KPMG

FEDERAL FINANCING BANK

Financial Statements

September 30, 2002 and 2001

(With Independent Auditors' Report Thereon)

KPMG

2001 M Street, NW
Washington, DC 20036

Independent Auditors' Report on the 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, 2002 and 2001, 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. 01-02, ***Audit Requirements for Federal Financial Statements.*** Those standards and OMB Bulletin No. 01-02 require that we plan and perform the audit to obtain reasonable assurance that the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes 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, 2002 and 2001, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with ***Government Auditing Standards,*** we have also issued reports dated October 23, 2002 on our consideration of the Bank's internal control over financial reporting and its compliance with certain provisions of laws and regulations. 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 audit.

KPMG LLP

October 23,2002

FEDERAL FINANCING BANK

Statements of Financial Position

September 30,2002 and 2001
(dollars in thousands)

Assets		2002	2001
Funds with U.S. Treasury	$	338,052	338,123
Loans receivable (note 2)		39,707,630	42,946,234
Allowance for loan losses (note 3)		(477,584)	(337,335)
Advances to others		29	162
Accrued interest receivable		528.673	872.894
Total assets	$	40,096,800	43,820,078
Liabilities and Accumulated Deficit			
Liabilities:			
Borrowings (note 4)	$	39,792,074	42,979,400
Accrued interest payable		857,646	1,198,013
Total liabilities		40,649,720	44,177,413
Accumulated deficit		(552,920)	(357,335)
Total liabilities and accumulated deficit	$	40,096,800	43,820,078

See accompanying notes to the financial statements.

FEDERAL FINANCING BANK

Statements of Operations and Changes in Net Position

Years ended September 30,2002 and 2001
(dollars in thousands)

		2002	2001
Revenue and financing sources:			
Interest on loans	$	3,059,603	3,181,488
Revenue from servicing loans		4,941	4,210
Total revenue		3,064,544	3,185,698
Expenses:			
Interest on borrowings		3,018,415	3,135,999
Bad debt expenses (note 3)		238,714	164,887
Administrative expenses		3,000	2,410
Total expenses		3,260,129	3,303,296
Net loss		(195,585)	(117,598)
Accumulated deficit:			
Beginning of year		(357,335)	(239,737)
End of year	$	(552,920)	(357,335)

See accompanying notes to the financial statements.

FEDERAL FINANCING BANK

Statements of Cash Flows

Years ended September 30,2002 and 2001
(dollars in thousands)

		2002	2001
Cash flows from operations:			
Net loss	$	(195,585)	(117,598)
Adjustments to reconcile net loss to net cash used in operations:			
Increase in allowance for losses		140,249	82,522
Gain on disposal of loans		(439)	—
Gain on retirement of borrowings		180	—
Amortization of discount on loans		505	—
Decrease in accrued interest receivable		344,221	150,447
Decrease in accrued interest payable		(340,367)	(153,202)
(Increase) decrease in advances to others		133	(114)
Increase in other assets and liabilities, net		—	678
Net cash used in operations		(51,103)	(37,267)
Cash flows from investing activities:			
Loan disbursements		(94,682,846)	(180,254,267)
Loan collections		97,903,077	180,266,562
Net cash provided by investing activities		3,220,231	12,295
Cash flows from financing activities:			
Borrowings		94,822,224	180,305,984
Repayments of borrowings		(97,991,423)	(180,280,109)
Net cash (used in) provided by financing activities		(3,169,199)	25.875
Net (decrease) increase in cash		(71)	903
Funds held with Treasury – beginning of year		338,123	337,220
Funds held with Treasury – end of year	$	338,052	338,123
Supplemental disclosures of cash flow information:			
Interest Paid (net of amount capitalized)		2,678,489	2,982,767
Supplemental schedule of non-cash investing and financing activities:			
Decrease in loans for capitalized interest receivable		18,995	20,122
Decrease in borrowings for capitalized interest payable		(18,307)	(19,373)

See accompanying notes to the 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, 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 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 of the Treasury, 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 of the Treasury 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 generally accepted accounting principles, 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 generally accepted accounting principles. FASAB has indicated, however, that financial statements prepared based upon standards promulgated by the FASB may also be regarded as in accordance with generally accepted accounting principles 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 on the accrual basis of accounting in accordance with accounting and financial reporting standards promulgated by the FASB.

(b) Funds held with 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 held with Treasury are considered cash.

