NATIONAL RURAL UTILITIES COOPERATIVE FINANCE CORP /DC/
Form 10-Q
October 14, 2011

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

FORM 10-Q

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended August 31, 2011

OR

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

Commission File Number 1-7102

NATIONAL RURAL UTILITIES COOPERATIVE FINANCE CORPORATION

(Exact name of registrant as specified in its charter)

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

52-0891669
(I.R.S. Employer Identification Number)

20701 COOPERATIVE WAY, DULLES, VA 20166
(Address of principal executive offices)
(Registrant’s telephone number, including area code, is 703-467-1800)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ¨ No ¨

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

Large accelerated filer ¨ Accelerated filer ¨ Non-accelerated filer x Smaller reporting company ¨

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

The Registrant is a tax-exempt cooperative and consequently is unable to issue any equity capital stock.

PART 1. FINANCIAL INFORMATION

Item 1. Financial Statements.

NATIONAL RURAL UTILITIES COOPERATIVE FINANCE CORPORATION

CONDENSED CONSOLIDATED BALANCE SHEETS
(UNAUDITED)
(in thousands)

A S S E T S

| | August 31, 2011 | May 31, 2011 |
|---|---|---|
| Cash and cash equivalents | $ 567,672 | $ 293,615 |
| Restricted cash | 8,168 | 7,690 |
| Investments in equity securities | 58,662 | 58,601 |
| Loans to members | 18,618,494 | 19,330,797 |
| Less: Allowance for loan losses | (152,100) | (161,177) |
| Loans to members, net | 18,466,394 | 19,169,620 |
| Accrued interest and other receivables | 207,624 | 201,122 |
| Fixed assets, net | 93,322 | 88,794 |
| Debt service reserve funds | 45,172 | 45,662 |
| Debt issuance costs, net | 40,291 | 41,714 |
| Foreclosed assets, net | 276,025 | 280,811 |
| Derivative assets | 365,752 | 343,760 |
| Other assets | 27,312 | 30,233 |
| | $ 20,156,394 | $ 20,561,622 |

See accompanying notes.

NATIONAL RURAL UTILITIES COOPERATIVE FINANCE CORPORATION

CONDENSED CONSOLIDATED BALANCE SHEETS
(UNAUDITED)
(in thousands)

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

| | August 31, 2011 | May 31, 2011 |
|---|---|---|
| Short-term debt | $ 5,527,486 | $ 5,842,924 |
| Accrued interest payable | 287,833 | 194,859 |
| Long-term debt | 11,088,656 | 11,293,249 |
| Patronage capital retirement payable | 46,086 | - |
| Deferred income | 17,426 | 17,719 |
| Other liabilities | 70,911 | 60,477 |
| Derivative liabilities | 611,326 | 477,433 |
| Subordinated deferrable debt | 186,440 | 186,440 |
| Members’ subordinated certificates: | | |
| Membership subordinated certificates | 646,161 | 646,161 |
| Loan and guarantee subordinated certificates | 721,713 | 756,801 |
| Member capital securities | 398,250 | 398,250 |
| Total members’ subordinated certificates | 1,766,124 | 1,801,212 |
| Commitments and contingencies | | |
| CFC equity: | | |
| Retained equity | 535,354 | 665,765 |
| Accumulated other comprehensive income | 9,567 | 9,758 |
| Total CFC equity | 544,921 | 675,523 |
| Noncontrolling interest | 9,185 | 11,786 |
| Total equity | 554,106 | 687,309 |
| | $ 20,156,394 | $ 20,561,622 |

See accompanying notes.

