

NATIONAL RURAL UTILITIES COOPERATIVE FINANCE CORP /DC/  
Form 10-K  
August 25, 2016

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

FORM 10-K

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934  
For the fiscal year ended May 31, 2016

OR  
 TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF  
1934

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number: 1-7102

NATIONAL RURAL UTILITIES COOPERATIVE FINANCE CORPORATION  
(Exact name of registrant as specified in its charter)

District of Columbia 52-0891669  
(State or other jurisdiction of incorporation or organization) (I.R.S. employer identification no.)  
20701 Cooperative Way, Dulles, Virginia, 20166  
(Address of principal executive offices) (Zip Code)  
Registrant's telephone number, including area code: (703) 467-1800

Securities registered pursuant to Section 12(b) of the Act:

Title of Each Class	Name of Each Exchange on Which Registered
6.55% Collateral Trust Bonds, due 2018	New York Stock Exchange
7.35% Collateral Trust Bonds, due 2026	New York Stock Exchange

Securities Registered Pursuant to Section 12(g) of the Act: None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes  No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Act. Yes  No

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  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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§229.405 of this chapter) is not contained herein, and will not be contained, to the best of the registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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  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

The Registrant does not issue capital stock because it is a tax-exempt cooperative.

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## TABLE OF CONTENTS

	Page
<b><u>PART I</u></b>	
<b><u>Item 1.</u></b> <u>Business</u>	<u>1</u>
<u>Overview</u>	<u>1</u>
<u>Our Business</u>	<u>2</u>
<u>Loan Programs</u>	<u>3</u>
<u>Guarantee Programs</u>	<u>6</u>
<u>Investment Policy</u>	<u>7</u>
<u>Industry</u>	<u>7</u>
<u>Lending Competition</u>	<u>9</u>
<u>Regulation</u>	<u>10</u>
<u>Members</u>	<u>11</u>
<u>Tax Status</u>	<u>13</u>
<u>Allocation and Retirement of Patronage Capital</u>	<u>13</u>
<u>Employees</u>	<u>15</u>
<b><u>Item 1A.</u></b> <u>Risk Factors</u>	<u>15</u>
<b><u>Item 1B.</u></b> <u>Unresolved Staff Comments</u>	<u>19</u>
<b><u>Item 2.</u></b> <u>Properties</u>	<u>19</u>
<b><u>Item 3.</u></b> <u>Legal Proceedings</u>	<u>20</u>
<b><u>Item 4.</u></b> <u>Mine Safety Disclosures</u>	<u>20</u>
<b><u>PART II</u></b>	
<b><u>Item 5.</u></b> <u>Market for Registrant’s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities</u>	<u>20</u>
<b><u>Item 6.</u></b> <u>Selected Financial Data</u>	<u>21</u>
<b><u>Item 7.</u></b> <u>Management’s Discussion and Analysis of Financial Condition and Results of Operations (“MD&amp;A”)</u>	<u>23</u>
<u>Introduction</u>	<u>23</u>
<u>Executive Summary</u>	<u>23</u>
<u>Critical Accounting Policies and Estimates</u>	<u>26</u>
<u>Accounting Changes and Developments</u>	<u>29</u>
<u>Consolidated Results of Operations</u>	<u>29</u>
<u>Consolidated Balance Sheet Analysis</u>	<u>37</u>
<u>Off-Balance Sheet Arrangements</u>	<u>46</u>
<u>Risk Management</u>	<u>49</u>
<u>Credit Risk</u>	<u>50</u>
<u>Liquidity Risk</u>	<u>57</u>
<u>Market Risk</u>	<u>66</u>
<u>Operational Risk</u>	<u>69</u>
<u>Non-GAAP Financial Measures</u>	<u>70</u>
<b><u>Item 7A.</u></b> <u>Quantitative and Qualitative Disclosures about Market Risk</u>	<u>75</u>
<b><u>Item 8.</u></b> <u>Financial Statements and Supplementary Data</u>	<u>75</u>
<u>Reports of Independent Registered Public Accounting Firm</u>	<u>76</u>
<u>Consolidated Statements of Operations</u>	<u>77</u>
<u>Consolidated Statements of Comprehensive Income</u>	<u>78</u>
<u>Consolidated Balance Sheets</u>	<u>79</u>

<u>Consolidated Statements of Changes in Equity</u>	<u>80</u>
<u>Consolidated Statements of Cash Flows</u>	<u>81</u>
<u>Notes to Consolidated Financial Statements</u>	<u>83</u>
<u>Note 1 — Summary of Significant Accounting Policies</u>	<u>83</u>
<u>Note 2 — Variable Interest Entities</u>	<u>93</u>
<u>Note 3 — Investment Securities</u>	<u>94</u>
<u>Note 4 — Loans and Commitments</u>	<u>95</u>
<u>Note 5 — Foreclosed Assets</u>	<u>105</u>
<u>Note 6 — Short-Term Borrowings</u>	<u>106</u>
<u>Note 7 — Long-Term Debt</u>	<u>107</u>
<u>Note 8 — Subordinated Deferrable Debt</u>	<u>110</u>
<u>Note 9 — Members’ Subordinated Certificates</u>	<u>111</u>
<u>Note 10 — Derivative Instruments and Hedging Activities</u>	<u>113</u>
<u>Note 11 — Equity</u>	<u>116</u>
<u>Note 12 — Employee Benefits</u>	<u>118</u>
<u>Note 13 — Guarantees</u>	<u>119</u>
<u>Note 14 — Fair Value Measurement</u>	<u>122</u>
<u>Note 15 — Business Segments</u>	<u>127</u>
<u>Supplementary Data</u>	<u>131</u>
<u>Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure</u>	<u>132</u>
<u>Item 9A. Controls and Procedures</u>	<u>132</u>
<u>Item 9B. Other Information</u>	<u>133</u>
<u>PART III</u>	
<u>Item 10. Directors, Executive Officers and Corporate Governance</u>	<u>134</u>
<u>Item 11. Executive Compensation</u>	<u>144</u>
<u>Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters</u>	<u>155</u>
<u>Item 13. Certain Relationships and Related Transactions, and Director Independence</u>	<u>155</u>
<u>Item 14. Principal Accounting Fees and Services</u>	<u>158</u>
<u>PART IV</u>	
<u>Item 15. Exhibits, Financial Statement Schedules</u>	<u>160</u>
<u>SIGNATURES</u>	<u>161</u>
<u>EXHIBIT INDEX</u>	<u>164</u>

## INDEX OF MD&amp;A TABLES

Table	Description	Page
—	MD&A Tables:	
1	Average Balances, Interest Income/Interest Expense and Average Yield/Cost	30
2	Rate/Volume Analysis of Changes in Interest Income/Interest Expense	32
3	Derivative Average Notional Balances and Average Interest Rates	34
4	Derivative Gains (Losses)	35
5	Loans Outstanding by Type and Member Class	38
6	Long-Term Loan Scheduled Repayments	38
7	Historical Retention Rate and Repricing Selection	39
8	Debt Product Types	40
9	Total Debt Outstanding and Weighted-Average Interest Rates	41
10	Member Investments	42
11	Unencumbered Loans	43
12	Collateral Pledged or on Deposit	44
13	Equity	45
14	Guarantees Outstanding	46
15	Maturities of Guarantee Obligations	47
16	Unadvanced Loan Commitments	47
17	Notional Maturities of Unadvanced Loan Commitments	48
18	Maturities of Notional Amount of Unconditional Committed Lines of Credit	49
19	Loan Portfolio Security Profile	50
20	Loan Concentration	52
21	Credit Exposure to 20 Largest Borrowers	53
22	TDR Loans	54
23	Nonperforming Loans	55
24	Allowance for Loan Losses	55
25	Rating Triggers for Derivatives	57
26	Short-Term Borrowings	58
27	Liquidity Reserve	59
28	Bank Revolving Credit Agreements	60
29	Issuances and Maturities of Long-Term and Subordinated Debt	62
30	Credit Ratings	62
31	Projected Sources and Uses of Liquidity	63
32	Contractual Obligations	64
33	Financial Covenant Ratios Under Bank Revolving Line of Credit Agreements	65
34	Financial Ratios Under Debt Indentures	65
35	Interest Rate Gap Analysis	67
36	Financial Instruments	68
37	Loan Repricing	69
38	Adjusted Financial Measures — Income Statement	71
39	TIER and Adjusted TIER	71
40	Adjusted Financial Measures — Balance Sheet	73
41	Leverage and Debt-to-Equity Ratios	73

## FORWARD-LOOKING STATEMENTS

This Annual Report on Form 10-K contains certain statements that are considered “forward-looking statements” within the Securities Act of 1933, as amended, and the Exchange Act of 1934, as amended. Forward-looking statements, which are based on certain assumptions and describe our future plans, strategies and expectations, are generally identified by our use of words such as “intend,” “plan,” “may,” “should,” “will,” “project,” “estimate,” “anticipate,” “believe,” “continue,” “potential,” “opportunity” and similar expressions, whether in the negative or affirmative. All statements about future expectations or projections, including statements about loan volume, the appropriateness of the allowance for loan losses, operating income and expenses, leverage and debt-to-equity ratios, borrower financial performance, impaired loans, and sources and uses of liquidity, are forward-looking statements. Although we believe that the expectations reflected in our forward-looking statements are based on reasonable assumptions, actual results and performance may differ materially from our forward-looking statements due to several factors. Factors that could cause future results to vary from our forward-looking statements include, but are not limited to, general economic conditions, legislative changes including those that could affect our tax status, governmental monetary and fiscal policies, demand for our loan products, lending competition, changes in the quality or composition of our loan portfolio, changes in our ability to access external financing, changes in the credit ratings on our debt, valuation of collateral supporting impaired loans, charges associated with our operation or disposition of foreclosed assets, regulatory and economic conditions in the rural electric industry, nonperformance of counterparties to our derivative agreements, the costs and effects of legal or governmental proceedings involving us or our members and the factors listed and described under “Item 1A. Risk Factors” of this Report. Except as required by law, we undertake no obligation to update or publicly release any revisions to forward-looking statements to reflect events, circumstances or changes in expectations after the date on which the statement is made.

## PART I

### Item 1. Business

#### OVERVIEW

National Rural Utilities Cooperative Finance Corporation (“CFC”) is a member-owned cooperative association incorporated under the laws of the District of Columbia in April 1969. CFC’s principal purpose is to provide its members with financing to supplement the loan programs of the Rural Utilities Service (“RUS”) of the United States Department of Agriculture (“USDA”). CFC makes loans to its rural electric members so they can acquire, construct and operate electric distribution, generation, transmission and related facilities. CFC also provides its members with credit enhancements in the form of letters of credit and guarantees of debt obligations. As a cooperative, CFC is owned by and exclusively serves its membership, which consists of not-for-profit entities or subsidiaries or affiliates of not-for-profit entities. CFC is exempt from federal income taxes under Section 501(c)(4) of the Internal Revenue Code. As a member-owned cooperative, CFC’s objective is not to maximize profit, but rather to offer its members cost-based financial products and services consistent with sound financial management. As described below under “Allocation and Retirement of Patronage Capital,” CFC annually allocates its net earnings, which consist of net income excluding the effect of certain noncash accounting entries, to (i) a cooperative educational fund; (ii) a general reserve, if necessary; (iii) members based on each member’s patronage of CFC’s loan programs during the year; and (iv) a members’ capital reserve. CFC funds its activities primarily through a combination of public and private issuances of debt securities, member investments and retained equity. As a tax-exempt, member-owned cooperative, we cannot issue equity securities.

Our financial statements include the consolidated accounts of CFC, Rural Telephone Finance Cooperative (“RTFC”), National Cooperative Services Corporation (“NCSC”) and subsidiaries created and controlled by CFC to hold foreclosed assets resulting from defaulted loans or bankruptcy. Unless stated otherwise, references to “we,” “our” or “us” relate to CFC and its consolidated entities. All references to members within this document include members, associates and

affiliates of CFC and its consolidated entities.

RTFC is a taxable Subchapter T cooperative association originally incorporated in South Dakota in 1987 and reincorporated as a member-owned cooperative association in the District of Columbia in 2005. RTFC's principal purpose is to provide financing for its rural telecommunications members and their affiliates. RTFC's membership consists of a combination of not-for-profit and for-profit entities. CFC is the sole lender to and manages the business operations of RTFC through a management agreement in effect until December 1, 2016, which is automatically renewed for one-year terms thereafter

unless terminated by either party. Under a guarantee agreement, RTFC pays CFC a fee and, in exchange, CFC reimburses RTFC for loan losses. As permitted under Subchapter T of the Internal Revenue Code, RTFC pays income tax based on its taxable income, excluding patronage-sourced earnings allocated to its patrons. RTFC is headquartered with CFC in Dulles, Virginia.

NCSC is a taxable cooperative incorporated in 1981 in the District of Columbia as a member-owned cooperative association. The principal purpose of NCSC is to provide financing to its members, entities eligible to be members of CFC and the for-profit and nonprofit entities that are owned, operated or controlled by, or provide significant benefit to Class A, B and C members of CFC. See “Members” below for a description of our member classes. NCSC’s membership consists of distribution systems, power supply systems and statewide and regional associations that were members of CFC as of May 31, 2016. CFC, which is the primary source of funding for NCSC, manages NCSC’s business operations under a management agreement that is automatically renewable on an annual basis unless terminated by either party. NCSC pays CFC a fee and, in exchange, CFC reimburses NCSC for loan losses under a guarantee agreement. As a taxable cooperative, NCSC pays income tax based on its reported taxable income and deductions. NCSC is headquartered with CFC in Dulles, Virginia.

CFC held foreclosed assets through one entity, Caribbean Asset Holdings, LLC (“CAH”), as of May 31, 2016. CAH was established as a holding company for various U.S. Virgin Islands, British Virgin Islands and St. Maarten-based telecommunications operating entities that were transferred in fiscal year 2011 to CAH as a result of a loan default by an RTFC borrower and subsequent bankruptcy proceedings. These operating entities provide local, long-distance and wireless telephone, cable television and Internet services to residential and commercial customers. On September 30, 2015, CFC entered into a Purchase Agreement (as amended, the “Purchase Agreement”) with CAH, ATN VI Holdings, LLC (“Buyer”) and ATN International, Inc. (formerly Atlantic Tele-Network, Inc.), the parent corporation of Buyer, to sell all of the issued and outstanding membership interests of CAH to Buyer for a purchase price of \$145 million, subject to certain adjustments described in the Purchase Agreement.

On July 1, 2016, the Purchase Agreement was amended and the sale of CAH was completed for a purchase price of approximately \$144 million. Our net proceeds at closing totaled \$109 million, which represents the purchase price of \$144 million less agreed-upon purchase price adjustments and transaction costs as of the closing date. The net proceeds are subject to post-closing adjustments, which are due from Buyer within 60 days of the closing date for review by us. CFC also remains subject to potential indemnification claims, as specified in the Purchase Agreement. Upon closing, \$16 million of the sale proceeds were deposited into escrow to fund potential indemnification claims for a period of 15 months following the closing. In connection with the sale, RTFC provided a loan in the amount of \$60 million to Buyer to finance a portion of the transaction. ATN International has provided a guarantee on an unsecured basis of Buyer’s obligations to RTFC pursuant to the financing. See “Note 5—Foreclosed Assets” for additional information on the sale of CAH. See “Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations (“MD&A”)—Executive Summary,” “MD&A—Consolidated Results of Operations—Non-Interest Income” and “Note 5—Foreclosed Assets” for additional information on the sale of CAH, including the impact on our financial statements.

Our principal operations are currently organized for management reporting purposes into three business segments: CFC, RTFC and NCSC. We provide information on the financial performance of our business segments in “Note 15—Business Segments.”

Our annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and any amendments to those reports, are available for free at [www.nrucf.coop](http://www.nrucf.coop) as soon as reasonably practicable after they are electronically filed with or furnished to the U.S. Securities and Exchange Commission (“SEC”). These reports also are available for free on the SEC’s website at [www.sec.gov](http://www.sec.gov). Information posted on our website is not incorporated by reference into this Form 10-K.



## OUR BUSINESS

Our business strategy and policies are set by our board of directors and may be amended or revised from time to time by the board of directors. We are a not-for-profit tax-exempt cooperative finance organization, whose primary focus is to provide our members with the credit products they need to fund their operations. As such, our business focuses on lending to electric systems and securing access to capital through diverse funding sources at rates that allow us to offer competitively priced credit products to our members.

### Focus on Electric Lending

CFC focuses on lending to electric utility cooperatives. Most of our electric cooperative borrowers continue to demonstrate stable operating performance and strong financial ratios because electricity is considered an essential service for the substantial majority of our electric cooperatives' customers. Our electric cooperative members experience limited competition as they generally operate in exclusive territories, the majority of which are not rate regulated. Loans to electric utility organizations represented approximately 99% of the outstanding loan portfolio as of May 31, 2016. Over the last five years, outstanding loans to electric utility organizations have increased by approximately 24%.

### Maintain Diversified Funding Sources

We strive to maintain diversified funding sources beyond capital market offerings of debt securities. We offer various short- and long-term unsecured debt securities to our members and affiliates, including commercial paper, select notes, daily liquidity fund notes, medium-term notes and subordinated certificates. While we continue to issue debt securities such as collateral trust bonds and medium-term notes in the capital markets and offer investments in commercial paper to non-members, we also have access to funds through bank revolving line of credit arrangements, government-guaranteed funding programs such as the Guaranteed Underwriter Program of the Rural Utilities Service ("RUS"), an agency of the USDA, as well as private placement note purchase agreements with the Federal Agricultural Mortgage Corporation ("Farmer Mac"). We provide additional information on our funding sources in "Item 7. MD&A—Consolidated Balance Sheet Analysis," "Item 7. MD&A—Liquidity Risk," "Note 6—Short-Term Borrowings," "Note 7—Long-Term Debt," "Note 8—Subordinated Deferrable Debt" and "Note 9—Members' Subordinated Certificates."

#### LOAN PROGRAMS

CFC lends to its members and associates. RTFC lends to its members, organizations affiliated with its members and associates. NCSC lends to its members and associates. See "Item 1. Business—Members" for additional information on the entities that comprise our membership. Loans to NCSC associates may require a guarantee of repayment to NCSC from the CFC member cooperative with which it is affiliated. CFC, RTFC and NCSC loans generally contain provisions that restrict further borrower advances or trigger an event of default if there is any material adverse change in the business or condition, financial or otherwise, of the borrower.

### CFC Loan Programs

#### Long-Term Loans

CFC's long-term loans generally have the following characteristics:

- terms of up to 35 years on a senior secured basis;
- amortizing or bullet maturity loans with serial payment structures;
- the property, plant and equipment financed by and securing the long-term loan has a useful life equal to or in excess of the loan maturity;
- flexibility for the borrower to select a fixed interest rate for periods of one to 35 years or a variable interest rate; and
- the ability for the borrower to select various tranches with either a fixed or variable interest rate for each tranche.

Borrowers typically have the option of selecting a fixed or variable interest rate at the time of each advance on long-term loan facilities. When selecting a fixed rate, the borrower has the option to choose a fixed rate for a term of one year through the final maturity of the loan. When the selected fixed interest rate term expires, the borrower may select another fixed rate for a term of one year through the loan maturity or the current variable rate. Long-term fixed

rates are set daily for new loan advances and loans that reprice. The fixed rate on each loan is determined on the day the loan is advanced or repriced based on the term selected. The variable rate is set on the first day of each month.

To be in compliance with the covenants in the loan agreement and eligible for loan advances, distribution systems generally must maintain an average modified debt service coverage ratio, as defined in the loan agreement, of 1.35 or greater. CFC may make long-term loans to distribution systems, on a case-by-case basis, that do not meet these general criteria. Power

supply systems generally are required either (i) to maintain an average modified debt service coverage ratio, as defined in the loan agreement, of 1.00 or greater or (ii) to establish and collect rates and other revenue in an amount to yield margins for interest, as defined in an indenture, in each fiscal year sufficient to equal at least 1.00 or (iii) both. CFC may make long-term loans to power supply systems, on a case-by-case basis, that may include other requirements, such as maintenance of a minimum equity level.