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(c) *Interest on Loans Receivable*

The Bank's general policy is to charge borrowers a fee of one-eighth of 1 percent over its cost of borrowing from Treasury. The income resulting from the fee covers the administrative expenses of the Bank, and any surplus is transferred to the Treasury's General Fund. Under amendments to the Federal Credit Reform Act, effective October 1, 1998, while the Bank is permitted to charge the one-eighth of 1 percent margin on new lending arrangements with government guaranteed borrowers, the margin is not retained by the Bank but rather is maintained 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 Federal Credit Reform Act, as amended, states that the Bank may require reimbursements from loan guarantors.

(d) *Capitalized Interest*

In accordance with loan agreements, the General Services Administration (GSA) and Historically Black Colleges and Universities (HBCU) have the option of deferring payments of interest on their loans until future periods. When GSA or HBCU elect, in advance, to defer interest payments, the accrued interest is recorded as capitalized interest receivable and added to their respective loan balance. The Bank correspondingly capitalizes the interest payable on its related borrowings. Capitalized interest receivable was approximately $103,289 and $122,284, and the related capitalized interest payable was $99,386 and $117,693 for the years ended September 30, 2002 and 2001, respectively.

(e) *Loan Servicing Fee*

The Bank charges certain Rural Utilities Services (RUS) borrowers a loan service fee. The Bank also charges the Civil Service Retirement and Disability Fund (CSRDF) a fee to service the loans receivable of the United States Postal Service (USPS) acquired by the Bank during an exchange of Treasury securities. The Bank's loan servicing fee is equal to one-eighth of one percent more than the contractual interest rate with Treasury.

(f) *Allowance for Loan Losses*

Loan principal and interest are generally guaranteed by Federal agencies and are backed by the full faith and credit of the U.S. Government. Direct loans to USPS are an exception since the U.S. Government does not guarantee them. The Bank has not incurred, and does not expect to incur, any credit-related losses on its loans.

However, the Bank incurs losses related to the provisions of certain legislation for Rural Utilities Service (RUS) and has recorded an allowance for loan losses related to this legislation. The Bank calculates its allowance for loan losses based on the total amount of future interest credit that it expects to provide to RUS, discounted at the effective interest rate on the underlying loans. The allowance for loan losses is based on estimates, and ultimate losses may vary from current estimates. Adjustments to the allowance for loan losses are reported in the period that they are determined to be necessary.

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(g) ***Accumulated Deficit***

The Bank can borrow from Treasury to meet its immediate cash needs and can also seek appropriations from Congress to make up for shortfalls that won't be met by profits.

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

The preparation of financial statements in conformity with generally accepted accounting principles 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.

(i) ***Related Parties***

The Bank is subject to the general supervision and direction of the Secretary of the Treasury. As provided by law, the Secretary of the Treasury 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 facilities and services that it provides. The amount of such reimbursements for the years ended September 30, 2002 and 2001 was $3,000 and $2,410, respectively, and is included as administrative expenses in the accompanying financial statements.

(j) ***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).

(k) ***Reclassification***

Certain fiscal year 2001 amounts have been reclassified to conform to current year presentation.

(2) Loans Receivable

Loans receivable include agency loans purchased, direct loans to Federal agencies, and loans to nonfederal entities. Agency loans purchased are either notes or pools of loans sold by Federal agencies in the form of certificates representing shares of ownership in the loan pool. The selling agencies guarantee the principal and interest repayments on the notes or certificates. Direct loans to agencies are debt securities issued to the Bank by agencies that Congress has authorized so that these Federal agencies can finance their activities. Loans to nonfederal entities are loans made to nonfederal borrowers whose obligation to repay the principal and interest are guaranteed by a Federal agency. At September 30,2002, the Bank had loans receivable of $39,707,630 with interest rates ranging from 1.558% to 16.183%, and maturing dates ranging from October 1, 2002 to December 31, 2036. At September 30, 2001, the Bank had loans receivable of $42,946,234 with interest rates ranging from 2.416% to 16.183%, and maturing dates ranging from October 1,2001 to December 31,2035.