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NATIONAL RURAL UTILITIES COOPERATIVE FINANCE CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(UNAUDITED)
(in thousands)

| | For the three months ended August 31, | |
|---|---|---|
| | 2011 | 2010 |
| Interest income | $ 247,250 | $ 251,053 |
| Interest expense | (202,044) | (219,512) |
| Net interest income | 45,206} | 31,541 |
| Recovery of loan losses | 9,130} | 12,288 |
| Net interest income after recovery of loan losses | 54,336} | 43,829 |
| Non-interest income: | | |
| Fee and other income | 4,723} | 10,292 |
| Derivative losses | (111,571) | (78,254) |
| Results of operations of foreclosed assets | (7,881) | 184 |
| Total non-interest income | (114,729) | (67,778) |
| Non-interest expense: | | |
| Salaries and employee benefits | (10,399) | (13,026) |
| Other general and administrative expenses | (5,990) | (8,287) |
| Recovery of guarantee liability | 60} | 548 |
| Fair value adjustment on foreclosed assets | (1,937) | (315) |
| Loss on early extinguishment of debt | (9,267) | - |
| Other | (397) | (96) |
| Total non-interest expense | (27,930) | (21,176) |
| Loss prior to income taxes | (88,323) | (45,125) |
| Income tax benefit | 1,701} | 2,780 |
| Net loss | (86,622) | (42,345) |
| Less: Net loss attributable to the noncontrolling interest | 2,590} | 5,149 |
| Net loss attributable to CFC | $ (84,032) | $ (37,196) |

See accompanying notes.

NATIONAL RURAL UTILITIES COOPERATIVE FINANCE CORPORATION

CONDENSED CONSOLIDATED STATEMENT OF CHANGES IN EQUITY
(UNAUDITED)
(in thousands)

| | Total | Noncontrolling interest | Total CFC equity | Accumulated other comprehensive income (loss) | CFC retained equity | Unallocated net loss | Members' capital reserve | Patronage capital allocated |
|---|---|---|---|---|---|---|---|---|
| Balance as of May 31, 2011 | $ 687,309} | $ 11,786} | $ 675,523} | $ 9,758} | $665,765} | $ (130,689) | $ 272,126} | $ 521,897} |
| Patronage capital retirement | (46,086) | - | (46,086) | - | (46,086) | - | - | (46,086) |
| Net loss | (86,622) | (2,590) | (84,032) | - | (84,032) | (84,032) | - | - |
| Other comprehensive loss | (198) | (7) | (191) | (191) | - | - | - | - |
| Total comprehensive loss | (86,820) | (2,597) | (84,223) | | | | | |
| Other | (297) | (4) | (293) | - | (293) | - | - | - |
| Balance as of August 31, 2011 | $ 554,106} | $ 9,185} | $ 544,921} | $ 9,567} | $535,354} | $ (214,721) | $ 272,126} | $ 475,811} |

See accompanying notes.

NATIONAL RURAL UTILITIES COOPERATIVE FINANCE CORPORATION

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

| | For the three months ended August 31, 2011 | 2010 |
|---|---|---|
| CASH FLOWS FROM OPERATING ACTIVITIES | | |
| Net loss | $ (86,622) | $ (42,345) |
| Adjustments to reconcile net loss to net cash provided by operating activities | | |
| Amortization of deferred income | (3,204) | (1,914) |
| Amortization of debt issuance costs and deferred charges | 3,139} | 3,154 |
| Depreciation | 725} | 488 |
| Recovery of loan losses | (9,130) | (12,288) |
| Recovery of guarantee liability | (60) | (548) |
| Results of operations of foreclosed assets | 7,881} | (184 ) |
| Fair value adjustment on foreclosed assets | 1,937} | 315 |
| Derivative forward value | 111,739} | 73,792 |
| Changes in operating assets and liabilities: | | |
| Accrued interest and other receivables | (5,218) | (4,558) |
| Accrued interest payable | 92,974} | 97,879 |
| Other | 17,139} | 10,170 |
| Net cash provided by operating activities | 131,300} | 123,961 |
| CASH FLOWS FROM INVESTING ACTIVITIES | | |
| Advances made on loans | (1,685,983) | (2,336,684) |
| Principal collected on loans | 2,386,760} | 2,338,873 |
| Net investment in fixed assets | (5,253) | (2,809) |
| Proceeds from foreclosed assets | 7,004} | 4,000 |
| Investments in foreclosed assets | (12,036) | - |
| Net proceeds from sale of loans | 11,339} | 44,665 |
| Change in restricted cash | (478) | 2,443 |
| Net cash provided by investing activities | 701,353} | 50,488 |