#### Line of Credit Loans

Line of credit loans are generally unsecured and may be committed or uncommitted facilities. Line of credit loans are designed primarily to assist borrowers with liquidity and cash management and are generally advanced at variable interest rates. Line of credit loans also are made available as interim financing when a member either receives RUS approval to obtain a loan and is awaiting its initial advance of funds or submits a loan application that is pending approval from RUS (sometimes referred to as “bridge loans”). These bridge loans are not required to be paid down for five consecutive business days. In these cases, when the borrower receives the RUS loan advance, the funds must be used to repay the bridge facilities.

Line of credit loans are typically revolving facilities. Certain line of credit loans require the borrower to pay off the principal balance for at least five consecutive business days at least once during each 12-month period. Under the provisions of our uncommitted lines of credit, we have the option, at our discretion, not to fund advances regardless of whether the borrower is in compliance with the terms and conditions of the facility.

#### Syndicated Line of Credit Loans

A syndicated line of credit loan is typically a large financing offered by a group of lenders that work together to provide funds for a single borrower. Syndicated loans are generally unsecured, floating-rate loans that can be provided on a revolving or term basis for tenors that range from several months to five years. Syndicated financings are arranged for borrowers on a case-by-case basis. CFC may act as lead lender, arranger and administrative agent for the syndicated facilities. CFC uses its best efforts to syndicate the loan requirements of certain borrowers. The success of such efforts depends on the financial position and credit quality of the borrower as well as market conditions.

#### RTFC Loan Programs

Loans to rural local exchange carriers or holding companies of rural local exchange carriers represented 97% and 94% of RTFC’s total outstanding loans as of May 31, 2016 and 2015, respectively. Most of these rural telecommunications companies have diversified their operations and also provide broadband services.

#### Long-Term Loans

RTFC makes long-term loans to rural telecommunications systems for debt refinancing, construction or upgrades of infrastructure, acquisitions and other corporate purposes.

RTFC’s long-term loans generally have the following characteristics:

- terms not exceeding 10 years on a senior secured basis;
- the property, plant and equipment financed by and securing the long-term loan has a useful life equal to or in excess of the loan maturity;
- flexibility for the borrower to select a fixed interest rate for periods from one year to the final loan maturity or a variable interest rate; and
- the ability for the borrower to select various tranches with either a fixed or variable interest rate for each tranche.

When a selected fixed interest rate term expires, generally the borrower may select another fixed-rate term or a variable rate. The fixed rate on a loan is determined on the day the loan is advanced or converted to a fixed rate based on the term selected. The long-term variable rate is set on the first day of each month.

To borrow from RTFC, a rural telecommunication system generally must be able to demonstrate the ability to achieve and maintain an annual debt service coverage ratio of 1.25. RTFC may make long-term loans to rural telecommunication systems, on a case-by-case basis, that do not meet these general criteria.

#### Line of Credit Loans

Line of credit loans are generally unsecured. Line of credit loans are designed primarily to assist borrowers with liquidity and cash management and are generally advanced at variable interest rates. Line of credit loans are typically revolving facilities and generally require the borrower to pay off the principal balance for at least five consecutive business days at least once during each 12-month period. Line of credit loans also are made available as interim financing, or bridge loans, when a borrower either receives RUS approval to obtain a loan and is awaiting its initial advance of funds or submits a loan application that is pending approval from RUS. RUS loan advances, when received, must be used to repay these bridge facilities.

#### NCSC Loan Programs

##### Long-Term Loans

NCSC's long-term loans generally have the following characteristics:

- terms of up to 35 years on a senior secured or unsecured basis;
- amortizing or bullet maturity loans with serial payment structures;
- the property, plant and equipment financed by and securing the long-term loan has a useful life equal to or in excess of the loan maturity;
- flexibility for the borrower to select a fixed interest rate for periods of one to 35 years or a variable interest rate; and
- the ability for the borrower to select various tranches with either a fixed or variable interest rate for each tranche.

NCSC allows borrowers to select a fixed interest rate or a variable interest rate at the time of each advance on long-term loan facilities. When selecting a fixed rate, the borrower has the option to choose a fixed rate for a term of one year through the final maturity of the loan. When the selected fixed interest rate term expires, the borrower may select another fixed rate for a term of one year through the loan maturity or the current variable rate. The fixed rate on a loan is determined on the day the loan is advanced or repriced based on the term selected. The variable rate is set on the first day of each month.

#### Line of Credit Loans

NCSC also provides unsecured revolving line of credit loans to assist borrowers with liquidity and cash management on terms similar to those provided by CFC and RTFC as described above.

#### Loan Features and Options

##### Interest Rates

As a member-owned cooperative finance organization, we are a cost-based lender. As such, our interest rates are set based on a yield that we believe will generate a reasonable level of earnings to cover our cost of funding, general and administrative expenses and loan loss provision. Various standardized discounts may reduce the stated interest rates for Class A and Class B borrowers meeting certain criteria related to performance, volume, collateral and equity requirements.

Conversion Option

Generally, a borrower may convert a long-term loan from a variable interest rate to a fixed interest rate at any time without a fee and convert a long-term loan from a fixed rate to another fixed rate or to a variable rate at any time upon payment of a conversion fee, if applicable, based on current loan policies.

5

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### Prepayment Option

Generally, borrowers may prepay long-term fixed-rate loans at any time, subject to payment of an administrative fee and a make-whole premium and prepay long-term variable-rate loans at any time, subject to payment of an administrative fee. Line of credit loans may be prepaid at any time without a fee, unless the interest rate on the loan is fixed or based on a London Interbank Offered Rate (“LIBOR”) index.

### Loan Security

Long-term loans are typically senior secured on parity with other secured lenders (primarily RUS), if any, by all assets and revenue of the borrower, subject to standard liens typical in utility mortgages such as those related to taxes, worker’s compensation awards, mechanics’ and similar liens, rights-of-way and governmental rights. We are able to obtain liens on parity with liens for the benefit of RUS because RUS’ form of mortgage expressly provides for other lenders such as CFC to have a parity lien position if the borrower satisfies certain conditions or obtains a written lien accommodation from RUS. When we make loans to borrowers that have existing loans from RUS, we generally require those borrowers to either obtain such a lien accommodation or satisfy the conditions necessary for our loan to be secured on parity under the mortgage with the loan from RUS.

As noted above, our line of credit loans are generally unsecured.

### GUARANTEE PROGRAMS

When we guarantee debt obligations of our members, we use the same credit policies and monitoring procedures for guarantees as for loans. If a member system defaults in its obligation to pay debt service, then we are obligated to pay any required amounts under our guarantees. Meeting our guarantee obligations satisfies the underlying obligation of our member systems and prevents the exercise of remedies by the guarantee beneficiary based upon a payment default by a member system. In general, the member system is required to repay any amount advanced by us with interest pursuant to the documents evidencing the member system’s reimbursement obligation. We were not required to perform pursuant to any of our guarantee obligations during the year ended May 31, 2016.

### Guarantees of Long-Term Tax-Exempt Bonds

We guarantee debt issued for our members’ construction or acquisition of pollution control, solid waste disposal, industrial development and electric distribution facilities. Governmental authorities issue such debt on a non-recourse basis and the interest thereon is exempt from federal taxation. The proceeds of the offering are made available to the member system, which in turn is obligated to pay the governmental authority amounts sufficient to service the debt.

If a system defaults for failure to make the debt payments, we are obligated to pay, after available debt service reserve funds have been exhausted, scheduled debt service under our guarantee. Such payment will prevent the occurrence of an event of default that would otherwise permit acceleration of the bond issue. The system is required to repay any amount that we advance pursuant to our guarantee plus interest on that advance. This repayment obligation, together with the interest thereon, is typically senior secured on parity with other lenders (including, in most cases, RUS), by a lien on substantially all of the system’s assets. If the security instrument is a common mortgage with RUS, then in general, we may not exercise remedies for up to two years following default. However, if the debt is accelerated under the common mortgage because of a determination that the related interest is not tax-exempt, the system’s obligation to reimburse us for any guarantee payments will be treated as a long-term loan. The system is required to pay us initial and/or ongoing guarantee fees in connection with these transactions.

Certain guaranteed long-term debt bears interest at variable rates that are adjusted at intervals of one to 270 days including weekly, every five weeks or semi-annually to a level favorable to their resale or auction at par. If funding



sources are available, the member that issued the debt may choose a fixed interest rate on the debt. When the variable rate is reset, holders of variable-rate debt have the right to tender the debt for purchase at par. In some transactions, we have committed to purchase this debt as liquidity provider if it cannot otherwise be re-marketed. If we hold the securities, the cooperative pays us the interest earned on the bonds or interest calculated based on our short-term variable interest rate, whichever is greater. The system is required to pay us stand-by liquidity fees in connection with these transactions.

## Letters of Credit

In exchange for a fee, we issue irrevocable letters of credit to support members' obligations to energy marketers, other third parties and to the USDA Rural Business and Cooperative Development Service. Each letter of credit is supported by a reimbursement agreement with the member on whose behalf the letter of credit was issued. In the event a beneficiary draws on a letter of credit, the agreement generally requires the member to reimburse us within one year from the date of the draw, with interest accruing from that date at our line of credit variable interest rate.

The Federal Communications Commission ("FCC") issued an order in May 2016 that designated CFC as an acceptable source for letters of credit in support of FCC programs that encourage deployment of high-speed broadband throughout rural America. The designation will allow CFC to provide credit support for rural electric and telecommunication cooperatives that participate in programs designed to increase deployment of broadband services to underserved rural areas.

## Other Guarantees

We may provide other guarantees as requested by our members. These guarantees may be made on a secured or unsecured basis with guarantee fees set to cover our general and administrative expenses, a provision for losses and a reasonable margin.

We provide additional information on our guarantee programs and outstanding guarantee amounts as of May 31, 2016 and 2015 in "Item 7. MD&A—Off-Balance Sheet Arrangements," "Item 7. MD&A—Credit Risk—Loan and Guarantee Portfolio Credit Risk" and "Note 13—Guarantees."

## INVESTMENT POLICY

We invest funds in accordance with policies adopted by our board of directors. Under our current investment policy, funds may be invested in direct obligations of, or guaranteed by, the United States or agencies thereof and investments in government-sponsored enterprises. Our policy also permits us to invest in certain financial institutions in the form of overnight investment products and Eurodollar deposits, bankers' acceptances, certificates of deposit, working capital acceptances or other deposits. Other permitted investments include highly rated obligations, such as commercial paper, certain obligations of foreign governments and certain corporate bonds. In addition, we may invest in repurchase agreements secured by direct obligations of the United States or its agencies and highly rated commercial paper that is set aside in a segregated account. All of these investments are subject to certain limitations set forth in our investment policy.

## INDUSTRY

### Overview

Since the enactment of the Rural Electrification Act in 1936, RUS has financed the construction of electric generating plants, transmission facilities and distribution systems to provide electricity to rural areas. Principally through the creation of local electric cooperatives originally financed under the Rural Electrification Act loan program in 47 states and three U.S. territories, the percentage of farms and residences in rural areas of the United States receiving central station electric service increased from 11% in 1934 to almost 100% currently.

RUS makes loan guarantees and provides other forms of financial assistance to rural electric system borrowers. Under the Rural Electrification Act, RUS is authorized to make direct loans to systems that qualify for the hardship program (5% interest rate), the municipal rate program (based on a municipal government obligation index) and a Treasury rate program (at Treasury plus 0.125%). RUS also is authorized to guarantee loans that bear interest at a rate agreed upon

by the borrower and the lender (which generally has been the Federal Financing Bank (“FFB”)). RUS exercises oversight over borrowers’ operations. Its loans and guarantees are secured by a mortgage or indenture on substantially all of the system’s assets and revenue.

Leading up to CFC's formation in 1969, there was a growing need for capital for electric cooperatives to build new electric facilities due to growth in rural America. The electric cooperatives formed CFC so a source of financing would be available to them to supplement the RUS loan programs and to mitigate uncertainty related to government funding.

CFC aggregates the combined strength of its rural electric member cooperatives to access the public capital markets. CFC works cooperatively with RUS; however, CFC is not a federal agency or a government-sponsored enterprise, and is not owned or controlled by any federal agency or government-sponsored enterprise. Our members are not required to have outstanding loans from RUS as a condition of borrowing from CFC. CFC meets the financial needs of its rural members by:

- providing bridge loans required by borrowers in anticipation of receiving RUS funding;
- providing financial products not otherwise available from RUS including lines of credit, letters of credit, guarantees on tax-exempt financing, weather-related disaster recovery lines of credit, unsecured loans and investment products such as commercial paper, member capital securities, select notes and medium-term notes;
- meeting the financing needs of those rural electric systems that repay or prepay their RUS loans and replace the government loans with private capital; and
- providing financing to RUS-eligible rural electric systems for facilities that are not eligible for financing from RUS.

#### Electric Member Competition

The movement toward electric competition at the retail level has largely ceased. The electric utility industry has evolved into a "hybrid" model in which there are significant differences in the retail regulatory approaches followed in different states and regions.

Customer choice regulation, where customers have a choice of alternative energy suppliers, has had little impact on distribution and power supply cooperatives, and we do not expect a material impact going forward. Retail customer choice existed in 14 states as of May 31, 2016. Those states were Connecticut, Delaware, Illinois, Maine, Maryland, Massachusetts, Michigan, New Hampshire, New Jersey, New York, Ohio, Pennsylvania, Rhode Island and Texas. In general, even in those states, very few consumers served by CFC members have switched to other suppliers.

Many factors restrict the choices customers have available to them and, therefore, mitigate the effect of customer choice and competition in areas served by cooperatives. These factors include, but are not limited to, the following:

- utilities in many states may still be regulated regarding rates on noncompetitive services, such as distribution;
- 20 states regulate the debt securities issued by utilities, including cooperatives, which could affect funding costs and, therefore, the electric rates charged to customers;
- Federal Energy Regulatory Commission regulation of rates as well as terms and conditions of transmission service;
- the fact that few competitors demonstrated much interest in providing electric energy to residential or rural customers; and
- distribution systems own the lines to the customer and it would not be feasible for a competitor to build a second line to serve the same customers in almost all situations. Therefore, the distribution systems still charge a fee or access tariff for the service of delivering power, regardless of who supplies the power.

#### Electric Member Regulation

There were 12 states in which some or all electric cooperatives are subject to state regulation over the rates they charge as of May 31, 2016. Electric cooperatives are subject to full or partial state regulation over their electric rates,

and the cooperatives in these states do not have a right to opt out of regulation. Those states are Arizona, Arkansas, Georgia, Hawaii, Kentucky, Louisiana, Maine, Maryland, New Mexico, Vermont, Virginia and West Virginia. The Federal Energy Regulatory Commission also has jurisdiction to regulate transmission rates, terms and conditions of service, and the issuance of securities by public utilities within its jurisdiction.

Our distribution and power supply members are subject to regulation by various federal, regional, state and local authorities with respect to the environmental effects of their operations. At the federal level, the U.S. Environmental Protection Agency (“EPA”) has proposed a number of rulemakings, including cooling water intake structures, coal ash disposal, hazardous air pollutants and interstate transport of air pollutants, that could force the electric utility industry to incur capital costs to comply with these regulations and possibly retire coal-fired generating capacity. On August 3, 2015, the EPA issued its final

Clean Power Plan Rule for regulating greenhouse gas emissions from existing fossil fuel-fired power plants. The regulation, falling under Section 111(d) of the federal Clean Air Act, is designed to cut carbon emissions (from 2005 levels) from affected facilities by 32% by 2030. The regulation has the potential to raise the cost of electricity from fossil fuel generation and accelerate the retirement of some existing plants. Numerous parties, including many of our members, have appealed the Clean Power Plan Rule to the United States Court of Appeals for the District of Columbia Circuit. The United States Supreme Court has stayed the Clean Power Plan Rule pending disposition of this appeal. In most cases, any associated costs of compliance can be passed on to cooperative consumers without additional regulatory approval.

#### LENDING COMPETITION

RUS is the largest lender to electric cooperatives. RUS provides long-term secured loans. CFC provides financial products and services, primarily in the form of long-term and short-term loans, to its electric cooperative members to supplement RUS financing, to provide loans to members that have elected not to borrow from RUS, and to bridge long-term financing provided by RUS.

CFC's primary competitor is CoBank, ACB, a federally chartered instrumentality of the United States that is a member of the Farm Credit System. CFC also competes with banks, other financial institutions and the capital markets to provide loans and other financial products to our members. As a result, we are competing with the customer service, pricing and funding options the member is able to obtain from these sources. We attempt to minimize the effect of competition by offering a variety of loan options and value-added services and by leveraging the working relationships developed with the majority of our members over the past 47 years. Further, on an annual basis, we allocate substantially all net earnings to members (i) in the form of patronage capital, which reduces our members' effective cost of borrowing and (ii) through the members' capital reserve. The value-added services that we provide include, but are not limited to, benchmarking tools, financial models, and various conferences, meetings and training workshops.

In order to meet other financing needs of our members, we offer options that include credit support in the form of letters of credit and guarantees, loan syndications and loan participations. Our credit products are tailored to meet the specific needs of each cooperative, and we often offer specific transaction structures that our competitors do not provide. CFC also offers certain risk mitigation products and interest rate discounts on secured, long-term loans for its members that meet certain criteria, including performance, volume, collateral and equity requirements.

CFC has established certain funds to benefit its members. Since 1981, CFC has set aside a portion of its annual net earnings in a cooperative educational fund to promote awareness and appreciation of the cooperative principles. As directed by the CFC Board of Directors, a portion of the contributions to the funds are distributed through the electric cooperative statewide associations. Since 1986, CFC has supported its members' efforts to protect their service territories from erosion or takeover by other utilities through assistance from the Cooperative System Integrity Fund, which is funded through voluntary contributions from members. Amounts from the Integrity Fund are distributed to applicants who establish that (i) all or a significant portion of their consumers, services or facilities face a hostile threat of acquisition or annexation by a competing entity; (ii) they face a significant threat in their ability to continue to provide non-electric energy services to customers; or (iii) they are facing regulatory, judicial or legislative challenges that threaten their existence under the cooperative business model.

Our rural electric borrowers are mostly private companies; thus, the overall size of the rural electric lending market cannot be determined from public information. We estimate the size of the overall rural electric lending market from the annual financial and statistical reports filed with us by our members using calendar year data; however, there are certain limitations with regard to these estimates, including the following:

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while the underlying data included in the financial and statistical reports may be audited, the preparation of the financial and statistical reports is not audited;  
in some cases, not all members provide the annual financial and statistical reports on a timely basis to be included in summarized results; and  
the financial and statistical reports do not include comprehensive data on indebtedness by lenders other than RUS.

According to financial data provided to us by our 806 reporting distribution systems and 56 reporting power supply systems as of December 31, 2015, and our 808 reporting electric cooperative distribution systems and 58 reporting power supply

systems as of December 31, 2014, long-term debt outstanding to CFC, RUS and other lenders in the electric cooperative industry by those entities was as follows as of December 31, 2015 and 2014:

(Dollars in thousands)	December 31,			
	2015		2014	
	Debt	% of	Debt	% of
	Outstanding	Total	Outstanding	Total
Total long-term debt reported by members: <sup>(1)</sup>				
Distribution	\$45,899,178		\$44,399,581	
Power supply	42,302,998		45,264,091	
Less: long-term debt funded by RUS	(39,070,188 )		(42,749,636 )	
Members' non-RUS long-term debt	\$49,131,988		\$46,914,036	
Funding source of member's long-term debt:				
Long-term debt funded by CFC	\$20,986,659	43 %	\$19,110,899	41 %
Long-term debt funded by other lenders	28,145,329	57	27,803,137	59
Members' non-RUS long-term debt	\$49,131,988	100 %	\$46,914,036	100 %

<sup>(1)</sup> Reported amounts are based on member-provided information, which may not have been subject to audit by an independent accounting firm.

Members' long-term debt funded by CFC, by type, as of December 31, 2015 and 2014 is summarized further below.

(Dollars in thousands)	December 31,			
	2015		2014	
	Debt	% of	Debt	% of
	Outstanding	Total	Outstanding	Total
Distribution	\$16,822,651	80 %	\$15,055,933	79 %
Power supply	4,164,008	20	4,054,966	21
Long-term debt funded by CFC	\$20,986,659	100 %	\$19,110,899	100 %

We are not able to specifically identify the amount of debt our members have outstanding to CoBank, ACB, from either the annual financial and statistical reports our members file with us or from CoBank, ACB's public disclosure, but we believe that CoBank, ACB, is the lender other than CFC and RUS with significant long-term debt outstanding to the rural electric cooperatives.