FEDERAL FINANCING BANK

Notes to the Financial Statements

September 30,2002 and 2001
(dollars in thousands)

Loans receivable at September 30, 2002 and 2001 consist of the following:

Agency		2002	2001
Agency loans purchased:			
Rural Utilities Service (CBO), Department of Agriculture	$	4,270,207	4,270,207
Farmers Home Administration, Department of Agriculture		3,855,000	6,810,000
Total agency loans purchased		8,125,207	11,080,207
Direct loans to agencies:			
U.S. Postal Service		11,114,000	11,313,000
Total direct loans to agencies		11,114,000	11,313,000
Guaranteed loans to federal and nonfederal entities:			
Rural Utilities Service, Department of Agriculture		14,058,225	13,599,239
General Services Administration		2,308,197	2,389,872
Foreign Military Sales, Department of Defense		1,922,515	2,156,658
Low Rent Public Housing, Department of Housing and Urban Development		1,207,315	1,278,695
Ship Leasing, Department of Defense, Navy		780,770	941,137
Small Business Administration		102,419	131,964
Historically Black Colleges and Universities, Department of Education		69,298	31,749
Virgin Islands, Department of the Interior		11,426	13,114
Community Development Block Grants, Department of Housing and Urban Development		5,019	7,822
Federal Railroad Administration, Department of Transportation		3,239	3,400
Total guaranteed loans to federal and non federal entities		20,468,423	20,553,650
Total loans receivable		39,707,630	42,946,857
Allowance for loan losses (see note 3)		(477,584)	(337,335)
Discount		—	(623)
Loans receivable, net	$	39,230,046	42,608,899

(Continued)

(dollars in thousands)

(3) Allowance for Loan Losses

Under Title III of the Rural Electrification Act of 1936, the Bank receives interest on certain loans to RUS which is less than the contractual interest due as stated in the loan agreements with RUS. This interest credit is calculated based on the balance in the RUS Liquidating Fund. The Bank has no control over the balance in the RUS Liquidating Fund and must absorb the cost of the interest credit (i.e., foregone interest) since it has no recourse against RUS. The Bank, however, remains obligated to pay the contractual interest on its borrowing from Treasury.

Statement of Financial Accounting Standards No. 114, *Accounting by Creditors for Impairment of a Loan,* requires that impaired loans be measured based on the present value of expected future cash flows discounted at the loan's effective interest rate or based on the fair market value of the loan or underlying collateral. Statement of Financial Accounting Standards No. 114 considers a loan to be impaired when, based on current information and events, it is probable that a creditor will be unable to collect all amounts due according to the contractual terms of the original agreement.

Management of the Bank has determined that certain RUS loans are impaired as defined by SFAS No. 114 since the Bank will not receive all interest due in accordance with the original terms of the loan agreements. Accordingly, the Bank has recorded an allowance for loan losses expected to be incurred.

Allowance for loan loss activity for the years ended September 30,2002 and 2001 is as follows:

		2002	2001
Allowance for loan losses, beginning of year	$	337,335	254,813
Provision for loan losses		238,714	164,887
Charge-offs		(98,465)	(82,365)
Allowance for loan losses, end of year	$	477,584	337,335

(4) Borrowings

The Bank finances its loan portfolio primarily by borrowing from the Treasury. Under the Act, the Bank may, with the approval of the Secretary of the Treasury, borrow without limit from the Treasury. At September 30, 2002, the Bank had Treasury borrowings of $24,792,074, with interest ranging from 1.558% to 16.050%, and maturing dates from October 1, 2002 to December 31, 2036. At September 30, 2001, the Bank had Treasury borrowings of $27,979,400, with interest rates ranging from 2.291% to 16.050%, and maturing dates from October 1,2001 to December 31,2035.

Additionally, at September 30, 2002 and 2001, the Bank had borrowings of $14,999,990 from the Civil Service Retirement and Disability Fund, which is administered by the Office of Personnel Management (OPM). The interest rate on the debt to OPM is based on a statutory formula resulting in interest rates ranging from 8.75% to 9.25% rather than the Bank's lending rate, and has maturing dates ranging from June 30,2003 to June 30,2005. Consequently, borrowings from OPM are not matched with specific loans in the Bank portfolio. However, an agreement executed at the time of the borrowings from OPM specified that the Bank's aggregate interest cost would remain the same as it would have been in the absence of such borrowings.

(Continued)

(dollars in thousands)

Borrowings from the public amounted to $10 at September 30,2002 and 2001.

The scheduled principal repayments below reflect maturities of the Bank's borrowings and do not necessarily match maturities of assets in the Bank's loan portfolio.