| | | |
|---|---|---|
| CASH FLOWS FROM FINANCING ACTIVITIES | | |
| (Repayments of) proceeds from issuances of short-term debt, net | (257,784) | 423,793 |
| Proceeds from issuance of long-term debt, net | 106,191} | 61,082 |
| Payments for retirement of long-term debt | (369,925) | (708,045 ) |
| Proceeds from issuance of members' subordinated certificates | 15,833} | 4,517 |
| Payments for retirement of members' subordinated certificates | (52,911) | (19,037) |
| Net cash used in financing activities | (558,596) | (237,690) |
| NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS | 274,057} | (63,241 ) |
| BEGINNING CASH AND CASH EQUIVALENTS | 293,615} | 513,906 |
| ENDING CASH AND CASH EQUIVALENTS | $ 567,672} | $ 450,665 |

See accompanying notes.

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NATIONAL RURAL UTILITIES COOPERATIVE FINANCE CORPORATION

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

| | For the three months ended August 31, 2011 | For the three months ended August 31, 2010 |
|---|---|---|
| SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION | | |
| Cash paid for interest | $ 105,931 | $ 118,479 |
| Cash paid for income taxes | - | 104 |
| | | |
| Non-cash financing and investing activities: | | |
| Increase to patronage capital retirement payable | $ 46,086 | $ 50,843 |
| Net decrease in debt service reserve funds/debt service reserve certificates | (490) | - |

See accompanying notes.

NATIONAL RURAL UTILITIES COOPERATIVE FINANCE CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(UNADITED)

(1) General Information and Accounting Policies

(a) Basis of Presentation

The accompanying financial statements include the consolidated accounts of National Rural Utilities Cooperative Finance Corporation ("CFC"), Rural Telephone Finance Cooperative ("RTFC") and National Cooperative Services Corporation ("NCSC") and certain entities created and controlled by CFC to hold foreclosed assets and accommodate loan securitization transactions, after elimination of intercompany accounts and transactions.

Unless stated otherwise, references to "we, "our" or "us" represent the consolidation of CFC, RTFC, NCSC and certain entities controlled by CFC to hold foreclosed assets and to accommodate loan securitization transactions. Foreclosed assets are held by two subsidiaries controlled by CFC. Denton Realty Partners, LP ("DRP") is a 100 percent wholly owned subsidiary and holds assets including a land development loan, limited partnership interests in certain real estate developments and developed lots and land, raw land and underground mineral rights in Texas. Caribbean Asset Holdings ("CAH") is a 100 percent wholly owned subsidiary and holds our investment in cable and telecommunications operating entities in the United States Virgin Islands ("USVI"), British Virgin Islands and St. Maarten.

The preparation of financial statements in conformity with accounting principles generally accepted in the United States ("GAAP") requires management to make estimates and assumptions that affect the assets, liabilities, revenue and expenses reported in the financial statements, as well as amounts included in the notes thereto, including discussion and disclosure of contingent liabilities. The accounting estimates that require our most significant and subjective judgments include the allowance for loan losses and the determination of the fair value of our derivatives and foreclosed assets. While we use our best estimates and judgments based on the known facts at the date of the financial statements, actual results could differ from these estimates as future events occur.

These interim unaudited condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and notes thereto included in our Annual Report on Form 10-K for the fiscal year ended May 31, 2011.

In the opinion of management, the accompanying condensed consolidated financial statements contain all adjustments (which consist only of normal recurring accruals) necessary for a fair presentation of our results of operations and financial position for the interim periods presented.