#### REGULATION

CFC, RTFC and NCSC are not subject to federal regulatory oversight or compliance with regard to lending. CFC, RTFC and NCSC are subject to state laws that pertain to the business conducted in each state, including but not limited to lending laws, usury laws and laws governing mortgages.

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") imposes requirements on certain entities that use derivatives such as clearing trades through a central organization, posting margin and recordkeeping. CFC does not participate in the derivatives markets for speculative, trading or investing purposes and does not make a market in derivatives. CFC is an end user of derivative financial instruments. CFC engages in over-the-counter derivative transactions to hedge the interest rate risks associated with lending to its members.

The U.S. Commodities Futures Trading Commission ("CFTC") is the lead federal agency responsible for promulgation of certain rules implementing the Dodd-Frank Act requirements related to the utilization of swaps and derivative products. In August 2013, the CFTC issued a final rule "Clearing Exemption for Certain Swaps Entered into by Cooperatives," which created an exemption from clearing for cooperatives. In April 2016, the CFTC issued a final rule



“Margin Requirements for

10

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Uncleared Swaps for Swap Dealers and Major Swap Participants, ” which includes an exemption from margin requirements for uncleared swaps for cooperatives that are financial end users. The exemption under each of these rules is applicable to CFC.

The Dodd-Frank Act requires the SEC to promulgate rules related to executive compensation and compensation clawbacks, which may require us to make additional disclosures or alter controls and/or risk management practices. We will continue to monitor and, where appropriate, advocate with respect to the implementation of the Dodd-Frank Act and its impact on us until all final rules become effective.

## MEMBERS

Our consolidated membership, after taking into consideration systems that are members of both CFC and NCSC and eliminating memberships between CFC, RTFC and NCSC, totaled 1,463 members and 230 associates as of May 31, 2016.

## CFC

CFC’s bylaws provide that cooperative or nonprofit corporations, public corporations, utility districts and other public bodies that received or are eligible to receive a loan or commitment for a loan from RUS or any successor agency (as well as subsidiaries, federations or statewide and regional associations that are wholly owned or controlled by such entities) are eligible for membership. One of the criteria for eligibility for RUS financing is a “rural area” test. CFC relies on the definition of “rural” as specified in the Rural Electrification Act, as amended. “Rural” is defined in the Rural Electrification Act as any area other than a city, town or unincorporated area that has a population of less than 20,000, or any area within the service area of a borrower who, at the date of enactment of the Food, Conservation and Energy Act of 2008, had an outstanding RUS electric loan. The definition of “rural” under the act permits an area to be defined as “rural” regardless of the development of such area subsequent to the approval of the outstanding loan. Thus, those entities that received or qualify for financing from RUS are eligible to apply for membership, upon approval of membership by the CFC Board of Directors, and subsequently borrow from CFC regardless of whether there is an outstanding loan with RUS. There are no requirements to maintain membership, although the board has the authority to suspend a member under certain circumstances. CFC has not suspended a member to date.

CFC has the following types of members, all of which are not-for-profit entities or subsidiaries or affiliates of not-for-profit entities.

### Class A – Distribution Systems

Cooperative or nonprofit corporations, public corporations, utility districts and other public bodies, which received or are eligible to receive a loan or commitment for a loan from RUS or any successor agency, and that are engaged or planning to engage in furnishing utility services to their members and patrons for their use as ultimate consumers. The majority of our distribution system members are consumer-owned electric cooperatives.

Distribution systems are utilities engaged in retail sales of electricity to residential and commercial consumers in their defined service areas. Such sales are generally on an exclusive basis using the distribution system’s infrastructure, including substations, wires and related support systems. Distribution systems vary in size from small systems that serve a few thousand customers to large systems that serve more than 200,000 customers. Thus, the amount of loan funding required by different distribution systems varies significantly. Distribution systems may serve customers in more than one state.

Most distribution systems have all-requirements power purchase contracts with their power supply systems, which are owned and controlled by the member distribution systems. Wholesale power for resale also comes from other sources, including power supply' contracts with government agencies, investor-owned utilities and other entities, and, in some cases, the distribution systems own generating facilities.

#### Class B – Power Supply Systems

Cooperative or nonprofit corporations that are federations of Class A members or of other Class B members, or both, or that are owned and controlled by Class A members or by other Class B members, or both, and that are engaged or planning to

engage in furnishing utility services primarily to Class A members or other Class B members. Our power supply system members are member-owned electric cooperatives.

The power supply systems vary in size from one with thousands of megawatts of power generation capacity to systems that have no generating capacity, which generally operate transmission lines to supply certain distribution systems or manage power supply purchase arrangements for the benefit of their distribution system members. Thus, the amount of loan funding required by different power supply systems varies significantly. Power supply members may serve distribution systems located in more than one state.

The wholesale power supply contracts with their distribution system members permit the power supply system, subject to regulatory approval in certain instances, to establish rates to produce revenue sufficient to cover debt service, to meet the cost of operation and maintenance of all generation, transmission and related facilities and to pay the cost of any power and energy purchased for resale.

#### Class C – Statewide and Regional Associations

Statewide and regional associations that are wholly owned or controlled by Class A members or Class B members, or both, or that are wholly owned subsidiaries of a CFC member, and that do not furnish utility services but supply other forms of service to their members. Such statewide organizations provide training and legislative, regulatory, media and related services. Certain states have an organization that represents and serves the distribution systems and power supply systems located in the state.

#### Class D – National Associations of Cooperatives

National associations of cooperatives that are Class A, Class B and Class C members, provided said national associations have, at the time of admission to membership in CFC, members domiciled in at least 80% of the states in the United States. National Rural Electric Cooperative Association (“NRECA”) is our sole Class D member. NRECA provides training, sponsors regional and national meetings, and provides legislative, regulatory, media and related services for nearly all rural electric cooperatives.

CFC Class A, B, C and D members are eligible to vote on matters put to a vote of the membership. Associates are not eligible to vote on matters put to a vote of the membership.

CFC’s membership as of May 31, 2016 was comprised of:

- 839 Class A distribution systems;
- 71 Class B power supply systems;
- 66 Class C statewide and regional associations, including NCSC; and
- 1 Class D national association of cooperatives.

In addition, CFC has associates that are nonprofit groups or entities organized on a cooperative basis that are owned, controlled or operated by Class A, B, C or D members and are engaged in or plan to engage in furnishing non-electric services primarily for the benefit of the ultimate consumers of CFC members. CFC had 49 associates, including RTFC, as of May 31, 2016.

#### RTFC

Membership in RTFC is limited to cooperative corporations, private corporations, public corporations, nonprofit corporations, utility districts and other public bodies that are approved by the RTFC Board of Directors and are

actively borrowing or are eligible to borrow from RUS. These companies must be engaged directly or indirectly in furnishing telephone or telecommunications services. Holding companies, subsidiaries and other organizations that are owned, controlled or operated by members are referred to as affiliates, and are eligible to borrow from RTFC. Associates are organizations that provide non-telecommunications services to rural telecommunications companies that are approved by the RTFC Board of Directors. Neither affiliates nor associates are eligible to vote at meetings of the members.

RTFC's membership was comprised of 487 members as of May 31, 2016. RTFC also had five associates as of May 31, 2016. CFC is not a member of RTFC. RTFC's members and associates consisted of 93 not-for-profit entities and 299 for-profit entities as of May 31, 2016.

#### NCSC

Membership in NCSC includes organizations that are Class A, B or C members of CFC, or eligible for such membership and are approved for membership by the NCSC Board of Directors.

NCSC's membership was comprised of 399 distribution systems, one power supply system and two statewide association as of May 31, 2016. All of NCSC's members also were CFC members. CFC, however, is not a member of NCSC. In addition to members, NCSC had 177 associates as of May 31, 2016. NCSC's associates may include members of CFC, entities eligible to be members of CFC and for-profit and not-for-profit entities that are owned, controlled or operated by or provide significant benefit to Class A, B and C members of CFC.

The business affairs of CFC, RTFC and NCSC are governed by separate boards of directors for each entity. We provide additional information on CFC's corporate governance in "Item 10. Directors, Executive Officers and Corporate Governance."

#### TAX STATUS

In 1969, CFC obtained a ruling from the Internal Revenue Service recognizing CFC's exemption from the payment of federal income taxes as an organization described under Section 501(c)(4) of the Internal Revenue Code.

In order for CFC to maintain its exemption under Section 501(c)(4) of the Internal Revenue Code, CFC must be "not organized for profit" and must be "operated exclusively for the promotion of social welfare" within the meaning of that section of the tax code. The Internal Revenue Service determined that CFC is an organization that is "operated exclusively for the promotion of social welfare" because the ultimate beneficiaries of its lending activities, like those of the RUS loan program, are the consumers of electricity produced by rural electric systems, the communities served by these systems and the nation as a whole.

As an organization described under Section 501(c)(4) of the Internal Revenue Code, no part of CFC's net earnings can inure to the benefit of any private shareholder or individual. This requirement is referred to as the private inurement prohibition and was added to Section 501(c)(4) of the Internal Revenue Code in 1996. A legislative exception allows organizations like CFC to continue to make allocations of net earnings to members in accordance with its cooperative status.

CFC believes its operations have not changed materially from those described to the Internal Revenue Service in its exemption filing. CFC reviews the impact on operations of any new activity or potential change in product offerings or business in general to determine whether such change in activity or operations would be inconsistent with its status as an organization described under Section 501(c)(4).

RTFC is a taxable cooperative under Subchapter T of the Internal Revenue Code and is not subject to income taxes on income from patronage sources that is allocated to its borrowers, as long as the allocation is properly noticed and at least 20% of the amount allocated is retired in cash prior to filing the applicable tax return. RTFC pays income tax based on its taxable income and deductions, excluding amounts allocated to its borrowers.

NCSC is a taxable cooperative that pays income tax based on its taxable income and deductions.

#### ALLOCATION AND RETIREMENT OF PATRONAGE CAPITAL

District of Columbia cooperative law requires cooperatives to allocate net earnings to patrons, to a general reserve in an amount sufficient to maintain a balance of at least 50% of paid-up capital, and to a cooperative educational fund, as well as permits additional allocations to board-approved reserves. District of Columbia cooperative law also requires that a

13

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cooperative's net earnings be allocated to all patrons in proportion to their individual patronage and each patron's allocation be distributed to the patron unless the patron agrees that the cooperative may retain its share as additional capital.

#### CFC

Annually, the CFC Board of Directors allocates its net earnings to its patrons in the form of patronage capital, to a cooperative educational fund, to a general reserve, if necessary, and to other board-approved reserves. Net earnings are calculated by adjusting net income to exclude the noncash effects of the accounting for derivative financial instruments. Patronage capital is not allocated to members if CFC has an adjusted net loss. Net losses, if any, do not affect amounts previously allocated as patronage capital or to the reserves. Net earnings are first applied against prior-period losses, if any, before an allocation of patronage capital is made. CFC has not experienced an adjusted net loss during the past 10 years and has allocated patronage capital to members for each such year.

An allocation to the general reserve is made, if necessary, to maintain the balance of the general reserve at 50% of the membership fees collected. CFC's bylaws require the allocation to the cooperative educational fund to be at least 0.25% of its net earnings. Funds from the cooperative educational fund are disbursed annually to statewide cooperative organizations to fund the teaching of cooperative principles and for other cooperative education programs.

Currently, CFC has one additional board-approved reserve, the members' capital reserve. The CFC Board of Directors determines the amount of net earnings that is allocated to the members' capital reserve, if any. The members' capital reserve represents net earnings that CFC holds to increase equity retention. The net earnings held in the members' capital reserve have not been specifically allocated to members, but may be allocated to individual members in the future as patronage capital if authorized by the CFC Board of Directors.

All remaining net earnings are allocated to CFC's members in the form of patronage capital. The amount of net earnings allocated to each member is based on the member's patronage of CFC's lending programs during the year. No interest is earned by members on allocated patronage capital. There is no effect on CFC's total equity as a result of allocating net earnings to members in the form of patronage capital or to board-approved reserves. The CFC Board of Directors has voted annually to retire a portion of the patronage capital allocation. Upon retirement, patronage capital is paid out in cash to the members to which it was allocated. CFC's total equity is reduced by the amount of patronage capital retired to its members and by amounts disbursed from board-approved reserves.

Pursuant to CFC's bylaws, the CFC Board of Directors determines the method, basis, priority and order of retirement of amounts allocated. The current policy of the CFC Board of Directors is to retire 50% of the prior fiscal year's allocated net earnings following the end of each fiscal year and to hold the remaining 50% for 25 years to fund operations. The amount and timing of future retirements remains subject to annual approval by the CFC Board of Directors, and may be affected by CFC's financial condition and other factors. The CFC Board of Directors has the authority to change the current practice for allocating and retiring net earnings at any time, subject to applicable cooperative law.

#### RTFC

In accordance with District of Columbia cooperative law and its bylaws and board policies, RTFC allocates its net earnings to its patrons, a cooperative educational fund and a general reserve, if necessary. Net losses are not allocated to members and do not affect amounts previously allocated as patronage capital or to the reserves. Current period earnings are first applied against any prior year losses before allocating patronage capital.



Pursuant to RTFC's bylaws, the RTFC Board of Directors shall determine the method, basis, priority and order of retirement of amounts allocated. RTFC's bylaws require that it allocate at least 1% of net earnings to a cooperative educational fund. Funds from the cooperative educational fund are disbursed annually to fund the teaching of cooperative principles and for other cooperative education programs. An allocation to the general reserve is made, if necessary, to maintain the balance of the general reserve at 50% of the membership fees collected. The remainder is allocated to borrowers in proportion to their patronage. RTFC provides notice to its members of the amount allocated and retires 20% of the allocation for that year in cash prior to the filing of the applicable tax return. Any additional amounts are retired as determined by the RTFC Board of Directors with due regard for RTFC's financial condition. There is no effect on the balance of equity due to the allocation of

net earnings to members or board-approved reserves. The retirement of amounts previously allocated to members or amounts disbursed from board-approved reserves reduces the balance of RTFC equity.

#### NCSC

In accordance with District of Columbia cooperative law and its bylaws and board policies, NCSC allocates its net earnings to a cooperative educational fund, to a general reserve, if necessary, and to other board-approved reserves. Net earnings are calculated by adjusting net income to exclude the noncash effects of the accounting for derivative financial instruments. Net losses, if any, do not affect amounts previously allocated to the reserves.

Pursuant to NCSC's bylaws, the NCSC Board of Directors shall determine the method, basis, priority and order of amounts allocated. An allocation to the general reserve is made, if necessary, to maintain the balance of the general reserve at 50% of the membership fees collected. There is no effect on the balance of equity due to the allocation of net earnings to board-approved reserves. NCSC's bylaws require the allocation to the cooperative educational fund to be at least 0.25% of its net earnings. Funds from the cooperative educational fund are disbursed annually to fund the teaching of cooperative principles and for other cooperative education programs.

#### EMPLOYEES

We had 243 employees as of May 31, 2016. We believe that our relations with our employees are good.

#### Item 1A. Risk Factors

Our financial condition, results of operations and liquidity are subject to various risks and uncertainties inherent in our business. The risks described below are the risks we consider to be material to our business. Other risks may prove to be material or important in the future. If any of the events or circumstances described in the following risks actually occur, our business, financial condition or results of operations could suffer adversely. You should consider all of the following risks together with all of the other information in this Annual Report on Form 10-K.

#### RISK FACTORS

Our business depends on access to external financing.

We depend on access to the capital markets and other sources of financing, such as our revolving credit agreements, investment from our members, private debt issuances through Farmer Mac and funding from the FFB through the Guaranteed Underwriter Program to fund new loan advances and refinance our long- and short-term debt and, if necessary, to fulfill our obligations under our guarantee and repurchase agreements. Market disruptions, downgrades to our long-term and/or short-term debt ratings, adverse changes in our business or performance, downturns in the electric industry and other events over which we have no control may deny or limit our access to the capital markets and/or subject us to higher costs for such funding. Our access to other sources of funding also could be limited by the same factors, by adverse changes in the business or performance of our members, by the banks committed to our revolving credit agreements or Farmer Mac, or by changes in federal law or the Guaranteed Underwriter Program.

Our funding needs are determined primarily by scheduled short- and long-term debt maturities and the amount of our loan advances to our borrowers relative to the scheduled payment amortization of loans previously made by us. If we are unable to timely issue debt into the capital markets or obtain funding from other sources, we may not have the funds to meet all of our obligations as they become due.

A reduction in the credit ratings for our debt could adversely affect our liquidity and/or cost of debt.

Our credit ratings are important to our liquidity. We currently contract with three nationally recognized statistical rating organizations to receive ratings for our secured and unsecured debt and our commercial paper. In order to access the commercial paper markets at current levels, we believe that we need to maintain our current ratings for commercial paper of P1 from Moody's Investors Service ("Moody's"), A-1 from S&P Global ("S&P") and F-1 from Fitch Ratings Inc. ("Fitch").

Changes in rating agencies' rating methodology, actions by governmental entities or others, additional losses from impaired loans and other factors could adversely affect the credit ratings on our debt. A reduction in our credit ratings could adversely affect our liquidity and competitive position, increase our borrowing costs or limit our access to the capital markets and the sources of financing available to us. A significant increase in our cost of borrowings and interest expense could cause us to sustain losses or impair our liquidity by requiring us to seek other sources of financing, which may be difficult to obtain.

Fluctuating interest rates could adversely affect our income, margin and cash flow.

We set our interest rates on loans based on our cost of funding. We set our line of credit interest rate and long-term variable interest rate monthly. We do not match fund the majority of our long-term fixed-rate loans with a specific debt issuance at the time the loans are advanced. Instead, long-term fixed-rate loans are aggregated until the volume reaches a level that will allow an economically efficient issuance of long-term debt to fund long-term fixed-rate loans. As such, we are exposed to interest rate risk on our long-term fixed-rate loans during the period from which we have set a fixed rate on the loan until the time we obtain the long-term funding. Fixed-rate loans funded with variable-rate debt totaled \$446 million, or 2%, of both total assets and total assets excluding derivative assets as of May 31, 2016.

A decrease in long-term fixed interest rates provided by other lenders could result in an increase in prepayments on long-term fixed-rate loans scheduled to reprice. Borrowers are able to prepay the long-term fixed-rate loan without a make-whole fee at the time the fixed-rate term expires. An increase in loan prepayments due to repricings could cause a decrease to earnings for the period of time it takes to use cash from such prepayments to repay maturing debt or make new loan advances. Loans with a fixed-rate term scheduled to reprice during the next 12 months totaled \$993 million as of May 31, 2016.

Competition from other lenders could adversely impact our financial results.

We compete with other lenders for the portion of the rural utility loan demand for which RUS will not lend and for loans to members that have elected not to borrow from RUS. The primary competition for the non-RUS loan volume is from CoBank, ACB, a federally chartered instrumentality of the United States that is a member of the Farm Credit System. As a government-sponsored enterprise, CoBank, ACB, has the benefit of an implied government guarantee with respect to its funding. Competition may limit our ability to raise rates to adequately cover increases in costs, which could have an adverse impact on our results of operations, and increasing interest rates to cover costs could cause a reduction in new lending business.

Our elected directors also serve as officers or directors of certain of our individual member cooperatives, which may result in a potential conflict of interest with respect to loans, guarantees and extensions of credit that we may make to or on behalf of such member cooperatives.

In accordance with our charter documents and the purpose for which we were formed, we lend only to our members and associates. CFC's directors are elected or appointed from our membership, with 10 director positions filled by directors of members, 10 director positions filled by general managers or chief executive officers of members, two positions appointed by NRECA and one at-large position that must, among other things, be a director, financial officer, general manager or chief executive of one of our members. CFC currently has loans outstanding to members that are affiliated with CFC directors and may periodically extend new loans to such members. The relationship of CFC's directors to our members may give rise to conflicts of interests from time to time. See "Item 13. Certain Relationships and Related Transactions, and Director Independence—Review and Approval of Transactions with Related Persons" for a description of our policies with regard to approval of loans to members affiliated with CFC directors.

We are subject to credit risks related to collecting the amounts owed to us on our outstanding loans. Increased credit risk related to our loans or actual losses that exceed our allowance for loan losses could impair our financial results.