Scheduled principal repayments of borrowings as of September 30,2002 are as follows:

2003	$	4,700,617
2004		1,546,709
2005		1,487,943
2006		3,168,375
2007		1,567,413
2008 and thereafter		27,321,017
Total	$	39,792,074

(5) 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 Borrowing

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, 2002 and 2001 was $48,273,570 and $50,354,090, respectively. The fair value of borrowings at September 30, 2002 and 2001 was $48,013,480 and $50,094,550, respectively.

(c) Advances to Others, Accrued Interest Receivable, Accrued Interest Payable, 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.

(6) Commitments and Contingencies

Nearly all of the Bank's loans are to Federal agencies or to private sector borrowers whose loans are guaranteed by a Federal agency. When an agency has to honor its guarantee because a borrower defaults, that agency must obtain an appropriation or use other resources to pay the Bank. However, if an appropriation is not granted or Federal agencies are not allowed to fund the losses by borrowing from the Treasury, and the Bank is legislatively required to absorb the debt the agency owes it, then the Bank would incurred a loss. The Bank has incurred such a loss related to forgone interest as described in note 3 and has established an allowance for loss related to foregone interest expected to be incurred in the future.

(7) Pensions and Accrued Annual Leave

Either the Civil Service Retirement System (CSRS) or the Federal Employees Retirement System (FERS) covers virtually all of the employees whose salary cost is charged to the Bank by Treasury through a reimbursable agreement.

Treasury funds a portion of pension benefits under the Civil Service and Federal Employees Retirement Systems relating to its employees and makes the necessary payroll withholding from them, however, it has no liability for future payments to employees under these programs and does not account for the assets of the Civil Service and Federal Employees Retirement Systems, nor does it have actuarial data with respect to accumulated plan benefits or the unfunded pension liability relative to its employees. These amounts are reported by OPM for the Retirement Systems and are not allocated to the individual employers. Similar to the accounting treatment afforded to the retirement programs, the actuarial data related to the health and life insurance programs is maintained by OPM and is not available on an individual employer basis.

(8) Subsequent Event

On October 18, 2002 the Bank borrowed $15,065,949 from the Treasury with interest rates ranging from 1.669% to 5.141% and maturing dates ranging from January 2, 2003 through December 31, 2026, to exercise its call option for $14,999,990 of debt and a portion of the interest payable amounting to $65,959 to the Civil Service Retirement and Disability Fund, administered by the Office of Personal Management (discussed in note 4) with interest rates ranging from 8.75% to 9.25% and maturing dates ranging from June 30,2003 to June 30, 2005. The call option was exercised at par and without penalty.

2001 M Street, NW
Washington, DC 20036

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 statement of financial position of the Federal Financing Bank (the Bank) as of September 30,2002, and the related statement of operations and changes in net position, and cash flows for the year then ended, and have issued our report thereon dated October 23,2002. We conducted our audit 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. 01-02,***Audit Requirements for Federal Financial Statements.***

In planning and performing our fiscal year 2002 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 OMB Bulletin No. 01-02, as applicable to the Bank, and ***Government Auditing Standards.*** 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 audits was not to provide assurance on the Bank's internal control over financial reporting. Consequently, we do not provide an opinion thereon.

Our consideration of 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 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, 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 any internal control, misstatements due to error or fraud may occur and not be detected. However, we noted no matters involving the internal control and its operations that we considered to be material weaknesses as defined above.

We noted other matters involving internal control and its operation that we have reported to the management of the Bank in a separate letter dated October 23,2002.

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, and Congress, and is not intended to be and should not be used by anyone other than these specified parties.

KPMG LLP

October 23,2002

2001 M **Street,** NW
Washington, DC 20036

Independent Auditors' Report on Compliance with Laws and Regulations

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

We have audited the statement of financial position of the Federal Financing Bank (the Bank) as of September 30, 2002 and the related statements of operations and changes in net position, and cash flows for the year then ended, and have issued our report thereon dated October 23, 2002. We conducted our audit 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. 01-02, ***Audit Requirements for Federal Financial Statements.***

The management of the Bank is responsible for complying with laws and regulations 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 and regulations, 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. 01-02. We limited our tests of compliance to the provisions described in the preceding sentence, and did not test compliance with all laws and regulations applicable to the Bank. However, providing an opinion on compliance with laws and regulations was not an objective of our audit, and, accordingly, we do not express such an opinion.

The results of our tests of compliance with certain provisions of laws and regulations described in the preceding paragraph of this report, disclosed no instances of noncompliance that are required to be reported herein under ***Government Auditing Standards*** or OMB Bulletin No. 01-02.

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

KPMG LLP

October 23,2002