(b) Variable Interest Entities

We are required to consolidate the financial results of RTFC and NCSC because CFC is the primary beneficiary of variable interests in RTFC and NCSC due to its exposure to absorbing the majority of their expected losses and because CFC manages the lending activities of RTFC and NCSC. Under separate guarantee agreements, RTFC and NCSC pay CFC a fee to indemnify against loan losses. CFC manages the lending activities of RTFC and NCSC through separate management agreements. Additionally, CFC is the sole lender to RTFC and the primary source of funding to NCSC. NCSC funds its lending programs either through loans from CFC or commercial paper and long-term notes issued by NCSC and guaranteed by CFC. Effective September 1, 2011, NCSC no longer issues commercial paper.

RTFC and NCSC creditors have no recourse against CFC in the event of a default by RTFC and NCSC, unless there is a guarantee agreement under which CFC has guaranteed NCSC or RTFC debt obligations to a third party. At August 31, 2011, CFC had guaranteed $459 million of NCSC debt, derivative instruments and guarantees with third parties, and CFC's maximum potential exposure for these instruments totaled $470 million. The maturities for NCSC obligations guaranteed by CFC run through 2031. Guarantees of NCSC debt and derivative instruments are not included in Note 9, Guarantees, as the debt and derivatives are reported on the consolidated balance sheet. At August 31, 2011, CFC guaranteed $0.8 million of RTFC guarantees with third parties. The maturities for RTFC obligations guaranteed by CFC run through 2012. All CFC loans to RTFC and NCSC are secured by all assets and revenue of RTFC and NCSC. At August 31, 2011, RTFC had total assets of $979 million including loans outstanding to members of $823 million, and NCSC had total assets of $614 million including loans outstanding of $541 million. At August 31, 2011, CFC had committed to lend RTFC up to $4,000 million, of which $812 million was outstanding. At August 31, 2011, CFC had committed to provide up to $2,000 million of credit to NCSC, of which $651 million was outstanding, representing $192 million of outstanding loans and $459 million of credit enhancements.

(c) Loan Sales

We account for the sale of loans resulting from direct loan sales to third parties and securitization transactions by removing the financial assets from our consolidated balance sheets when control has been surrendered. We recognize related servicing fees on an accrual basis over the period for which servicing activity is provided. Deferred transaction costs and unamortized deferred loan origination costs related to the loans sold are included in the calculation of the gain or loss on the sale. We do not hold any continuing interest in the loans sold to date. We have no obligation to repurchase loans from the purchaser, except in the case of breaches of representations and warranties. We retain the servicing performance obligations on these loans. We have not recorded a servicing asset or liability.

During the three months ended August 31, 2011 and 2010, we sold distribution loans with outstanding principal balances totaling $11 million and $45 million, respectively, at par for cash. We recorded a loss on sale of loans, representing the unamortized deferred loan origination costs and transaction costs for the loans sold, which was immaterial during the three months ended August 31, 2011 and 2010.

(d) Interest Income

Interest income on loans is recognized using the effective interest method. The following table presents the components of interest income:

| | For the three months ended August 31, | |
|---|---|---|
| (dollar amounts in thousands) | 2011 | 2010 |
| Interest on long-term fixed-rate loans | $ 226,038 | $ 222,969 |
| Interest on long-term variable-rate loans | 8,252 | 12,656 |
| Interest on line of credit loans | 9,626 | 11,977 |
| Interest on investments | 928 | 1,030 |
| Fee income (1) | 2,406 | 2,421 |
| Total interest income | $ 247,250 | $ 251,053 |

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

Deferred income on the consolidated balance sheets primarily includes deferred conversion fees totaling $11 million and $12 million at August 31, 2011 and May 31, 2011, respectively.

(e) Interest Expense

The following table presents the components of interest expense:

| | For the three months ended August 31, | |
|---|---|---|
| (dollar amounts in thousands) | 2011 | 2010 |
| Interest expense on debt (1): | | |
| Commercial paper and bank bid notes | $ 1,769 | $ 1,723 |
| Medium-term notes | 53,841 | 63,104 |
| Collateral trust bonds | 77,272 | 78,549 |
| Subordinated deferrable debt | 2,806 | 4,916 |

| | | | | |
|---|---|---|---|---|
| Subordinated certificates | | 18,301 | | 20,306 |
| Long-term notes payable | | 39,827 | | 45,992 |
| Debt issuance costs (2) | | 5,125 | | 2,577 |
| Fee expense (3) | | 3,103 | | 2,345 |
| Total interest expense | $ | 202,044 | $ | 219,512 |