Our allowance for loan losses, which is established through a provision charged to expense, represents management's best estimate of probable losses that have been incurred within the existing loan portfolio. The level of the allowance reflects management's continuing evaluation of credit risk related to industry concentrations; economic conditions; specific credit risks; loan loss experience; current loan portfolio quality; present economic, political and regulatory conditions; and unidentified losses and risks inherent in the current loan portfolio. The determination of the appropriate level of the allowance for loan losses involves a high degree of subjectivity and requires us to make significant estimates of current credit risks and future trends, all of which may undergo material changes. Changes in economic conditions affecting

borrowers, new information regarding existing loans, identification of additional problem loans and other factors, both within and outside of our control, may require an increase in the allowance for loan losses. In addition, if actual losses incurred exceed current estimates of probable losses included in the allowance for loan losses, we will need additional provisions to increase the allowance for loan losses. Material increases in the allowance for loan losses will result in a decrease in net income and may have a material adverse effect on our financial results.

We have been and may in the future be in litigation with borrowers related to enforcement or collection actions pursuant to loan documents. In such cases, the borrower or others may assert counterclaims against us or initiate actions against us related to the loan documents. Unfavorable rulings could have a material adverse effect on our financial results.

We may obtain entities or other assets through foreclosure, which would subject us to the same performance and financial risks as any other owner or operator of similar businesses or assets.

As a financial institution, from time to time we may obtain entities and assets of borrowers in default through foreclosure proceedings. If we become the owner and operator of entities or assets obtained through foreclosure, we are subject to the same performance and financial risks as any other owner or operator of similar assets or entities. In particular, the value of the foreclosed assets or entities may deteriorate and have a negative impact on our results of operations. We assess foreclosed assets, if any, for impairment periodically as required under generally accepted accounting principles in the United States (“GAAP”). Impairment charges, if required, represent a reduction to earnings in the period of the charge. There may be substantial judgment used in the determination of whether such assets are impaired and in the calculation of the amount of the impairment. In addition, when foreclosed assets are sold to a third party, the sale price we receive may be below the amount previously recorded in our financial statements, which will result in a loss being recorded in the period of the sale.

The nonperformance of counterparties to our derivative agreements could impair our financial results.

We use interest rate swaps to manage our interest rate risk. There is a risk that the counterparties to these agreements will not perform as agreed, which could adversely affect our results of operations. The nonperformance of a counterparty on an agreement would result in the derivative no longer being an effective risk management tool, which could negatively affect our overall interest rate risk position. In addition, if a counterparty fails to perform on our derivative obligation, we could incur a financial loss to replace the derivative with another counterparty and/or a loss through the failure of the counterparty to pay us amounts owed.

A decline in our credit rating could trigger payments under our derivative agreements, which could impair our financial results.

We have certain interest rate swaps that contain credit risk-related contingent features referred to as rating triggers. Under certain rating triggers, if the credit rating for either counterparty falls to the level specified in the agreement, the other counterparty may, but is not obligated to, terminate the agreement. If either counterparty terminates the agreement, a net payment may be due from one counterparty to the other based on the fair value, excluding credit risk, of the underlying derivative instrument. These rating triggers are based on our senior unsecured credit ratings by Moody’s and S&P. Based on the fair market value of our interest rate exchange agreements subject to rating triggers, we would have been required to make a payment of up to \$368 million as of May 31, 2016, if all agreements for which we owe amounts were terminated as of that date and our senior unsecured ratings fell to or below Baa1 by Moody’s or to or below BBB+ by S&P. In calculating the required payments, we only considered agreements that, when netted for each counterparty pursuant to a master netting agreement, would require a payment upon termination. In the event that we are required to make a payment as a result of a rating trigger, it could have a material adverse impact on our financial results.

Our concentration of loans to borrowers within the rural electric industry could impair our revenue if that industry experiences economic difficulties.

Approximately 99% of our total outstanding loan exposure as of May 31, 2016 was to rural electric cooperatives. Factors that have a negative impact on our member rural electric cooperatives' financial results could also impair their ability to make payments on our loans. If our members' financial results materially deteriorate, we could be required to increase our allowance for loan losses through provisions for loan loss on our income statement that would reduce reported net income.

Advances in technology may change the way electricity is generated and transmitted prior to the maturity of our loans to rural electric systems.

Advances in technology could reduce demand for generation and transmission services. The development of alternative technologies that produce electricity, including solar cells, wind power and microturbines, has expanded due to environmental concerns and could ultimately provide affordable alternative sources of electricity and permit end users to adopt distributed generation systems that would allow them to generate electricity for their own use. As these and other technologies, including energy conservation measures, are created, developed and improved, the quantity and frequency of electricity usage by rural customers could decline. Advances in technology and conservation that cause our electric system members' power supply, transmission and/or distribution facilities to become obsolete prior to the maturity of loans secured by these assets could have an adverse impact on the ability of our members to repay such loans, which could result in an increase in nonperforming or restructured loans. These conditions could increase our credit risk exposure and negatively impact our financial results.

Loss of our tax-exempt status could adversely affect our earnings.

CFC has been recognized by the Internal Revenue Service as an organization for which income is exempt from federal taxation under Section 501(c)(4) of the Internal Revenue Code (other than any net income from an unrelated trade or business). In order to maintain CFC's tax-exempt status, it must continue to operate exclusively for the promotion of social welfare by operating on a cooperative basis for the benefit of its members by providing them cost-based financial products and services consistent with sound financial management, and no part of CFC's net earnings may inure to the benefit of any private shareholder or individual other than the allocation or return of net earnings or capital to its members in accordance with CFC's bylaws and incorporating statute in effect in 1996.

If CFC were to lose its status as a 501(c)(4) organization, we believe that it would be subject to the tax rules generally applicable to cooperatives under Subchapter T of the Internal Revenue Code. As a Subchapter T cooperative, CFC would be allowed to allocate its patronage-sourced income to its members and exclude the amount of such patronage dividends for which qualified written notices of allocation are provided to members and at least 20% of the amount allocated is returned in cash. However, CFC would be taxed as a regular corporation on income in excess of allowed deductions, if any.

Our ability to comply with covenants related to our revolving credit agreements, collateral trust bond and medium-term note indentures and debt agreements could affect our ability to retire patronage capital, may accelerate certain debt obligations and could affect our ability to obtain financing and maintain the current credit rating levels on our debt.

We must maintain compliance with all covenants and conditions related to our revolving credit agreements and debt indentures. We are required to maintain a minimum adjusted TIER for the six most recent fiscal quarters of 1.025, an adjusted leverage ratio of no more than 10-to-1 and we must maintain loans pledged as collateral for various debt issuances at or below 150% of the related secured debt outstanding as a condition to borrowing under our revolving credit agreements. Our revolving credit agreements also state that we must earn a minimum annual adjusted TIER of 1.05 in order to retire patronage capital to members. See "MD&A—Non-GAAP Financial Measures" for additional information on our adjusted measures and a reconciliation to the most comparable GAAP measures.

If we are unable to borrow under the revolving credit agreements, our short-term debt ratings would most likely decline, and our ability to issue commercial paper could become significantly impaired. As a member-owned cooperative, all of our retained equity belongs to our members. As such, a restriction on the retirement of patronage capital in any year would result in a delay in the return of such amounts to the members until we earn an annual TIER of at least 1.05 and our board approves the retirement of the amounts allocated from the year in which retirement was restricted. A patronage capital retirement in any one year reduces the effective cost of borrowing for a member's loan from CFC. Thus, if CFC does not retire patronage capital to its members, it results in a higher effective interest rate on borrowings from CFC for that year.



Pursuant to our collateral trust bond indentures, we are required to maintain eligible collateral pledged at least equal to 100% of the principal amount of the bonds issued under the indenture. Pursuant to one of our collateral trust bond indentures and our medium-term note indenture, we are required to limit senior indebtedness to 20 times the sum of our members' equity, subordinated deferrable debt and members' subordinated certificates.

If we are in default under our collateral trust bond or medium-term note indentures, the existing holders of these securities have the right to accelerate the repayment of the full amount of the outstanding debt principal of the security before the

stated maturity of such debt. That acceleration of debt repayments poses a significant liquidity risk as we might not have enough cash or committed credit available to repay the debt. In addition, if we are not in compliance with the collateral trust bond and medium-term note covenants, we would be unable to issue new debt securities under such indentures. If we were unable to issue new collateral trust bonds and medium-term notes, our ability to fund new loan advances and refinance maturing debt would be impaired.

We are required to pledge eligible distribution system or power supply system loans as collateral equal to at least 100% of the outstanding balance of debt issued under a revolving note purchase agreement with Farmer Mac. We also are required to pledge distribution or power supply loans as collateral equal to at least 100% of the outstanding balance of debt under the Guaranteed Underwriter Program. Collateral coverage less than 100% for either of these debt programs constitutes an event of default, which if not cured within 30 days, could result in creditors accelerating the repayment of the outstanding debt principal before the stated maturity. This poses a liquidity risk of possibly not having enough cash or committed credit available to repay the debt. In addition, we would be unable to issue new debt securities under the applicable debt agreement, which could impair our ability to fund new loan advances and refinance maturing debt.

Breaches of our information technology systems may damage relationships with our members or subject us to reputational, financial, legal or operational consequences.

Cyber-related attacks pose a risk to the security of our members' strategic business information and the confidentiality and integrity of our data. Security breaches may occur through the actions of third parties, employee error, malfeasance, technology failures or other irregularities. Any such breach or unauthorized access could result in a loss of this information, a delay or inability to provide service of affected products, damage to our reputation, including a loss of confidence in the security of our products and services, and significant legal and financial exposure. Because the techniques used to obtain unauthorized access, disable or degrade service or sabotage systems change frequently, we may be unable to anticipate these techniques or implement adequate preventative measures. While CFC maintains insurance coverage that, subject to policy terms and conditions, covers certain aspects of cyber risks, such insurance coverage may be insufficient to cover all losses. Data security and privacy continue to receive heightened legislative and regulatory focus in the United States. Many states have enacted legislation requiring notification to those affected by a security breach. Our failure to comply with these laws and regulations could result in fines, sanction and litigation. Additionally, new regulation in the areas of data security and privacy may increase our costs and our members' costs.

As a tax-exempt cooperative and nonbank financial institution, our lending activities are not subject to the regulations and oversight of U.S. federal agencies such as the Federal Reserve, the Federal Deposit Insurance Corporation or the Office of Comptroller of Currency. Because we are not under the purview of such regulation, we could engage in activities that could expose us to greater credit, market and liquidity risk, reduce our safety and soundness and adversely affect our financial results.

Financial institutions subject to regulations, oversight and monitoring by U.S. federal agencies are required to maintain specified levels of capital and may be restricted from engaging in certain lending-related and other activities that could adversely affect the safety and soundness of the financial institution or are considered conflicts of interest. As a tax-exempt, nonbank financial institution, we are not required by law or regulation to adhere to these requirements. There is no regulatory agency to monitor compliance with our risk policies and practices and identify and address potential deficiencies that could adversely affect our financial results. Without regulatory oversight and monitoring, there is a greater potential for us to engage in activities that could pose a risk to our safety and soundness relative to regulated financial institutions.

#### Item 1B. Unresolved Staff Comments

None.

Item 2. Properties

CFC owns approximately 141,000 square feet of office, meeting and storage space that serves as its headquarters in Loudoun County, Virginia.

19

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Item 3. Legal Proceedings

From time to time, CFC is subject to certain legal proceedings and claims in the ordinary course of business, including litigation with borrowers related to enforcement or collection actions. Management presently believes that the ultimate outcome of these proceedings, individually and in the aggregate, will not materially harm our financial position, liquidity or results of operations. CFC establishes reserves for specific legal matters when it determines that the likelihood of an unfavorable outcome is probable and the loss is reasonably estimable. Accordingly, no reserve has been recorded with respect to any legal proceedings at this time. In June 2015, RTFC received a notice of deficiency from the Virgin Islands Bureau of Internal Revenue (“BIR”) alleging that RTFC owes tax or other amounts, plus interest, in connection with tax years 1996 and 1997, and 1999 through 2005. On September 4, 2015, RTFC filed a petition with the District Court of the Virgin Islands in response to the BIR’s notice of deficiency. The BIR filed an answer to RTFC’s petition with the District Court of the Virgin Islands on December 11, 2015. The matter remains pending before the court. RTFC believes that these allegations are without merit and will continue to contest this determination.

Item 4. Mine Safety Disclosures

Not applicable.

PART II

Item 5. Market for Registrant’s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities

Not applicable.

## Item 6. Selected Financial Data

The following table provides a summary of selected financial data for the five-year period ended May 31, 2016. In addition to financial measures determined in accordance with generally accepted accounting principles in the United States (“GAAP”), management also evaluates performance based on certain non-GAAP measures, which we refer to as “adjusted” measures. Our key non-GAAP metrics consist of adjusted times interest earned ratio (“adjusted TIER”) and adjusted debt-to-equity ratio. The most comparable GAAP measures are TIER and debt-to-equity ratio, respectively. The primary adjustments we make to calculate these non-GAAP measures consist of (i) adjusting interest expense and net interest income to include the impact of net periodic derivative cash settlements; (ii) adjusting net income, senior debt and total equity to exclude the noncash impact of the accounting for derivative financial instruments; (iii) adjusting senior debt to exclude the amount that funds CFC member loans guaranteed by RUS, subordinated deferrable debt and members’ subordinated certificates; and (iv) adjusting total equity to include subordinated deferrable debt and members’ subordinated certificates. See “Item 7. MD&A—Non-GAAP Financial Measures” for a detailed reconciliation of these adjusted measures to the most comparable GAAP measures. We believe our non-GAAP adjusted metrics, which are not a substitute for GAAP and may not be consistent with similarly titled non-GAAP measures used by other companies, provide meaningful information and are useful to investors because the financial covenants in our revolving credit agreements and debt indentures are based on these adjusted metrics.

## Five-Year Summary of Selected Financial Data

(Dollars in thousands)	Year Ended May 31,					Increase/(Decrease)	
	2016	2015	2014	2013	2012	2016 vs. 2015	2015 vs. 2014
<b>Statement of operations</b>							
Interest income	\$1,012,636	\$952,976	\$957,540	\$955,753	\$960,961	6 %	—
Interest expense	(681,850)	(635,684)	(654,655)	(692,025)	(761,778)	7	(3)
Net interest income	330,786	317,292	302,885	263,728	199,183	4	5
Benefit (provision) for loan losses	646	21,954	(3,498)	70,091	18,108	(97)	(728)
Fee and other income	21,785	36,783	17,762	38,181	17,749	(41)	107
Derivative gains (losses) <sup>(1)</sup>	(309,841)	(196,999)	(34,421)	84,843	(236,620)	57	472
Results of operations of foreclosed assets	(6,899)	(120,148)	(13,494)	(897)	(67,497)	(94)	790
Operating expenses <sup>(2)</sup>	(86,343)	(76,530)	(72,566)	(84,182)	(65,337)	13	5
Other non-interest expense	(1,593)	(870)	(1,738)	(10,928)	(16,990)	83	(50)
Income (loss) before income taxes	(51,459)	(18,518)	194,930	360,836	(151,404)	178	(109)
Income tax (expense) benefit	(57)	(409)	(2,004)	(2,749)	2,607	(86)	(80)
Net income (loss)	\$(51,516)	\$(18,927)	\$192,926	\$358,087	\$(148,797)	172 %	(110) %
<b>Adjusted statement of operations</b>							
Adjusted interest expense <sup>(3)</sup>	\$(770,608)	\$(718,590)	\$(728,617)	\$(748,486)	\$(774,624)	7 %	(1) %
Adjusted net interest income <sup>(3)</sup>	242,028	234,386	228,923	207,267	186,337	3	2
Adjusted net income <sup>(3)</sup>	169,567	95,166	153,385	216,783	74,977	78	(38)
<b>Ratios</b>							
	0.92	0.97	1.29	1.52	0.80	(5) bps	(32) bps

Fixed-charge coverage ratio/TIER

(4)								
Adjusted TIER <sup>(3)</sup>	1.22	1.13	1.21	1.29	1.10	9	(8)	

21

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	May 31,					Increase/(Decrease)	
	2016	2015	2014	2013	2012	2016 vs. 2015	2015 vs. 2014
<b>Balance sheet</b>							
Cash, investments and time deposits	\$632,480	\$818,308	\$943,892	\$908,694	\$250,212	(23)%	(13)%
Loans to members <sup>(5)</sup>	23,162,696	21,469,017	20,476,642	20,305,874	18,919,612	8	5
Allowance for loan losses	(33,258 )	(33,690 )	(56,429 )	(54,325 )	(143,326 )	(1)	(40)
Loans to members, net	23,129,438	21,435,327	20,420,213	20,251,549	18,776,286	8	5
Total assets <sup>(6)</sup>	24,270,200	22,846,059	22,190,685	22,032,702	19,907,820	6	3
Short-term borrowings	2,938,848	3,127,754	4,099,331	4,557,434	3,449,593	(6)	(24)
Long-term debt	17,473,603	16,244,794	14,475,635	13,787,254	13,141,033	8	12
Subordinated deferrable debt	742,212	395,699	395,627	395,729	180,990	88	—
Members' subordinated certificates	1,443,810	1,505,420	1,612,191	1,765,776	1,739,454	(4)	(7)
Total debt outstanding <sup>(6)</sup>	22,598,473	21,273,667	20,582,784	20,506,193	18,511,070	6	3
Total liabilities <sup>(6)</sup>	23,452,822	21,934,273	21,220,311	21,221,441	19,417,065	7	3
Total equity	817,378	911,786	970,374	811,261	490,755	(10)	(6)
Guarantees <sup>(7)</sup>	909,208	986,500	1,064,822	1,112,771	1,249,330	(8)	(7)
<b>Ratios</b>							
Leverage ratio <sup>(8)</sup>	29.81	25.14	22.97	27.53	42.11	467 bps	217 bps
Adjusted leverage ratio <sup>(3)</sup>	6.08	6.58	6.24	6.11	6.45	(50)	34
Debt-to-equity ratio <sup>(9)</sup>	28.69	24.06	21.87	26.16	39.57	463	219
Adjusted debt-to-equity ratio <sup>(3)</sup>	5.82	6.26	5.90	5.76	6.00	(44)	36

— Change is less than 1% or not meaningful.

<sup>(1)</sup>Consists of derivative cash settlements and derivative forward value amounts. Derivative cash settlement amounts represent net periodic contractual interest accruals related to derivatives not designated for hedge accounting. Derivative forward value amounts represent changes in fair value during the period, excluding net periodic contractual accruals, related to derivatives not designated for hedge accounting and expense amounts reclassified into income related to the cumulative transition loss recorded in accumulated other comprehensive income (“AOCI”) as of June 1, 2001, as a result of adoption of the derivative accounting guidance that required derivatives to be reported at fair value on the balance sheet.

<sup>(2)</sup>Consists of the salaries and employee benefits and the other general and administrative expenses components of non-interest expense, each of which is presented separately on our consolidated statements of operations.

<sup>(3)</sup> See “Non-GAAP Financial Measures” for details on the calculation of these non-GAAP adjusted ratios and the reconciliation to the most comparable GAAP measures.

<sup>(4)</sup>Calculated based on net income (loss) plus interest expense for the period divided by interest expense for the period. The fixed-charge coverage ratios and TIER were the same during each period presented because we did not have any capitalized interest during these periods.

<sup>(5)</sup>Loans to members consist of the unpaid principal balance of member loans plus unamortized deferred loan origination costs, which totaled \$10 million as of May 31, 2016, 2015, 2014 and 2013, and deferred loan origination costs of \$8 million as of May 31, 2012.

<sup>(6)</sup>Total debt outstanding and total liabilities include debt issuance costs of \$57 million as of May 31, 2016. Debt issuance costs were previously classified as an asset on our consolidated balance sheets. In the first quarter of fiscal year 2016, we early-adopted the Financial Accounting Standards Board (“FASB”) guidance that amends the

presentation of debt issuance costs in the financial statements by requiring that debt issuance costs related to a recognized debt liability be presented in the balance sheet as a direct deduction from the carrying amount of that debt liability, consistent with debt discounts, rather than as an asset. We retrospectively applied this guidance, which resulted in the reclassification of unamortized debt issuance costs of \$47 million, \$42 million, \$39 million and \$44 million as of May 31, 2015, 2014, 2013 and 2012, respectively, from total assets on our consolidated balance sheet to total debt outstanding. Other than this reclassification, the adoption of the guidance did not impact our consolidated financial statements. See “Note 1—Summary of Significant Accounting Policies—Accounting Standards Adopted in Fiscal Year 2016” for additional information.

