Independent Auditors' Report

Inspector General, U.S. Department of the Treasury and
the Board of Directors, Federal Financing Bank:

We have audited the accompanying statements of financial position of the Federal Financing Bank (the Bank) as of September 30, 2012 and 2011, and the related statements of operations and changes in net position and cash flows for the years then ended (hereinafter referred to as "financial statements"). 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 Office of Management and Budget (OMB) Bulletin No. 07-04, *Audit Requirements for Federal Financial Statements*, as amended. Those standards and OMB Bulletin No. 07-04 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 also 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, 2012 and 2011, and the results of its operations and its cash flows for the years then ended in conformity with U.S. generally accepted accounting principles.

Our audits were conducted for the purpose of forming an opinion on the financial statements taken as a whole. The information in the Management's Discussion and Analysis and other supplementary information included in Schedule 1 is presented for purposes of additional analysis and is not required as 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 do not express an opinion or provide any assurance on them.

In accordance with *Government Auditing Standards*, we have also issued our reports dated November 9, 2012, on our consideration of the Bank's internal control over financial reporting and our tests of 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 compliance. 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 assessing the results of our audits.

KPMG LLP

November 9, 2012

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Independent Auditors' Report on Internal Control Over Financial Reporting

Inspector General, U.S. Department of the Treasury and
the Board of Directors, Federal Financing Bank:

We have audited the statements of financial position of the Federal Financing Bank (the Bank) as of September 30, 2012 and 2011 and the statements of operations and changes in net position, and cash flows for the years then ended (hereinafter referred to as "financial statements"), and have issued our report thereon dated November 9, 2012.

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. 07-04, *Audit Requirements for Federal Financial Statements*, as amended. Those standards and OMB Bulletin No. 07-04 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 over financial reporting. In planning and performing our fiscal year 2012 audit, we considered the Bank's internal control over financial reporting by obtaining an understanding of the design effectiveness of the Bank's internal control, determining whether internal controls had been placed in operation, assessing control risk, and performing tests of controls as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Bank's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the Bank's internal control over financial reporting. We did not test all internal controls relevant to operating objectives as broadly defined by the *Federal Managers' Financial Integrity Act of 1982*.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis. A material weakness is a deficiency, or a combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis.

Our consideration of internal control over financial reporting was for the limited purpose described in the third paragraph of this report and was not designed to identify all deficiencies in internal control over financial reporting that might be deficiencies, significant deficiencies, or material weaknesses. In our fiscal year 2012 audit, we did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses, as defined above. However, we identified a certain deficiency in internal control over financial reporting described in Exhibit I, *Improvement Needed over Reporting of Fair Value Borrowings* that we consider to be a significant deficiency in internal control over financial reporting. A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

The Bank's written response to the significant deficiency identified in our audit is presented in Exhibit I.

We noted certain additional matters that we have reported to management of the Bank in a separate letter dated November 9, 2012.

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, 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 9, 2012

Improvement Needed over Reporting of Fair Value Borrowings

The Bank discloses the fair value (FV) of borrowings of $65 billion in note 6 – *Fair Value of Financial Instruments and Interest Rate Volatility* – section b. The fair value for all borrowings, except for borrowings used to fund certain guaranteed loans based on the FCRA, is determined using discounted cash flow analyses based on contractual repayment terms.

The Bank needs to improve the effectiveness of its controls over the preparation, review and approval of the FV disclosures. As a result of our test procedures over the calculation of the FV disclosures for borrowings, we noted 14 instances where the Bank used an incorrect interest rate to perform the FV calculation, resulting in an understatement of the FV of borrowings. As a result of our observations, the Bank performed additional analysis over the FV disclosures for Borrowings and adjusted its fiscal year 2012 footnote disclosure over the FV of borrowings accordingly.

OMB Circular A-123, *Establishing Management Controls* states, “Management is responsible for developing and maintaining effective internal control. Effective internal control provides assurance that significant weaknesses in the design or operation of internal control, that could adversely affect the agency’s ability to meet its objectives, would be prevented or detected in a timely manner.” Additionally, the Government Accountability Office (GAO) Standards for Internal Control in the Federal Government states that “Control activities are an integral part of an entity’s planning, implementing, reviewing, and accountability for stewardship of government resources and achieving effective results. Control activities occur at all levels and functions of the entity. They include a wide range of diverse activities such as approvals, authorizations, verifications, reconciliations, and performance reviews.”

Recommendations

We recommend that FFB management implement the following recommendations to improve controls over the preparation, review and approval of the FV disclosures:

1) As part of the review procedures over note 4 – *Loans Receivable* and note 5 – *Borrowings*, trace the minimum and maximum interest rates from the notes to the population of loans/borrowings used in the calculation of the fair value;
2) Apply certain edit checks (e.g., Transactions with 0% interest rates, duplicate entries, or out years that seem unusual) to the population of borrowings/loans used in the fair value calculations to ensure the population is complete and accurate; and
3) Refine the sampling procedures currently performed to test the accuracy of the loans/borrowings included in the population used for the FV calculation.

Management’s Response

Management concurs with the finding and recommendations.

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Independent Auditors' Report on Compliance and Other Matters

Inspector General, U.S. Department of the Treasury and
the Board of Directors, Federal Financing Bank:

We have audited the statements of financial position of the Federal Financing Bank (the Bank) as of September 30, 2012 and 2011, and the related statements of operations and changes in net position and cash flows for the years then ended (hereinafter referred to as "financial statements"), and have issued our report thereon dated November 9, 2012.

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. 07-04, *Audit Requirements for Federal Financial Statements*, as amended. Those standards and OMB Bulletin No. 07-04 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. 07-04. 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 herein under *Government Auditing Standards* or OMB Bulletin No. 07-04.

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, 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 9, 2012