(1) Represents interest expense and the amortization of discounts on debt.
(2) Includes amortization of all deferred charges related to the issuance of debt, principally underwriters' fees, legal fees, printing costs and comfort letter fees. Amortization is calculated using the effective interest method. Also includes issuance costs related to dealer commercial paper, which are recognized as incurred.
(3) Includes various fees related to funding activities, including fees paid to banks participating in our revolving credit agreements. Fees are recognized as incurred or amortized on a straight-line basis over the life of the respective agreement.

We exclude indirect costs, if any, related to funding activities from interest expense.

(f) Derivative Financial Instruments

We are an end-user of financial derivative instruments. We use derivatives such as interest rate swaps and treasury locks for forecasted transactions to mitigate interest rate risk. Consistent with the accounting standards for derivative financial instruments, we record derivative instruments on the consolidated balance sheets as either an asset or liability measured at fair value. In recording the fair value of derivative assets and liabilities, we do not net our positions under contracts with individual counterparties. Changes in the fair value of derivative instruments along with realized gains and losses from cash settlements are recognized in the derivative gains (losses) line item of the consolidated statement of operations unless specific hedge accounting criteria are met.

We formally document, designate and assess the effectiveness of transactions that receive hedge accounting treatment. If applicable hedge accounting criteria are satisfied, the change in fair value of derivative instruments is recorded to other comprehensive income, and net cash settlements are recorded in interest expense. The gain or loss on derivatives used as a cash flow hedge of a forecasted debt transaction is recorded as a component of other comprehensive income and amortized as interest expense using the effective interest method over the term of the hedged debt. Any ineffectiveness in the hedging relationship is recognized as cash settlements in the period for which ineffectiveness has been determined in the derivative gains (losses) line item.

A transition adjustment of $62 million was recorded as an other comprehensive loss on June 1, 2001, the date we implemented the accounting standards for derivative financial instruments. This amount will be amortized into earnings through April 2029 in the derivative gains (losses) line of the statement of operations.

Cash activity associated with interest rate swaps is classified as an operating activity in the consolidated statements of cash flows.

(g) Loss on early extinguishment of debt

We redeem outstanding debt early from time to time to manage liquidity and interest rate risk. When we redeem outstanding debt early, we recognize a gain or loss related to the difference between the amount paid to redeem the debt and the net book value of the extinguished debt as a component of non-interest expense in the gain (loss) on early extinguishment of debt line item.

On August 19, 2011, we redeemed $250 million of our $1,500 million, 7.25 percent Series C medium-term notes with an original maturity of March 1, 2012 at a premium. Both the premium and unamortized issuance costs totaling $9 million were recorded as a loss on extinguishment of debt during the quarter ended August 31, 2011.

(2) Loans and Commitments

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

| | August 31, 2011 | | May 31, 2011 | |
|---|---|---|---|---|
| (dollar amounts in thousands) | Loans outstanding | Unadvanced commitments (1) | Loans outstanding | Unadvanced commitments (1) |
| Total by loan type (2): | | | | |
| Long-term fixed-rate loans (1) | $ 16,272,689 | $ - | $ 16,404,940 | $ - |
| Long-term variable-rate loans (1) | 997,381 | 5,524,092 | 1,278,391 | 5,461,484 |
| Loans guaranteed by RUS (3) | 225,581 | - | 226,695 | - |
| Line of credit loans | 1,116,176 | 8,772,994 | 1,414,650 | 8,609,191 |
| Total loans outstanding | 18,611,827 | 14,297,086 | 19,324,676 | 14,070,675 |
| Deferred origination costs | 6,667 | - | 6,121 | - |
| Less: Allowance for loan losses | (152,100) | - | (161,177) | - |
| Net loans outstanding | $ 18,466,394 | $ 14,297,086 | $ 19,169,620 | |