<sup>(7)</sup>Reflects the total amount of member obligations for which CFC has guaranteed payment to a third party as of the end of each period. This amount represents our maximum exposure to loss, which significantly exceeds the guarantee liability recorded on our consolidated balance sheets as the guarantee liability is determined based on anticipated losses. See “Note 13—Guarantees” for additional information.

<sup>(8)</sup>Calculated based on total liabilities and guarantees at period end divided by total equity at period end.

<sup>(9)</sup>Calculated based on total liabilities at period end divided by total equity at period end.



Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

INTRODUCTION

Our financial statements include the consolidated accounts of National Rural Utilities Cooperative Finance Corporation ("CFC"), Rural Telephone Finance Cooperative ("RTFC"), National Cooperative Services Corporation ("NCSC") and subsidiaries created and controlled by CFC to hold foreclosed assets. See "Item 1. Business—Overview" for information on the business activities of each of these entities. Unless stated otherwise, references to "we," "our" or "us" relate to CFC and its consolidated entities. All references to members within this document include members, associates and affiliates of CFC and its consolidated entities.

Management monitors a variety of key indicators to evaluate our business performance. In addition to financial measures determined in accordance with GAAP, management also evaluates performance based on certain non-GAAP measures, which we refer to as "adjusted" measures. Our primary non-GAAP metrics include adjusted net income, adjusted net interest income and net interest yield, adjusted times interest earned ratio ("adjusted TIER"), adjusted debt-to-equity ratio and adjusted leverage ratio. The most comparable GAAP measures are net income, net interest income, TIER, debt-to-equity ratio and leverage ratio, respectively. We believe our non-GAAP adjusted metrics, which are not a substitute for GAAP and may not be consistent with similarly titled non-GAAP measures used by other companies, provide meaningful information and are useful to investors because management evaluates performance based on these metrics, and the financial covenants in our revolving credit agreements and debt indentures are based on adjusted TIER and the adjusted debt-to-equity ratio. See "Non-GAAP Financial Measures" for a detailed reconciliation of these adjusted measures to the most comparable GAAP measures.

The following MD&A is intended to provide the reader with an understanding of our results of operations, financial condition and liquidity by discussing the drivers of changes from period to period and the key measures used by management to evaluate performance, such as leverage ratios, growth and credit quality metrics. MD&A is provided as a supplement to, and should be read in conjunction with, our audited consolidated financial statements and related notes in this Annual Report on Form 10-K for the fiscal year ended May 31, 2016 ("2016 Form 10-K" ) and the information contained elsewhere in this Report, including the risk factors discussed under "Part I—Item 1A. Risk Factors."

EXECUTIVE SUMMARY

Our primary objective as a member-owned cooperative lender is to provide cost-based financial products to our rural electric members while maintaining a sound financial position required for investment-grade credit ratings on our debt instruments. Our objective is not to maximize net income; therefore, the rates we charge our member-borrowers reflect our adjusted interest expense plus a spread to cover our operating expenses, a provision for loan losses and earnings sufficient to achieve interest coverage to meet our financial objectives. Our goal is to earn an annual minimum adjusted TIER of 1.10 and to achieve and maintain an adjusted debt-to-equity ratio below 6.00-to-1.

We are subject to period-to-period volatility in our reported GAAP results due to changes in market conditions and differences in the way our financial assets and liabilities are accounted for under GAAP. Our financial assets and liabilities expose us to interest-rate risk. We use derivatives, primarily interest rate swaps, as part of our strategy in managing this risk. Our derivatives are intended to economically hedge and manage the interest-rate sensitivity mismatch between our financial assets and liabilities. We are required under GAAP to carry derivatives at fair value on our consolidated balance sheet; however, our other financial assets and liabilities are carried at amortized cost. Changes in interest rates and spreads result in periodic fluctuations in the fair value of our derivatives, which may cause volatility in our earnings because we do not apply hedge accounting. As a result, the mark-to-market changes in our derivatives are recorded in earnings. Based on the composition of our derivatives, we generally record derivative losses in earnings when interest rates decline and derivative gains when interest rates rise. This earnings volatility generally is not indicative of the underlying economics of our business, as the derivative forward fair value gains or losses recorded each period may or may not be realized over time, depending on future changes in market conditions and the terms of our derivative instruments. As such, management uses our adjusted non-GAAP results, which include

realized net periodic derivative settlements but exclude the impact of unrealized derivative forward fair value gains and losses, to evaluate our operating performance. Because derivative forward

fair value gains and losses do not impact our cash flows, liquidity or ability to service our debt costs, our financial debt covenants are also based on our non-GAAP adjusted results.

## Financial Performance

### Reported Results

We reported a net loss of \$52 million and a TIER of 0.92 for fiscal year ended May 31, 2016 (“fiscal year 2016”). In comparison, we reported a net loss of \$19 million and a TIER of 0.97 for fiscal year 2015, and net income of \$193 million and a TIER of 1.29 for fiscal year 2014. The variance in our results between fiscal years was largely attributable to derivative losses, which totaled \$310 million, \$197 million and \$34 million in fiscal years 2016, 2015 and 2014, respectively. The increase in our reported net loss of \$33 million in fiscal year 2016 from the prior year was driven by the significant increase in derivative losses of \$113 million, stemming from a flattening of the yield curve, coupled with a reduction of \$21 million in the benefit recorded for loan losses, a decrease in fee and other income of \$15 million and an increase in operating expenses of \$10 million, which together more than offset the favorable impact of the absence of an impairment charge related to Caribbean Asset Holdings, LLC (“CAH”) of \$111 million recorded in fiscal year 2015 and an increase in net interest income of \$13 million. The increase in net interest income resulted from an increase in average total loans of \$1,669 million, or 8%, from the prior year. Our debt-to-equity ratio increased to 28.69 as of May 31, 2016, from 24.06 as of May 31, 2015, mainly due to increased borrowings to fund the growth in our loan portfolio and a decrease in equity resulting from our reported net loss and patronage capital retirement.

### Adjusted Non-GAAP Results

Our adjusted net income totaled \$170 million and our adjusted TIER was 1.22 for fiscal year 2016. In comparison, we had adjusted net income of \$95 million and adjusted TIER of 1.13 for fiscal year 2015, and adjusted net income of \$153 million and adjusted TIER of 1.21 for fiscal year 2014. The increase in adjusted net income of \$74 million in fiscal year 2016 from the prior year was driven by the absence of the CAH impairment charge of \$111 million recorded in fiscal year 2015 and an increase in adjusted net interest income of \$8 million, resulting from the growth in average total loan balances, as noted above. The favorable impact of these items was partially offset by the reduction in the benefit recorded for loan losses, the decrease in fee and other income and higher operating expenses. Our adjusted debt-to-equity ratio decreased to 5.82 as of May 31, 2016, from 6.26 as of May 31, 2015, predominately due to an increase in adjusted equity resulting from the issuance of \$350 million of subordinated deferrable debt in the fourth quarter of fiscal year 2016.

### Lending Activity

Total loans outstanding, which consists of the unpaid principal balance and excludes deferred loan origination costs, was \$23,153 million as of May 31, 2016, an increase of \$1,693 million, or 8%, from May 31, 2015. The increase was primarily due to an increase in CFC distribution and power supply loans of \$1,579 million and \$220 million, respectively, which was largely attributable to members refinancing with us loans made by other lenders and member advances for capital investments. This increase was partially offset by a decrease in NCSC loans of \$51 million and a decrease in RTFC loans of \$44 million.

Long-term fixed-rate loans totaling \$1,078 million repriced during fiscal year 2016. Of this total, \$1,001 million repriced to a new long-term fixed rate; \$55 million repriced to a long-term variable rate; \$4 million repriced to a new rate offered as part of our loan sales program; and \$18 million were repaid in full.

As part of our strategy in managing our credit risk exposure, we entered into a long-term standby purchase commitment agreement with Farmer Mac on August 31, 2015, as amended on May 31, 2016. Under this agreement,

we may designate certain loans to be covered under the commitment, subject to approval by Farmer Mac, and in the event any such loan later goes into material default for at least 90 days, upon request by us, Farmer Mac must purchase such loan at par value. We designated, and Farmer Mac approved loans that had an aggregate outstanding principal balance of \$926 million as of May 31, 2016. No loans had been put to Farmer Mac for purchase, pursuant to this agreement, as of May 31, 2016.

## Financing Activity

Our outstanding debt volume generally increases and decreases in response to member loan demand. As outstanding loan balances increased during fiscal year 2016, our debt volume also increased. Total debt outstanding was \$22,598 million as of May 31, 2016, an increase of \$1,325 million, or 6%, from May 31, 2015. The increase was primarily attributable to an increase of \$498 million in collateral trust bonds, an increase of \$392 million under the note purchase agreement with Farmer Mac, an increase of \$371 million under the Guaranteed Underwriter Program of USDA and an increase of \$347 million in subordinated deferrable debt.

In July 2015, we executed a new three-year \$300 million secured revolving note purchase agreement with Farmer Mac to provide an additional source of liquidity. In November 2015, we amended and restated our \$1,665 million three-year and \$1,645 million five-year bank revolving line of credit agreements with a syndicate of banks, which resulted in an extension of the maturity dates to November 19, 2018 and November 19, 2020, respectively, from October 28, 2017 and October 28, 2019, respectively. Commitments of \$25 million under the three-year agreement will expire at the prior maturity date of October 28, 2017. Commitments of \$45 million under the five-year agreement will expire at the prior maturity date of October 28, 2019.

On March 29, 2016, we closed on a \$250 million committed loan facility (“Series K”) under the Guaranteed Underwriter Program. Under the Series K facility, we are able to borrow any time before January 15, 2019, with each advance having a final maturity no longer than 20 years from the advance date.

We provide additional information on our financing activities below under “Consolidated Balance Sheet Analysis—Debt” and “Liquidity Risk.”

## Outlook for the Next 12 Months

We currently expect the amount of new long-term loan advances to exceed scheduled loan repayments over the next 12 months. However, we anticipate a decline in earnings from our core lending operations, which we refer to as our adjusted net interest income, over the next 12 months primarily due to a continued decline in the average yield of our loan portfolio, coupled with an expected increase in interest expense.

Long-term debt scheduled to mature over the next 12 months totaled \$2,552 million as of May 31, 2016. We believe we have sufficient liquidity from the combination of existing cash and time deposits, member loan repayments, committed loan facilities and our ability to issue debt in the capital markets, to our members and in private placements to meet the demand for member loan advances and satisfy our obligations to repay long-term debt maturing over the next 12 months. We also may consider the early redemption of certain maturing debt to reduce large debt maturity amounts when it is economically feasible. As of May 31, 2016, we had access to liquidity reserves totaling \$6,951 million, which consisted of \$545 million in cash and cash equivalents and time deposits, up to \$600 million available under committed loan facilities from the Federal Financing Bank under the Guaranteed Underwriter Program, \$3,309 million available under committed bank revolving lines of credit, up to \$300 million available under a note purchase agreement with Farmer Mac executed during fiscal year 2016 and, subject to market conditions, up to \$2,197 million available under the previously existing revolving note purchase agreement with Farmer Mac.

We believe we can continue to roll over member outstanding short-term debt of \$2,279 million as of May 31, 2016, based on our expectation that our members will continue to reinvest their excess cash in our commercial paper, daily liquidity fund and select notes. We expect to continue to roll over our outstanding dealer commercial paper of \$660 million as of May 31, 2016. We intend to manage our short-term wholesale funding risk by maintaining outstanding dealer commercial paper at an amount below \$1,250 million for the foreseeable future. We expect to continue to be in compliance with the covenants under our revolving credit agreements, which will allow us to mitigate our roll-over risk as we can draw on these facilities to repay dealer or member commercial paper that cannot be rolled over.

Our goal is to achieve and maintain an adjusted debt-to-equity ratio at or below 6.00. However, because of the significant increase in outstanding loan balances during the fiscal year 2016, it was necessary to increase our borrowings to fund the loan growth, which caused our adjusted debt-to-equity ratio to exceed our targeted ratio for an extended period. As discussed above, we issued \$350 million of subordinated deferrable debt in the capital markets in the fourth quarter of fiscal

25

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year 2016 to manage and reduce our adjusted debt-to-equity ratio below our targeted maximum ratio. As a result, our adjusted debt-to-equity ratio fell to 5.82 as of May 31, 2016. We expect to maintain our adjusted debt-to-equity ratio at a level of 6.00 or below over the next 12 months. As indicated below in “Non-GAAP Financial” measures, subordinated debt is treated in the same manner as equity in calculating our adjusted debt-to-equity ratio pursuant to the financial covenants under our revolving bank line of credit agreements.

#### Subsequent Event

On September 30, 2015, CFC entered into a Purchase Agreement (as amended, the “Purchase Agreement”) with CAH, ATN VI Holdings, LLC (“Buyer”) and ATN International, Inc. (formerly Atlantic Tele-Network, Inc.), the parent corporation of Buyer, to sell all of the issued and outstanding membership interests of CAH to Buyer for a purchase price of \$145 million, subject to certain adjustments described in the Purchase Agreement.

On July 1, 2016, the Purchase Agreement was amended and the sale of CAH was completed for a purchase price of approximately \$144 million. Our net proceeds at closing totaled \$109 million, which represents the purchase price of \$144 million less agreed-upon purchase price adjustments and transaction costs as of the closing date. The net proceeds are subject to post-closing adjustments, which are due from Buyer within 60 days of the closing date for review by us. CFC also remains subject to potential indemnification claims, as specified in the Purchase Agreement. Upon closing, \$16 million of the sale proceeds were deposited into escrow to fund potential indemnification claims for a period of 15 months following the closing. In connection with the sale, RTFC provided a loan in the amount of \$60 million to Buyer to finance a portion of the transaction. ATN International has provided a guarantee on an unsecured basis of Buyer’s obligations to RTFC pursuant to the financing. We provide additional information on the sale of CAH, including the impact on our financial statements, below under “MD&A—Consolidated Results of Operations—Non-Interest Income” and “Note 5—Foreclosed Assets.”

#### CRITICAL ACCOUNTING POLICIES AND ESTIMATES

The preparation of financial statements in accordance with GAAP requires management to make a number of judgments, estimates and assumptions that affect the amount of assets, liabilities, income and expenses in the consolidated financial statements. Understanding our accounting policies and the extent to which we use management’s judgment and estimates in applying these policies is integral to understanding our financial statements. We provide a discussion of our significant accounting policies under “Note 1—Summary of Significant Accounting Policies.”

We have identified certain accounting policies as critical because they involve significant judgments and assumptions about highly complex and inherently uncertain matters, and the use of reasonably different estimates and assumptions could have a material impact on our results of operations or financial condition. Our most critical accounting policies and estimates involve the determination of the allowance for loan losses and fair value. We evaluate our critical accounting estimates and judgments required by our policies on an ongoing basis and update them as necessary based on changing conditions. There were no material changes in the assumptions used in our critical accounting policies and estimates during the current year.

Management has discussed significant judgments and assumptions in applying our critical accounting policies with the Audit Committee of our board of directors. See “Item 1A. Risk Factors” for a discussion of the risks associated with management’s judgments and estimates in applying our accounting policies and methods.

#### Allowance for Loan Losses

We maintain an allowance for loan losses that represents management’s estimate of probable losses inherent in our loan portfolio as of each balance sheet date. Our allowance for loan losses, which totaled \$33 million and \$34 million as of

May 31, 2016 and 2015, respectively, includes a collective allowance for all loans in our portfolio that are not individually impaired and a specific allowance for individually impaired loans.

#### Collective Allowance

As part of our credit risk management process, we regularly evaluate each borrower and loan in our loan portfolio and assign an internal risk rating. We engage an independent third party to perform an annual review of a sample of loans to corroborate the internally assigned risk ratings. The collective loss reserve is calculated using an internal model to estimate incurred losses for segments within our loan portfolio that have similar risk characteristics. Our loan segments, which are



based on member borrower type, are stratified further into loan pools based on the borrower risk rating. We then apply loss factors to the outstanding principal balance of each of these loan pools. The loss factors reflect the probability of default, or default rate, and the loss severity, or recovery rate, over an estimated loss emergence period of five years for each loan pool. We utilize third-party industry default data to estimate default rates. We utilize our historical loss experience for each borrower type, adjusted for management's judgment, to estimate recovery rates. Management may also apply judgment to adjust the loss factors derived from our models, taking into consideration model imprecision and specific, known events, such as current credit conditions, that may affect the credit quality of our loan portfolio but are not yet reflected in our model-generated loss factors. We determine the collective allowance by applying the default rate and recovery rate to each loan pool.

#### Specific Allowance

The specific allowance for individually impaired loans that are not collateral dependent is calculated based on the difference between the recorded investment in the loan and the present value of the expected future cash flows, discounted at the loan's effective interest rate. If the loan is collateral dependent, we measure the impairment based on the current fair value of the collateral less estimated selling costs.

#### Key Assumptions

Determining the appropriateness of the allowance for loan losses is a complex process subject to numerous estimates and assumptions requiring significant management judgment about matters that involve a high degree of subjectivity and are difficult to predict. The key assumptions in determining our collective allowance that require significant management judgment and may have a material impact on the amount of the allowance include our evaluation of the risk profile of various loan portfolio segments and the internally assigned borrower risk ratings; the estimated loss emergence period; the selection of third-party proxy data to determine the probability of default; our historical loss experience and assumptions regarding recovery rates; and management's judgment in the selection and evaluation of qualitative factors to assess the overall current level of exposure within our loan portfolio. The key assumptions in determining our specific allowance that require significant management judgment and may have a material impact on the amount of the allowance include estimating the amount and timing of expected cash flows from impaired loans and estimating the value of underlying collateral, which impacts loss severity and certain cash flow assumptions. The degree to which any particular assumption affects the allowance for loan losses depends on the severity of the change and its relationship to the other assumptions.

We regularly evaluate the underlying assumptions we use in determining the allowance for loan losses and periodically update our assumptions to better reflect present conditions, including current trends in borrower risk and/or general economic trends, portfolio concentration risk, changes in risk management practices, changes in the regulatory environment and other environmental factors specific to our loan portfolio segments. We did not change the nature of the underlying assumptions and inputs used in determining our allowance for loan losses during fiscal year 2016. At the end of fiscal year 2015, we adjusted the recovery rate assumptions used in determining the collective allowance for loan losses for certain portfolio segments to reflect our most recent historical loss experience and made adjustments to certain qualitative factors that we consider in estimating losses. These changes in assumptions, which accounted for \$18 million of the \$23 million total reduction in the allowance for loan losses as of May 31, 2015, were a significant driver of the benefit for loan losses of \$22 million recorded in fiscal year 2015. In comparison, we recorded a benefit for loan losses of \$1 million for the current fiscal year 2016.

#### Sensitivity Analysis

As noted above, our allowance for credit losses is sensitive to numerous factors, depending on the portfolio segment. Changes in our assumptions or economic conditions could affect our estimate of probable credit losses inherent in the

portfolio at the balance sheet date, which would also impact the related provision for loan losses recognized in our consolidated results of operations. For example, changes in the inputs below, without consideration of any offsetting or correlated effects of other inputs, would have the following effects on our total allowance of loan losses as of May 31, 2016.

A 10% increase or decrease in the default rates for all of our portfolio segments would result in a corresponding increase or decrease of \$3 million.

27

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• A 1% increase or decrease in the recovery rates for all of our portfolio segments would result in a corresponding decrease or increase of \$3 million.

• A one-notch downgrade in the internal risk ratings for our entire loan portfolio would result in an increase of approximately \$36 million, while a one-notch upgrade would result in a decrease of approximately \$17 million.

The purpose of these sensitivity analyses is to provide an indication of the isolated impacts of hypothetical alternative assumptions on modeled loss estimates. It is difficult to estimate how potential changes in a specific factor might affect the total allowance for loan losses because management evaluates a variety of factors and inputs in estimating the allowance for loan losses.

We provide additional information on the methodology for determining the allowance for loan losses in “Note 1—Summary of Significant Accounting Policies” and changes in our allowance for loan losses in “Note 4—Loans and Commitments.”

### Fair Value

A portion of our assets and liabilities are carried at fair value on our consolidated balance sheet, with changes in fair value recorded either through earnings or other comprehensive income (loss) in accordance with applicable accounting standards. These include all available-for-sale investment securities and derivatives. The determination of fair value is important for certain other assets that are periodically evaluated for impairment using fair value, such as individually impaired loans and foreclosed assets.

Fair value is defined as the price that would be received for an asset or paid to transfer a liability in an orderly transaction between market participants on the measurement date (also referred to as an exit price). The fair value accounting guidance provides a three-level fair value hierarchy for classifying fair value measurement techniques. This hierarchy is based on the markets in which the assets or liabilities trade and whether the inputs to the valuation techniques used to measure fair value are observable or unobservable. Fair value measurement is assigned a level based on the lowest level of any input that is significant to the fair value measurement in its entirety. The three levels of the fair value hierarchy are summarized below:

Level 1: Quoted prices (unadjusted) in active markets for identical assets or liabilities

Level 2: Observable market-based inputs, other than quoted prices in active markets for identical assets or liabilities

Level 3: Unobservable inputs

The degree of management judgment involved in determining fair value is dependent upon the availability of quoted prices in active markets or observable market parameters. When quoted prices and observable data in active markets are not fully available, management’s judgment is necessary to estimate fair value. Changes in market conditions, such as reduced liquidity in the capital markets or changes in secondary market activities, may reduce the availability and reliability of quoted prices or observable data used to determine fair value.

Significant judgment may be required to determine whether certain assets and liabilities measured at fair value are classified as Level 2 or Level 3. In making this determination, we consider all available information that market participants use to measure fair value, including observable market data, indications of market liquidity and orderliness, and our understanding of the valuation techniques and significant inputs used. Based upon the specific facts and circumstances, judgments are made regarding the significance of Level 3 inputs used in determining the fair value of the asset or liability in its entirety. If Level 3 inputs are considered significant, the valuation technique is classified as Level 3. The process for determining fair value using unobservable inputs is generally more subjective and involves a high degree of management judgment and assumptions.

Assets and liabilities recorded at fair value on a recurring basis consisted primarily of financial instruments, including available-for-sale investment securities, deferred compensation investments and derivatives, represented 1% of our total assets as of both May 31, 2016 and 2015, and 3% and 2%, respectively, of total liabilities as of May 31, 2016 and 2015. The fair value of these financial instruments was determined using either Level 1 or 2 inputs. We did not have any financial instruments recorded at fair value on a recurring basis for which the fair value was determined using Level 3 inputs as of May 31, 2016 and 2015.

We discuss the valuation inputs and assumptions used in determining the fair value, including the extent to which we have relied on significant unobservable inputs to estimate fair value, in “Note 14—Fair Value Measurement.”

#### ACCOUNTING CHANGES AND DEVELOPMENTS

See “Note 1—Summary of Significant Accounting Policies” for information on accounting standards adopted in fiscal year 2016, as well as recently issued accounting standards not yet required to be adopted and the expected impact of these accounting standards. To the extent we believe the adoption of new accounting standards has had or will have a material impact on our results of operations, financial condition or liquidity, we discuss the impacts in the applicable section(s) of MD&A.

#### CONSOLIDATED RESULTS OF OPERATIONS

The section below provides a comparative discussion of our consolidated results of operations between fiscal year 2016 and 2015 and between fiscal year 2015 and 2014. Following this section, we provide a comparative analysis of our consolidated balance sheets as of May 31, 2016 and 2015. You should read these sections together with our “Executive Summary—Outlook for the Next 12 Months” where we discuss trends and other factors that we expect will affect our future results of operations.

#### Net Interest Income

Net interest income represents the difference between the interest income and applicable fees earned on our interest-earning assets, which include loans and investment securities, and the interest expense on our interest-bearing liabilities. Our net interest yield represents the difference between the yield on our interest-earning assets and the cost of our interest-bearing liabilities plus the impact from non-interest bearing funding. We expect net interest income and our net interest yield to fluctuate based on changes in interest rates and changes in the amount and composition of our interest-earning assets and interest-bearing liabilities. We do not fund each individual loan with specific debt. Rather, we attempt to minimize costs and maximize efficiency by funding large aggregated amounts of loans.

Table 1 presents our average balance sheets for fiscal years 2016, 2015 and 2014, and for each major category of our interest-earning assets and interest-bearing liabilities, the interest income earned or interest expense incurred, and the average yield or cost. Table 1 also presents non-GAAP adjusted interest expense, adjusted net interest income and adjusted net interest yield, which reflect the inclusion of net accrued periodic derivative cash settlements in interest expense. We provide reconciliations of our non-GAAP adjusted measures to the most comparable GAAP measures under “Non-GAAP Financial Measures.”

Table 1: Average Balances, Interest Income/Interest Expense and Average Yield/Cost  
Year Ended May 31,

(Dollars in thousands)	2016		2015		2014					
Assets:	Average Balance	Interest Income/Expense	Average Yield/Cost	Average Balance	Interest Income/Expense	Average Yield/Cost	Average Balance	Interest Income/Expense	Average Yield/Cost	
Long-term fixed-rate loans <sup>(1)</sup>	\$20,734,387	\$959,701	4.63 %	\$18,990,768	\$898,181	4.73 %	\$18,377,834	\$897,918	4.89 %	
Long-term variable-rate loans	708,801	19,858	2.80	702,397	20,184	2.87	737,186	20,388	2.77	
Line of credit loans	1,031,548	24,864	2.41	1,119,647	26,411	2.36	1,278,549	31,376	2.45	
Restructured loans	12,947	512	3.95	7,560	15	0.20	10,819	136	1.26	
Nonperforming loans	3,164	142	4.49	1,572	—	—	7,952	236	2.97	
Interest-based fee income <sup>(2)</sup>	—	(1,088)	—	—	252	—	—	406	—	
Total loans	22,490,847	1,003,989	4.46	20,821,944	945,043	4.54	20,412,340	950,460	4.66	
Cash, investments and time deposits	639,060	8,647	1.35	806,942	7,933	0.98	953,589	7,080	0.74	
Total interest-earning assets	\$23,129,907	\$1,012,636	4.38 %	\$21,628,886	\$952,976	4.41 %	\$21,365,929	\$957,540	4.48 %	
Other assets, less allowance for loan losses	808,479			944,746			1,225,389			
Total assets	\$23,938,386			\$22,573,632			\$22,591,318			
Liabilities:										
Short-term debt	\$2,995,530	\$14,728	0.49 %	\$3,586,509	\$14,374	0.40 %	\$4,282,107	\$13,457	0.31 %	
Medium-term notes	3,412,061	86,270	2.53	2,926,721	71,739	2.45	2,804,289	85,502	3.05	
Collateral trust bonds	6,917,265	333,338	4.82	6,288,187	315,106	5.01	5,898,955	305,760	5.18	
Subordinated deferrable debt	435,488	21,245	4.88	400,000	19,143	4.79	395,661	19,118	4.83	
Subordinated certificates	1,458,376	60,449	4.14	1,488,059	63,559	4.27	1,663,847	79,195	4.76	
Long-term notes payable	6,818,705	165,820	2.43	5,988,964	151,763	2.53	5,502,370	151,623	2.76	
Total interest-bearing liabilities	\$22,037,425	\$681,850	3.09 %	\$20,678,440	\$635,684	3.07 %	\$20,547,229	\$654,655	3.19 %	
Other liabilities	1,036,907			954,638			1,101,475			
Total liabilities	23,074,332			21,633,078			21,648,704			
Total equity	864,054			940,554			942,614			

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Total liabilities and equity	\$23,938,386		\$22,573,632		\$22,591,318	
Net interest spread <sup>(3)</sup>		1.29 %		1.34 %		1.29 %
Impact of non-interest bearing funding <sup>(4)</sup>		0.14		0.13		0.13
Net interest income/net interest yield <sup>(5)</sup>	\$330,786	1.43 %	\$317,292	1.47 %	\$302,885	1.42 %
Adjusted net interest income/adjusted net interest yield:						
Interest income	\$1,012,636	4.38 %	\$952,976	4.41 %	\$957,540	4.48 %
Interest expense	681,850	3.09	635,684	3.07	654,655	3.19
Add: Net accrued periodic derivative cash settlements <sup>(6)</sup>	88,758	0.89	82,906	0.94	73,962	0.88
Adjusted interest expense/adjusted average cost <sup>(7)</sup>	\$770,608	3.50 %	\$718,590	3.48 %	\$728,617	3.55 %
Adjusted net interest spread <sup>(3)</sup>		0.88 %		0.93 %		0.93 %
Impact of non-interest bearing funding		0.17		0.15		0.14
Adjusted net interest income/adjusted net interest yield <sup>(8)</sup>	\$242,028	1.05 %	\$234,386	1.08 %	\$228,923	1.07 %

(1)Interest income includes loan conversion fees, which are generally deferred and recognized in interest income using the effective interest method. A small portion of conversion fees that are intended to cover the administrative costs related to the loan conversion are recognized into interest income immediately at the date of conversion.

(2)Amounts primarily include the amortization of deferred loan origination costs and late payment fees. Up-front loan arranger fees, which are not based on interest rates, are included in fee and other income for fiscal year 2016.

(3)Net interest spread represents the difference between the average yield on interest-earning assets and the average cost of interest-bearing funding. Adjusted net interest spread represents the difference between the average yield on interest-earning assets and the adjusted average cost of interest-bearing funding.

(4)Includes other liabilities and equity.

(5)Net interest yield is calculated based on net interest income for the period divided by average interest-earning assets for the period.

(6)Represents the impact of net accrued periodic derivative cash settlements during the period, which is added to interest expense to derive non-GAAP adjusted interest expense. The average (benefit)/cost associated with derivatives is calculated based on the net accrued periodic derivative cash settlements during the period divided by the average outstanding notional amount of derivatives during the period. The average outstanding notional amount of derivatives was \$9,993 million, \$8,811 million and \$8,381 million for fiscal years 2016, 2015 and 2014, respectively.

(7)Adjusted interest expense represents interest expense plus net accrued derivative cash settlements during the period. Net accrued derivative cash settlements are reported on our consolidated statements of operations as a component of derivative gains (losses). Adjusted average cost is calculated based on adjusted interest expense for the period divided by average interest-bearing funding during the period.

(8)Adjusted net interest yield is calculated based on adjusted net interest income for the period divided by average interest-earning assets for the period.

Table 2 displays the change in our net interest income between periods and the extent to which the variance is attributable to (i) changes in the volume of our interest-earning assets and interest-bearing liabilities or (ii) changes in the interest rates of these assets and liabilities. The table also presents the change in adjusted net interest income between periods.



Table 2: Rate/Volume Analysis of Changes in Interest Income/Interest Expense

(Dollars in thousands)	2016 vs. 2015			2015 vs. 2014		
	Total	Variance due to: <sup>(1)</sup>		Total	Variance due to: <sup>(1)</sup>	
		Variance	Volume		Rate	Variance
<b>Interest income:</b>						
Long-term fixed-rate loans	\$61,520	\$82,466	\$(20,946)	\$263	\$29,947	\$(29,684)
Long-term variable-rate loans	(326 )	184	(510 )	(204 )	(962 )	758
Line of credit loans	(1,547 )	(2,078 )	531	(4,965 )	(3,900 )	(1,065 )
Restructured loans	497	11	486	(121 )	(41 )	(80 )
Nonperforming loans	142	—	142	(236 )	(189 )	(47 )
Fee income	(1,340 )	—	(1,340 )	(154 )	—	(154 )
Total loans	58,946	80,583	(21,637 )	(5,417 )	24,855	(30,272 )
Cash, investments and time deposits	714	(1,650 )	2,364	853	(1,089 )	1,942
Interest income	\$59,660	\$78,933	\$(19,273)	\$(4,564)	\$23,766	\$(28,330)
<b>Interest expense:</b>						
Short-term debt	\$354	\$(2,369 )	\$2,723	\$917	\$(2,186 )	\$3,103
Medium-term notes	14,531	11,897	2,634	(13,763 )	3,733	(17,496 )
Collateral trust bonds	18,232	31,524	(13,292 )	9,346	20,175	(10,829 )
Long-term notes payable	14,057	21,026	(6,969 )	140	13,409	(13,269 )
Subordinated deferrable debt	2,102	1,698	404	25	210	(185 )
Subordinated certificates	(3,110 )	(1,268 )	(1,842 )	(15,636 )	(8,367 )	(7,269 )
Interest expense	46,166	62,508	(16,342 )	(18,971 )	26,974	(45,945 )
Net interest income	\$13,494	\$16,425	\$(2,931 )	\$14,407	\$(3,208 )	\$17,615
<b>Adjusted net interest income:</b>						
Interest income	\$59,660	\$78,933	\$(19,273)	\$(4,564)	\$23,766	\$(28,330)
Interest expense	46,166	62,508	(16,342 )	(18,971 )	26,974	(45,945 )
Net accrued periodic derivative cash settlements <sup>(2)</sup>	5,852	11,122	(5,270 )	8,944	3,797	5,147
Adjusted interest expense <sup>(3)</sup>	52,018	73,630	(21,612 )	(10,027 )	30,771	(40,798 )
Adjusted net interest income	\$7,642	\$5,303	\$2,339	\$5,463	\$(7,005 )	\$12,468

<sup>(1)</sup>The changes for each category of interest income and interest expense are divided between the portion of change attributable to the variance in volume and the portion of change attributable to the variance in rate for that category. The amount attributable to the combined impact of volume and rate has been allocated to each category based on the proportionate absolute dollar amount of change for that category.

<sup>(2)</sup>For net accrued periodic derivative cash settlements, the variance due to average volume represents the change in derivative cash settlements resulting from the change in the average notional amount of derivative contracts outstanding. The variance due to average rate represents the change in derivative cash settlements resulting from the net difference between the average rate paid and the average rate received for interest rate swaps during the period.

<sup>(3)</sup> See “Non-GAAP Financial Measures” for additional information on our adjusted non-GAAP measures.

Net interest income of \$331 million for fiscal year 2016 increased by \$13 million, or 4%, from fiscal year 2015, driven by an increase in average interest-earning assets of 7%, which was partially offset by a decrease in the net interest yield of 3% (4 basis points) to 1.43%.

▲Average Interest-Earning Assets: The increase in average interest-earning assets during fiscal year 2016 was primarily attributable to growth in average total loans of \$1,669 million, or 8%, over the prior year, as members refinanced with

us loans made by other lenders and obtained advances to fund capital investments.

**Net Interest Yield:** The decrease in the net interest yield in fiscal year 2016 reflects the combined impact of a slight increase in our average cost of funds and a modest decline in the average yield on interest-earning assets. Our average cost of funds increased by 2 basis points in fiscal year 2016 to 3.09%. This increase was largely due to our decision in the third quarter of fiscal year 2015 to significantly reduce the level of outstanding dealer commercial paper, which has a much lower cost than our other funding options. The decrease in the average yield on interest-earning assets of 3 basis points in fiscal year 2016 to 4.38% was largely attributable to reduced rates on fixed-rate loans, reflecting the repricing of higher-rate loans to lower interest rates and lower interest rates on new loan originations as a result of the overall low interest rate environment.

Net interest income of \$317 million in fiscal 2015 increased by \$14 million, or 5%, from fiscal year 2014, driven by an increase in the net interest yield of 4% (5 basis points) to 1.47%, coupled with a 1% increase in average interest-earning assets.

**Average Interest-Earning Assets:** Average interest-earning assets increased modestly during fiscal year 2015, reflecting loan advances that exceeded loan payments as members refinanced with us loans issued by other lenders and obtained advances to fund capital investments.

**Net Interest Yield:** The increase in the net interest yield in fiscal year 2015 was largely attributable to a reduction in our cost of funds from the refinancing of maturing higher-cost debt with lower-cost debt, which more than offset a decrease in the average yield on interest-earning assets.

Adjusted net interest income of \$242 million in fiscal year 2016 increased by \$8 million, or 3%, from the prior year, driven by an increase in average interest-earning assets of 7%, which was partially offset by a decrease in the adjusted net interest yield of 3% (3 basis points) to 1.05%. The decrease in the adjusted net interest yield also reflected the combined impact of an increase in our average cost of funds resulting from actions taken in the third quarter of fiscal year 2015 to significantly reduce the level of lower-cost dealer commercial paper, coupled with the decline in the average yield on interest-earning assets.

Adjusted net interest income of \$234 million in fiscal year 2015 increased by \$5 million, or 2%, from the prior year, driven by an increase in the adjusted net interest yield of 1% (1 basis point) to 1.08%, coupled with a 1% increase in average interest-earning assets.

Our adjusted net interest income and adjusted net interest yield include the impact of net accrued periodic derivative cash settlements during the year. We recorded net periodic derivative cash settlement expense of \$89 million, \$83 million and \$74 million in fiscal years 2016, 2015 and 2014, respectively. See “Non-GAAP Financial Measures” for additional information on our adjusted measures.

#### Provision for Loan Losses

Our provision for loan losses in each period is primarily driven by the level of allowance that we determine is necessary for probable incurred loan losses inherent in our loan portfolio as of each balance sheet date.

We recorded a benefit for loan losses of \$1 million and \$22 million in fiscal years 2016 and 2015, respectively, compared with a provision of \$3 million in fiscal year 2014. The change in the provision for loan losses between fiscal years was primarily attributable to a reduction in the allowance for loan losses of \$23 million during fiscal year 2015, which mainly resulted from an increase in recovery rates used in determining the allowance as of May 31, 2015. The increase in the recovery rates, which are based on historical data, accounted for \$18 million of the \$23 million reduction in the allowance for loan losses as of May 31, 2015. See “Critical Accounting Policies and Estimates—Allowance for Loan Losses” for additional information on these changes in assumptions.

Excluding the impact of the change in the allowance attributable to the changes in assumptions made in fiscal year 2015, our provision for loan losses over the past three fiscal years has ranged from a benefit of \$1 million and \$4 million in fiscal year 2016 and 2015, respectively, and a provision of \$3 million in fiscal year 2014, reflecting an overall improvement in the credit quality and risk profile of our loan portfolio.

We provide additional information on our allowance for loan losses under “Credit Risk—Allowance for Loan Losses” and “Note 4—Loans and Commitments” of this Report. For information on our allowance methodology, see “Critical Accounting Policies and Estimates” and “Note 1—Summary of Significant Accounting Policies” of this Report.

#### Non-Interest Income

Non-interest income consists of fee and other income, gains and losses on derivatives not accounted for in hedge accounting relationships and results of operations of foreclosed assets.

We recorded losses from non-interest income of \$295 million and \$280 million and \$30 million in fiscal years 2016, 2015 and 2014, respectively. The variances in non-interest income between periods were primarily attributable to changes in net derivative losses recognized in our consolidated statements of operations and the results of operations of CAH, which we sold on July 1, 2016. In addition, prepayment fees on loans paid off prior to maturity may contribute to variances in non-interest income.

#### Derivative Gains (Losses)

Our derivative instruments are an integral part of our interest rate risk management strategy. Our principal purpose in using derivatives is to manage our aggregate interest rate risk profile within prescribed risk parameters. The derivative instruments we use primarily include interest rate swaps, which we typically hold to maturity. The primary factors affecting the fair value of our derivatives and derivative gains (losses) recorded in our results of operations include changes in interest rates, the shape of the yield curve and the composition of our derivative portfolio. We generally do not designate interest rate swaps, which presently account for all of our derivatives, for hedge accounting.

Accordingly, changes in the fair value of interest rate swaps are reported in our consolidated statements of operations under derivative gains (losses). We did not have any derivatives designated as accounting hedges as of May 31, 2016 and 2015.

We currently use two types of interest rate swap agreements: (i) we pay a fixed rate and receive a variable rate (“pay-fixed swaps”) and (ii) we pay a variable rate and receive a fixed rate (“receive-fixed swaps”). The benchmark rate for the substantial majority of the floating rate payments under our swap agreements is the London Interbank Offered Rate (“LIBOR”). Table 3 displays the average notional amount outstanding, by swap agreement type, and the weighted-average interest rate paid and received for derivative cash settlements during fiscal years 2016, 2015 and 2014. As indicated in

Table 3, our derivative portfolio currently consists of a higher proportion of pay-fixed swaps than receive-fixed swaps. The profile of our derivative portfolio may change as a result of changes in market conditions and actions taken to manage interest rate risk.

Table 3: Derivative Average Notional Amounts and Average Interest Rates

	Year Ended May 31,									
	2016				2015				2014	
(Dollars in thousands)	Average Notional Balance	Weighted-Average Rate Paid	Weighted-Average Rate Received	Average Notional Balance	Weighted-Average Rate Paid	Weighted-Average Rate Received	Average Notional Balance	Weighted-Average Rate Paid	Weighted-Average Rate Received	
Pay-fixed swaps	\$6,322,338	3.03 %	0.45 %	\$5,583,647	3.25 %	0.25 %	\$5,310,019	3.36 %	0.24 %	
Receive-fixed swaps	3,670,585	0.88	2.97	3,227,288	0.83	3.45	3,070,679	0.94	3.95	
Total	\$9,992,923	2.24 %	1.38 %	\$8,810,935	2.36 %	1.43 %	\$8,380,698	2.47 %	1.60 %	

The average remaining maturity of our pay-fixed and receive-fixed swaps was 18 years and three years, respectively, as of May 31, 2016. In comparison, the average remaining maturity of our pay-fixed and receive-fixed swaps was 16 years and three years, respectively, as of May 31, 2015.

Pay-fixed swaps generally decrease in value as interest rates decline and increase in value as interest rates rise. In contrast, receive-fixed swaps generally increase in value as interest rates decline and decrease in value as interest rates rise. Because our pay-fixed and receive-fixed swaps are referenced to different maturity terms along the swap yield curve, different changes in the swap yield curve—parallel, flattening or steepening—will result in differences in the fair value of our

derivatives. See “Note 14—Fair Value Measurement” for information on how we estimate the fair value of our derivative instruments. The chart below provides comparative yield curves as of May 31, 2016, 2015 and 2014.

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Benchmark rates obtained from Bloomberg.

We recorded derivative losses of \$310 million, \$197 million and \$34 million in fiscal years 2016, 2015 and 2014, respectively. Table 4 presents the components of net derivative gains (losses) recorded in our consolidated results of operations. Derivative cash settlements represent the net interest amount accrued during a period for interest-rate swap payments. The derivative forward value represents the change in fair value of our interest rate swaps during the reporting period due to changes in expected future interest rates over the remaining life of our derivative contracts.

Table 4: Derivative Gains (Losses)

(Dollars in thousands)	Year Ended May 31,		
	2016	2015	2014
Derivative gains (losses) attributable to:			
Derivative cash settlements	\$(88,758 )	\$(82,906 )	\$(73,962)
Derivative forward value gain (loss)	(221,083 )	(114,093 )	39,541
Derivative losses	\$(309,841)	\$(196,999)	\$(34,421)

The derivative losses of \$310 million in fiscal year 2016 were primarily attributable to a net decrease in the fair value of our swaps due to a flattening of the swap yield curve resulting from an increase in short-term interest rates and a decline in long-term interest rates, as depicted in the chart of the comparative yield curves above. This flattening of the yield curve was more pronounced during the third quarter as the U.S. Federal Reserve raised the short-term federal funds rate by 25 basis points in December 2015, the first rate change since the federal funds rate was lowered to near zero seven years ago. As

shorter-term rates increased, longer-term rates declined to near record lows amid increased market volatility, a drop in oil prices and global market uncertainty.

The net derivative losses of \$197 million in fiscal year 2015 were primarily attributable to a flattening of the swap yield curve during the period as the overall level of interest rates on the longer end of the yield curve declined while short-term interest rates rose. The decline in longer-term rates resulted in a net decrease in the fair value of our pay-fixed swaps and the increase in shorter-term rates resulted in an overall decrease in the fair value of our receive-fixed swaps, which together resulted in the net derivative losses during the year.

The derivative losses of \$34 million in fiscal year 2014 were largely attributable to a decrease in swap interest rates on the longer end of the yield curve, which resulted in a net decrease in the fair value of our pay-fixed swaps.

See “Note 10—Derivative Instruments and Hedging Activities” for additional information on our derivative instruments.

#### Results of Operations of Foreclosed Assets

Results of operations of foreclosed assets consist of the operating results of entities controlled by CFC that hold foreclosed assets, impairment charges related to those entities and gains or losses related to the disposition of the entities. We previously had two entities, CAH and DRP, that held foreclosed assets. We dissolved DRP during the fourth quarter of fiscal 2015, following the sale of DRP’s remaining assets. We had only one entity, CAH, that held foreclosed assets as of May 31, 2016. CAH was classified as held for sale beginning with the quarter ended August 31, 2015. Since that date, we have assessed the fair value less cost to sell of CAH each reporting period, reported our investment in CAH at the lower of the carrying value, as of the date of transfer to held for sale, or fair value less cost to sell and recognized subsequent changes in fair value less cost to sell in earnings.

We recorded a loss in our consolidated statement of operations related to foreclosed assets of \$7 million for fiscal year 2016, compared with losses of \$120 million and \$13 million in fiscal years 2015 and 2014, respectively. The loss of \$7 million recorded in fiscal year 2016 was attributable to impairment of our investment in CAH due to a reduction in the fair value less estimated cost to sell. The loss of \$120 million in fiscal year 2015 was driven by CAH impairment charges of \$111 million, while the loss of \$13 million in fiscal year 2014 was primarily attributable to results of operations of CAH.

As indicated above in “Executive Summary,” on September 30, 2015, CFC entered into a Purchase Agreement to sell to Buyer all of the issued and outstanding membership interests of CAH, which owns the telecommunications and cable television operations held by its operating subsidiaries, for a purchase price of \$145 million, subject to certain adjustments as specified in the Purchase Agreement. On July 1, 2016, the Purchase Agreement was amended and the sale of CAH was completed for a purchase price of approximately \$144 million, subject to certain adjustments.

Our reported investment in CAH totaled \$103 million as of May 31, 2016, which represents the fair value less estimated cost to sell as of that date. The measurement of fair value takes into consideration the contractual purchase price less agreed-upon purchase price adjustments, including cash on hand, changes in working capital and settlement of CAH’s pension and other postretirement benefit plan obligations, as well as the unrecognized net loss of \$10 million recorded in accumulated other comprehensive income (“AOCI”) attributable to actuarial-related changes in CAH’s pension and other postretirement benefit plan obligations. Upon closing of the sale of CAH, the unrecognized net loss of \$10 million recorded in AOCI as of May 31, 2016 was derecognized as an offset against the sale proceeds, which



will have no effect on our consolidated statement of operations for the first quarter of fiscal year 2017.

Our net proceeds at closing totaled \$109 million, which represents the purchase price of \$144 million less agreed-upon purchase price adjustments, as noted above, and transaction costs as of the closing date. The net proceeds at closing take into consideration the impact of CAH's operating results subsequent to our May 31, 2016 fiscal year end and the July 1, 2016 closing date, and the impact of these results on CAH's cash on hand and transaction costs as of the closing date. The net proceeds are subject to post-closing adjustments, which are due from Buyer within 60 days of the closing date for review by us. We expect to record any required post-closing adjustments in the first quarter of fiscal year 2017. CFC also remains subject to potential indemnification claims, as specified in the Purchase Agreement. Upon closing, \$16 million of the sale proceeds were deposited into escrow to fund potential indemnification claims for a period of 15 months following the closing. In connection with the sale, RTFC provided a loan in the amount of \$60 million to Buyer to finance a portion of the

transaction. ATN International has provided a guarantee on an unsecured basis of Buyer's obligations to RTFC pursuant to the financing. See "Note 5—Foreclosed Assets" for additional information on the sale of CAH.

#### Non-Interest Expense

Non-interest expense consists of salaries and employee benefit expense, general and administrative expenses, losses on early extinguishment of debt and other miscellaneous expenses.

We recorded non-interest expense of \$88 million, \$77 million and \$74 million in fiscal years 2016, 2015 and 2014, respectively. The increase in non-interest expense of \$11 million in fiscal year 2016, from the prior fiscal year was primarily attributable to an increase in costs related to system infrastructure enhancements and higher legal fees. The increase in non-interest expense of \$3 million in fiscal year 2015, from the prior year was due to modest increases in salaries and employee benefits and other general and administrative expenses.

#### Net Income (Loss) Attributable to Noncontrolling Interests

Net income (loss) attributable to noncontrolling interests represents 100% of the results of operations of RTFC and NCSC, as the members of RTFC and NCSC own or control 100% of the interest in their respective companies. The fluctuations in net income (loss) attributable to noncontrolling interests are primarily due to fluctuations in the fair value of NCSC's derivative instruments.

We recorded a net loss attributable to noncontrolling interests of \$2 million in fiscal year 2016, compared with net income of less than \$1 million in fiscal year 2015 and net income of \$3 million in fiscal year 2014.

#### CONSOLIDATED BALANCE SHEET ANALYSIS

Total assets of \$24,270 million as of May 31, 2016 increased by \$1,424 million, or 6%, from May 31, 2015, primarily due to growth in our loan portfolio. Total liabilities of \$23,453 million as of May 31, 2016 increased by \$1,519 million, or 7%, from May 31, 2015, primarily due to debt issuances to fund our loan portfolio growth. Total equity decreased \$94 million to \$817 million as of May 31, 2016. The decrease in total equity was attributable to the net loss of \$52 million in fiscal year 2016 and the patronage capital retirement of \$39 million in September 2015.

Following is a discussion of changes in the major components of our assets and liabilities during fiscal year 2016. Period-end balance sheet amounts may vary from average balance sheet amounts due to liquidity and balance sheet management activities that are intended to manage liquidity requirements for the company and our customers, and our market risk exposure in accordance with our risk appetite.

#### Loan Portfolio

We offer long-term fixed- and variable-rate loans and line of credit variable-rate loans. Borrowers may choose a fixed or variable interest rate for periods of one to 35 years. When a selected fixed-rate term expires, the borrower may select either another fixed-rate term or a variable rate or elect to repay the loan in full. We also offer a conversion option to members with long-term loan agreements, which allows borrowers to change the rate and term prior to the repricing date. Borrowers are generally charged a conversion fee when converting from a fixed to a variable rate, or a fixed rate to another fixed rate.

#### Loans Outstanding

Loans outstanding consist of advances from either new approved loans or from the unadvanced portion of loans previously approved. Table 5 summarizes total loans outstanding, by type and by member class, for the five-year period ended May 31, 2016.



Table 5: Loans Outstanding by Type and Member Class

(Dollars in millions)	May 31,									
	2016		2015		2014		2013		2012	
Loans by type:	Amount	%	Amount	%	Amount	%	Amount	%	Amount	%
Long-term loans:										
Long-term fixed-rate loans	\$21,217	92 %	\$19,543	91 %	\$18,176	88 %	\$17,918	88 %	\$16,743	89 %
Long-term variable-rate loans	757	3	699	3	754	4	782	4	765	4
Loans guaranteed by RUS	174	1	179	1	202	1	211	1	219	1
Total long-term loans	22,148	96	20,421	95	19,132	93	18,911	93	17,727	94
Line of credit loans	1,005	4	1,038	5	1,335	7	1,385	7	1,185	6
Total loans outstanding <sup>(1)</sup>	\$23,153	100%	\$21,459	100%	\$20,467	100%	\$20,296	100%	\$18,912	100%

## Loans by member class:

## CFC:

Distribution	\$17,674	77 %	\$16,095	75 %	\$15,035	74 %	\$14,941	74 %	\$14,075	74 %
Power supply	4,401	19	4,181	20	4,086	20	4,008	20	3,597	19
Statewide and associate	55	—	65	—	68	—	71	—	74	1
CFC total	22,130	96	20,341	95	19,189	94	19,020	94	17,746	94
RTFC	342	1	386	2	450	2	503	2	572	3
NCSC	681	3	732	3	828	4	773	4	594	3
Total loans outstanding <sup>(1)</sup>	\$23,153	100%	\$21,459	100%	\$20,467	100%	\$20,296	100%	\$18,912	100%

<sup>(1)</sup> Total loans outstanding represents the outstanding unpaid principal balance of loans. Unamortized deferred loan origination costs, which totaled \$10 million as of May 31, 2016, 2015, 2014 and 2013, and \$8 million as of May 31, 2012 are excluded from total loans outstanding. These costs, however, are included in loans to members reported on the consolidated balance sheets.

Total loans outstanding of \$23,153 million as of May 31, 2016 increased by \$1,693 million, or 8%, from May 31, 2015. The increase was primarily due to an increase in CFC distribution and power supply loans of \$1,579 million and \$220 million, respectively, which was largely attributable to members refinancing with us loans made by other lenders and member advances for capital investments. This increase was partially offset by a decrease in NCSC loans of \$51 million and a decrease in RTFC loans of \$44 million.

We provide additional information on our loan product types in “Item 1. Business—Loan Programs” and “Note 4—Loans and Commitments.” See “Debt—Secured Borrowings” below for information on encumbered and unencumbered loans and “Credit Risk Management” for information on the credit risk profile of our loan portfolio.

## Scheduled Loan Repayments

Table 6 displays the scheduled long-term loan principal repayments for each of the next five fiscal years and thereafter.

Table 6: Long-Term Loan Scheduled Repayments

(Dollars in thousands)	Fixed Rate		Variable Rate	
	Loan Amortization	Weighted-Average Interest Rate	Loan Amortization <sup>(1)</sup>	Total Loan Amortization <sup>(1)</sup>
Fiscal year:				
2017	\$1,138,826	4.25 %	\$ 62,023	\$ 1,200,849

2018	1,068,609	4.38		51,230	1,119,839
2019	1,049,365	4.44		114,897	1,164,262
2020	1,066,943	4.52		56,176	1,123,119
2021	1,061,905	4.56		33,536	1,095,441
Thereafter	16,004,928	4.78		439,638	16,444,566
Total	\$21,390,576	4.69	%	\$ 757,500	\$ 22,148,076

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<sup>(1)</sup> Represents scheduled amortization loan payment amounts based on current rates without taking into consideration loans that may reprice.

#### Loan Retention Rate

Table 7 compares the historical retention rate of long-term fixed-rate loans that repriced during the past three years and provides information on the percentage of borrowers that selected either another fixed-rate term or a variable rate. The retention rate is calculated based on the election made by the borrower at the repricing date. As indicated in Table 7, the average retention rate of repriced loans has been 95% over the most recent three fiscal years.

Table 7: Historical Retention Rate and Repricing Selection

(Dollars in thousands)	May 31,		2015		2014	
	Amount	%	Amount	%	Amount	%
Loans retained:						
Long-term fixed rate selected	\$ 1,001,118	93 %	\$ 991,279	81 %	\$ 983,754	84 %
Long-term variable rate selected	54,796	5	154,946	13	68,780	6
Loans repriced and sold by CFC	4,459	—	3,904	—	21,464	2
Total loans retained	1,060,373	98	1,150,129	94	1,073,998	92
Total loans repaid	17,956	2	76,380	6	90,030	8
Total	\$ 1,078,329	100%	\$ 1,226,509	100%	\$ 1,164,028	100%

#### Debt

We utilize both short-term and long-term borrowings as part of our funding strategy and asset/liability management. We seek to maintain diversified funding sources across products, programs and markets to manage funding concentrations and reduce our liquidity or debt roll-over risk. Our funding sources include a variety of secured and unsecured debt securities in a wide range of maturities to our members and affiliates and in the capital markets.

#### Debt Product Types

We offer various short- and long-term unsecured debt securities to our members and affiliates, including commercial paper, select notes, daily liquidity fund notes, medium-term notes and subordinated certificates. We issue collateral trust bonds and medium-term notes in the capital markets and also offer investments in commercial paper to nonmembers. Additionally, we have access to borrowings from banks, private placements and U.S. government agencies. Table 8 displays our primary debt product types and selected key attributes for each product type.

Table 8: Debt Product Types

Debt Product Type	Maturity Range	Market	Secured/Unsecured
Short-term funding programs:			
Commercial paper	1 to 270 days	Capital markets, members and affiliates	Unsecured
Select notes	30 to 270 days	Members and affiliates	Unsecured
Daily liquidity fund notes	Demand note	Members and affiliates	Unsecured
Other funding programs:			
Revolving credit agreements	3 to 5 years	Bank institutions	Unsecured
Collateral trust bonds <sup>(1)</sup>	Up to 30 years	Capital markets	Secured
Guaranteed Underwriter Program notes payable <sup>(2)</sup>	Up to 20 years	U.S. government	Secured
Farmer Mac notes payable <sup>(3)</sup>	Up to 16 years	Private placement	Secured
Medium-term notes	9 months to 30 years	Capital markets, members and affiliates	Unsecured
Other notes payable <sup>(4)</sup>	Up to 30 years	Private placement	Both
Subordinated deferrable debt <sup>(5)</sup>	Up to 30 years	Capital markets	Unsecured
Members' subordinated certificates <sup>(6)</sup>	Up to 100 years	Members	Unsecured

<sup>(1)</sup>Collateral trust bonds are secured by the pledge of permitted investments and eligible mortgage notes from distribution system borrowers in an amount at least equal to the outstanding principal amount of collateral trust bonds.

<sup>(2)</sup> Represents notes payable under the Guaranteed Underwriter Program of the USDA, which supports the Rural Economic Development Loan and Grant program. The Federal Financing Bank provides the financing for these notes, and RUS provides a guarantee of repayment. We are required to pledge eligible mortgage notes from distribution and power supply system borrowers in an amount at least equal to the outstanding principal amount of the notes payable.

<sup>(3)</sup> We are required to pledge eligible mortgage notes from distribution and power supply system borrowers in an amount at least equal to the outstanding principal amount under note purchase agreements with Farmer Mac.

<sup>(4)</sup> Other notes payable consist of unsecured and secured Clean Renewable Energy Bonds and unsecured notes payable issued by NCSC. We are required to pledge eligible mortgage notes from distribution and power supply system borrowers in an amount at least equal to the outstanding principal amount under the Clean Renewable Energy Bonds Series 2009A note purchase agreement.

<sup>(5)</sup> Subordinated deferrable debt is subordinate and junior to senior debt and debt obligations we guarantee, but senior to subordinated certificates. We have the right at any time, and from time to time, during the term of the subordinated deferrable debt to suspend interest payments for a maximum period of 20 consecutive quarters. To date, we have not exercised our option to suspend interest payments. We have the right to call the subordinated deferrable debt, at par, any time after 10 years.

<sup>(6)</sup> Members' subordinated certificates are subordinate and junior to senior debt, subordinated debt and debt obligations we guarantee. Members' subordinated certificates generally mature 100 years subsequent to issuance. Loan and guarantee subordinated certificates have the same maturity as the related long-term loan. Some certificates also may amortize annually based on the outstanding loan balance. Member capital securities generally mature 30 years or 35 years subsequent to issuance. Member capital securities are callable at par beginning five or 10 years subsequent to the issuance and anytime thereafter.

## Debt Outstanding

Table 9 displays the composition, by product type, of our outstanding debt and the weighted average interest rate as of May 31, 2016, 2015 and 2014. Table 9 also displays the composition of our debt based on several additional selected attributes.





Table 9: Total Debt Outstanding and Weighted-Average Interest Rates

(Dollars in thousands)	May 31, 2016		2015		2014	
	Outstanding Amount	Weighted- Average Interest Rate	Outstanding Amount	Weighted- Average Interest Rate	Outstanding Amount	Weighted- Average Interest Rate
Debt product type:						
Commercial paper:						
Members, at par	\$848,007	0.45 %	\$736,162	0.15 %	\$858,389	0.13 %
Dealer, net of discounts	659,935	0.43	984,954	0.15	1,973,557	0.14
Total commercial paper	1,507,942	0.44	1,721,116	0.15	2,831,946	0.14
Select notes to members	701,849	0.62	671,635	0.29	548,610	0.27
Daily liquidity fund notes to members	525,959	0.34	509,131	0.08	486,501	0.06
Bank bid notes	—	—	—	—	20,000	0.60
Collateral trust bonds	7,253,096	4.28	6,755,067	4.48	5,955,987	4.65
Guaranteed Underwriter Program notes payable	4,777,111	2.98	4,406,465	3.14	4,298,645	3.15
Farmer Mac notes payable	2,303,123	1.15	1,910,688	0.77	1,667,505	1.15
Medium-term notes:						
Members, at par	654,058	1.66	618,170	1.15	498,262	1.31
Dealer, net of discounts	2,648,369	3.02	2,733,853	2.55	2,215,760	2.68
Total medium-term notes	3,302,427	2.75	3,352,023	2.29	2,714,022	2.43
Other notes payable	40,944	3.61	46,423	3.67	51,750	3.73
Subordinated deferrable debt	742,212	4.98	395,699	4.75	395,627	4.75
Members' subordinated certificates:						
Membership subordinated certificates	630,063	4.94	645,035	4.89	644,944	4.90
Loan and guarantee subordinated certificates	593,701	2.99	640,889	2.94	699,723	3.01
Member capital securities	220,046	5.00	219,496	5.00	267,524	6.12
Total members' subordinated certificates	1,443,810	4.14	1,505,420	4.08	1,612,191	4.28
Total debt outstanding	\$22,598,473	3.03 %	\$21,273,667	2.93	\$20,582,784	2.91 %
Security type:						
Unsecured debt	37	%	59	%	63	%
Secured debt	63		41		37	
Total	100	%	100	%	100	%
Borrower type:						
Members	18	%	19	%	20	%
Private placement	32		30		29	
Capital markets	50		51		51	
Total	100	%	100	%	100	%
Interest rate type including impact of swaps:						
Fixed-rate debt <sup>(1)</sup>	88	%	81	%	79	%
Variable-rate debt <sup>(2)</sup>	12		19		21	

Total	100	%	100	%	100	%
Interest rate type:						
Fixed-rate debt	74	%	72	%	68	%
Variable-rate debt	26		28		32	
Total	100	%	100	%	100	%
Original contractual maturity:						
Short-term borrowings	13	%	15	%	20	%
Long-term and subordinated debt <sup>(3)</sup>	87		85		80	
Total	100	%	100	%	100	%

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<sup>(1)</sup> Includes variable-rate debt that has been swapped to a fixed rate net of any fixed-rate debt that has been swapped to a variable rate.

(2) Includes fixed-rate debt that has been swapped to a variable rate net of any variable-rate debt that has been swapped to a fixed rate. Also includes commercial paper notes, which generally have maturities of less than 90 days. The interest rate on commercial paper notes does not change once the note has been issued; however, the rates on new commercial paper notes change daily.

(3) Consists of long-term debt, subordinated deferrable debt and total members' subordinated debt reported on the consolidated balance sheets.

Total debt outstanding of \$22,598 million as of May 31, 2016 increased \$1,325 million, or 6%, from May 31, 2015, primarily due to the issuance of debt to fund the growth in our loan portfolio. The increase reflected a net increase of \$392 million under the note purchase agreement with Farmer Mac, a net increase of \$371 million under the Guaranteed Underwriter Program of the USDA, a net increase of \$498 million in collateral trust bonds and a net increase of \$347 million in subordinated deferrable debt. Significant financing-related developments affecting the change in our debt outstanding during fiscal year 2016 are summarized below.

On July 7, 2015, we received an advance of \$180 million under the revolving note purchase agreement with Farmer Mac.

On July 31, 2015, we received an advance of \$250 million with a 20-year final maturity under the Guaranteed Underwriter Program of the USDA.

On October 27, 2015, we issued \$350 million aggregate principal amount of 2.30% collateral trust bonds due 2020, and \$400 million aggregate principal amount of 3.25% collateral trust bonds due 2025.

On February 5, 2016, we received an advance of \$150 million with a 20-year final maturity under the Guaranteed Underwriter Program of the USDA.

On February 8, 2016, we issued \$350 million aggregate principal amount of 1.65% collateral trust bonds due 2019, and \$350 million aggregate principal amount of 2.70% collateral trust bonds due 2023.

On February 16, 2016, we redeemed \$300 million of 3.05% collateral trust bonds due March 1, 2016. The premium and unamortized issuance costs, which totaled less than \$1.0 million, were recorded as a loss on early extinguishment of debt in the third quarter of fiscal year 2016.

On February 18, 2016, we received an advance of \$250 million under the revolving note purchase agreement with Farmer Mac.

On April 20, 2016, we issued \$350 million of 5.25% subordinated deferrable debt due 2046, callable at par on or after April 20, 2026.

#### Member Investments

Debt securities issued to our members represent an important, stable source of funding. Table 10 displays outstanding member debt, by debt product type, as of May 31, 2016 and 2015.

Table 10: Member Investments

(Dollars in thousands)	May 31,	2015		Increase/(Decrease)
	2016	Amount	Amount	
	Amount	% of Total (1)	% of Total (1)	
Commercial paper	\$848,007	56 %	\$736,162	43 % \$ 111,845
Select notes	701,849	100	671,635	100 30,214
Daily liquidity fund notes	525,959	100	509,131	100 16,828
Medium-term notes	654,058	20	618,170	18 35,888
Members' subordinated certificates	1,443,810	100	1,505,420	100 (61,610 )
Total	\$4,173,683		\$4,040,518	\$ 133,165

Percentage of total debt outstanding 18 % 19 %

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<sup>(1)</sup> Represents the percentage of each line item outstanding to our members.

Member investments accounted for 18% and 19% of total debt outstanding as of May 31, 2016 and 2015, respectively. Over the past three fiscal years, outstanding member investments have averaged \$4,189 million.

### Short-Term Borrowings

Short-term borrowings consist of borrowings with an original contractual maturity of one year or less and do not include the current portion of long-term debt. Short-term borrowings totaled \$2,939 million and accounted for 13% of total debt outstanding as of May 31, 2016, compared with \$3,128 million, or 15%, of total debt outstanding as of May 31, 2015.

### Long-Term and Subordinated Debt

Long-term debt, defined as debt with an original contractual maturity date of greater than one year, primarily consists of medium-term notes, collateral trust bonds, notes payable under the Guaranteed Underwriter Program and notes payable under our note purchase agreement with Farmer Mac. Subordinated debt consists of subordinated deferrable debt and members' subordinated certificates. Our subordinated deferrable debt and members' subordinated certificates have original contractual dates of greater than one year. Long-term and subordinated debt totaled \$19,660 million and accounted for 87% of total debt outstanding as of May 31, 2016, compared with \$18,146 million, or 85%, of total debt outstanding as of May 31, 2015. As discussed above, the increase in total debt outstanding, including long-term and subordinated debt, was primarily due to the issuance of debt to fund loan portfolio growth.

### Collateral Pledged and on Deposit

We are required to pledge loans as collateral in borrowing transactions under our collateral trust bond indentures, note purchase agreements with Farmer Mac and bond agreements under the Guaranteed Underwriter Program of the USDA. We are required to maintain pledged collateral equal to at least 100% of the outstanding amount of borrowings. However, we typically maintain pledged collateral in excess of the required percentage to ensure that required collateral levels are maintained and to facilitate the timely execution of debt issuances by reducing or eliminating the lead time to pledge additional collateral. Under the provisions of our bank revolving credit agreements, the excess collateral that we are allowed to pledge cannot exceed 150% of the outstanding borrowings under our collateral trust bond indentures, Farmer Mac or the Guaranteed Underwriter Program of the USDA. In certain cases, provided that all conditions of eligibility under the different programs are satisfied, we may withdraw excess pledged collateral or transfer collateral from one borrowing program to another to facilitate a new debt issuance.

On December 13, 2012, we entered into an amended, restated and consolidated pledge agreement with RUS and U.S. Bank National Association pursuant to the Guaranteed Underwriter Program, which consolidated all prior pledge agreements. Under this agreement, we were required to hold mortgage notes on deposit equal to at least 100% of our outstanding borrowings. On March 29, 2016, we entered into a second amended, restated and consolidated pledge agreement with RUS and U.S. Bank National Association, which requires that we pledge all mortgage notes previously held on deposit pursuant to the Guaranteed Underwriter Program. The March 29, 2016 agreement replaces the previous pledge agreement dated December 13, 2012, and governs all future collateral requirements under the Guaranteed Underwriter Program.

Of our total debt outstanding of \$22,598 million as of May 31, 2016, \$14,348 million, or 63%, was secured by pledged loans. In comparison, of our total debt outstanding of \$21,274 million as of May 31, 2015, \$13,088 million, or 62%, was secured by pledged loans or loans on deposit. Table 11 displays the unpaid principal balance of loans pledged or on deposit for secured debt, the excess collateral pledged and unencumbered loans as of May 31, 2016 and 2015.

### Table 11: Unencumbered Loans

May 31,

(Dollars in thousands)	2016	2015
Total loans outstanding <sup>(1)</sup>	\$23,152,517	\$21,459,220
Less: Total secured debt or debt requiring collateral on deposit	(14,643,108 )	(13,386,713 )
Excess collateral pledged or on deposit <sup>(2)</sup>	(1,673,404 )	(1,351,254 )
Unencumbered loans	\$6,836,005	\$6,721,253
Unencumbered loans as a percentage of total loans	30	% 31 %

<sup>(1)</sup>Excludes unamortized deferred loan origination costs of \$10 million as of May 31, 2016 and 2015.

<sup>(2)</sup>Excludes cash collateral pledged to secure debt. If there is an event of default under most of our indentures, we can only withdraw the excess collateral if we substitute cash or permitted investments of equal value.

The amounts and levels of collateral may fluctuate due to the following:

our distribution and power supply loans are typically amortizing loans that require scheduled principal payments over the life of the loan, whereas the debt securities issued under secured indentures and agreements typically have bullet maturities;

our distribution and power supply borrowers have the option to prepay their loans; and

individual loans may become ineligible for various reasons, some of which may be temporary.

Table 12 displays the collateral coverage ratios as of May 31, 2016 and 2015 for the debt agreements noted above that require us to either pledge collateral or maintain loans on deposit.

Table 12: Collateral Pledged or on Deposit

Debt Agreement	Requirement		Actual	
	Debt Indenture Minimum	Revolving Credit Agreements Maximum	May 31,	
			2016	2015
Collateral trust bonds 1994 indenture	100%	150 %	121 %	106 %
Collateral trust bonds 2007 indenture	100	150	110	108
Guaranteed Underwriter Program notes payable <sup>(1)</sup>	100	150	110	112
Farmer Mac notes payable	100	150	117	113
Clean Renewable Energy Bonds Series 2009A	100	150	115	117

<sup>(1)</sup> Represents notes payable under the Guaranteed Underwriter Program of the USDA, which supports the Rural Economic Development Loan and Grant program. The Federal Financing Bank provides the financing for these notes, and RUS provides a guarantee of repayment. We are required to pledge collateral in an amount at least equal to the outstanding principal amount of the notes payable.

We provide additional information on our borrowings, including the maturity profile, below in “Liquidity Risk.” We provide a more detailed description of each of our debt product types in “Note 6—Short-Term Borrowings,” “Note 7—Long-Term Debt,” “Note 8—Subordinated Deferrable Debt” and “Note 9—Members’ Subordinated Certificates.” Refer to “4—Loans and Commitments—Pledging of Loans and Loans on Deposit” for additional information related to pledged collateral.

### Equity

Table 13 presents the components of total members’ equity, total CFC equity and total equity as of May 31, 2016 and 2015. As displayed in Table 13, total members’ equity excludes the cumulative unrealized derivative forward value gains (losses), which we record in earnings.

Table 13: Equity

(Dollars in thousands)	May 31,		Increase/ (Decrease)
	2016	2015	
Membership fees	\$974	\$976	\$(2 )
Educational fund	1,798	1,767	31
Total membership fees and educational fund	2,772	2,743	29
Patronage capital allocated	713,853	668,980	44,873
Members' capital reserve	587,219	501,731	85,488
Unallocated net income (loss)	(513,610 )	(293,212 )	(220,398 )
Less: Cumulative derivative forward value losses <sup>(1)</sup>	(507,904 )	(287,077 )	(220,827 )
Adjusted unallocated net income (loss) <sup>(2)</sup>	(5,706 )	(6,135 )	429
Total members' equity	1,298,138	1,167,319	130,819
Add: Prior-year cumulative derivative forward value losses	(287,077 )	(172,412 )	(114,665 )
Current-year derivative forward value losses <sup>(3)</sup>	(220,827 )	(114,665 )	(106,162 )
Cumulative derivative forward value losses <sup>(1)</sup>	(507,904 )	(287,077 )	(220,827 )
CFC retained equity	790,234	880,242	(90,008 )
Accumulated other comprehensive income	1,058	4,080	(3,022 )
Total CFC equity	791,292	884,322	(93,030 )
Noncontrolling interests	26,086	27,464	(1,378 )
Total equity	\$817,378	\$911,786	\$(94,408 )

<sup>(1)</sup>Calculated based on the prior-year cumulative derivative forward gains (losses) plus the current-year derivative forward value gains (losses).

<sup>(2)</sup>Adjusted unallocated net income excludes cumulative unrealized derivative forward value gains (losses).

<sup>(3)</sup>Represents the unrealized derivative forward value gains (losses) recorded during the current fiscal year.

As noted above, the decrease in total equity of \$94 million to \$817 million as of May 31, 2016, was attributable to the net loss of \$52 million and the patronage capital retirement of \$39 million in September 2015. In July 2015, the CFC Board of Directors authorized the retirement of allocated net earnings totaling \$39 million, which represented 50% of the patronage capital amount of \$78 million allocated to members for fiscal year 2015. The \$39 million was returned to members in cash in September 2015.

In July 2016, the CFC Board of Directors authorized the allocation of fiscal year 2016 adjusted net income as follows: \$1 million to the Cooperative Educational Fund, \$86 million to the members' capital reserve and \$84 million to members in the form of patronage capital. The amount of patronage capital allocated each year by CFC's Board of Directors is based on adjusted non-GAAP net income, which excludes the impact of derivative forward value gains (losses). See "Non-GAAP Financial Measures" for information on adjusted net income.

In July 2016, the CFC Board of Directors also authorized the retirement of allocated adjusted net income totaling \$42 million, which represented 50% of the fiscal year 2016 allocation. We expect to return this amount to members in cash in the second quarter of fiscal year 2017. The remaining portion of the allocated amount will be retained by CFC for 25 years under guidelines adopted by the CFC Board of Directors in June 2009.

The CFC Board of Directors is required to make annual allocations of net earnings, if any. CFC has made annual retirements of allocated net earnings in 36 of the last 37 fiscal years; however, future retirements of allocated amounts are determined based on CFC's financial condition. The CFC Board of Directors has the authority to change the current practice for allocating and retiring net earnings at any time, subject to applicable cooperative laws. See "Item 1. Business—Allocation and Retirement of Patronage Capital" for additional information.





## OFF-BALANCE SHEET ARRANGEMENTS

In the ordinary course of business, we engage in financial transactions that are not presented on our consolidated balance sheets, or may be recorded on our consolidated balance sheets in amounts that are different from the full contract or notional amount of the transaction. Our off-balance sheet arrangements consist primarily of guarantees of member obligations and unadvanced loan commitments intended to meet the financial needs of our members.

## Guarantees

We provide guarantees for certain contractual obligations of our members to assist them in obtaining various forms of financing. We use the same credit policies and monitoring procedures in providing guarantees as we do for loans and commitments. If a member defaults on its obligation, we are obligated to pay required amounts pursuant to our guarantees. Meeting our guarantee obligations satisfies the underlying obligation of our member systems and prevents the exercise of remedies by the guarantee beneficiary based upon a payment default by a member. In general, the member is required to repay any amount advanced by us with interest, pursuant to the documents evidencing the member's reimbursement obligation. Table 14 displays our guarantees outstanding, by guarantee type and by company, as of May 31, 2016 and 2015.

Table 14: Guarantees Outstanding

(Dollars in thousands)	May 31, 2016	2015	Increase/ (Decrease)
Guarantee type:			
Long-term tax-exempt bonds	\$475,965	\$489,520	\$(13,555 )
Letters of credit	319,596	382,233	(62,637 )
Other guarantees	113,647	114,747	(1,100 )
Total	\$909,208	\$986,500	\$(77,292 )
Company:			
CFC	\$892,289	\$952,875	\$(60,586 )
RTFC	1,574	1,574	—
NCSC	15,345	32,051	(16,706 )
Total	\$909,208	\$986,500	\$(77,292 )

We recorded a guarantee liability of \$17 million and \$20 million, respectively, as of May 31, 2016 and 2015, related to the contingent and noncontingent exposures for guarantee and liquidity obligations associated with our members' debt. Of our total guarantee amounts, 66% and 56% as of May 31, 2016 and 2015, respectively, were secured by a mortgage lien on substantially all of the system's assets and future revenue of the borrowers.

We had outstanding letters of credit for the benefit of our members totaling \$320 million as of May 31, 2016. Of this amount, \$244 million was related to obligations for which we may be required to advance funds based on various trigger events specified in the letters of credit agreements. If we are required to advance funds, the member is obligated to repay the advance amount to us. The remaining \$76 million of letters of credit are intended to provide liquidity for pollution control bonds.

In addition to the letters of credit presented above in Table 14, we had master letter of credit facilities in place as of May 31, 2016, under which we may be required to issue up to an additional \$83 million in letters of credit to third parties for the benefit of our members. All of our master letter of credit facilities as of May 31, 2016 were subject to material adverse change clauses at the time of issuance. Prior to issuing a letter of credit under these facilities, we confirm that there has been no material adverse change in the business or condition, financial or otherwise, of the borrower since the time the loan was approved and that the borrower is currently in compliance with the letter of

credit terms and conditions.

In addition to the guarantees described above, we were the liquidity provider for long-term, variable-rate, tax-exempt bonds issued for our member cooperatives totaling \$482 million as of May 31, 2016. As liquidity provider on these tax-exempt

46

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bonds, we may be required to purchase bonds that are tendered or put by investors. Investors provide notice to the remarketing agent that they will tender or put a certain amount of bonds at the next interest rate reset date. If the remarketing agent is unable to sell such bonds to other investors by the next interest rate reset date, we have unconditionally agreed to purchase such bonds. Our obligation as liquidity provider is in the form of a letter of credit on \$76 million of the tax-exempt bonds, which is discussed above and included in Table 14 as a component of the letters of credit amount of \$320 million as of May 31, 2016. We were not required to perform as liquidity provider pursuant to these obligations during the year ended May 31, 2016. In addition to being a liquidity provider, we also provided a guarantee of payment of principal and interest on \$406 million of these bonds, included in the above table, as of May 31, 2016.

Table 15 presents the maturities for each of the next five fiscal years and thereafter of the notional amount of our outstanding guarantee obligations as of May 31, 2016.

Table 15: Maturities of Guarantee Obligations

(Dollars in thousands)	Outstanding Maturities of Guaranteed Obligations						
	Balance	2017	2018	2019	2020	2021	Thereafter
Guarantees	\$ 909,208	\$ 164,607	\$ 217,194	\$ 14,561	\$ 62,405	\$ 112,622	\$ 337,819

We provide additional information about our guarantee obligations in “Note 13—Guarantees.”

#### Unadvanced Loan Commitments

Unadvanced commitments represent approved and executed loan contracts for which funds have not been advanced to borrowers. Table 16 below displays the amount of unadvanced loan commitments, which consist of line of credit and long-term loan commitments, as of May 31, 2016 and 2015. Our line of credit commitments include both contracts that are not subject to material adverse change clauses and contracts that are subject to material adverse change clauses.

Table 16: Unadvanced Loan Commitments

(Dollars in thousands)	May 31,			
	2016	% of Total	2015	% of Total
Line of credit commitments:				
Conditional <sup>(1)</sup>	\$6,248,546	47 %	\$6,529,159	46 %
Not conditional <sup>(2)</sup>	2,447,902	19	2,764,968	20
Total line of credit unadvanced commitments	8,696,448	66	9,294,127	66
Total long-term loan unadvanced commitments	4,508,562	34	4,835,623	34
Total unadvanced loan commitments	\$13,205,010	100%	\$14,129,750	100%

<sup>(1)</sup>Represents amount related to facilities that are subject to material adverse change clauses.

<sup>(2)</sup>Represents amount related to facilities that are not subject to material adverse change clauses.

Unadvanced line of credit commitments are typically revolving facilities for periods not to exceed five years. Historically, borrowers have not drawn the full commitment amount for line of credit facilities, and we have experienced a very low utilization rate on line of credit loan facilities, regardless of whether or not a material adverse change clause exists at the time of advance. We believe this borrowing pattern is likely to continue because electric cooperatives generate a significant amount of cash from the collection of revenue from their customers and therefore generally do not need to draw down on loan commitments to supplement operating cash flow. In addition, the majority of the unadvanced line of credit commitments serve as a supplemental back-up liquidity to our borrowers.

Unadvanced long-term loan commitments generally expire five years from the date of the loan agreement. Borrowers historically have requested advances on commitments in multiple transactions over an extended period of time; however, they generally do not draw the full commitment amount. We also believe this borrowing pattern is likely to continue because (i) electric cooperatives generally execute loan contracts to cover multi-year work plans; as such, it is expected that

47

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advances on such loans will occur over a multi-year period; (ii) electric cooperatives generate a significant amount of cash from the collection of revenue from their customers, which provides available operating cash flows to reduce the amount of additional funding needed for capital expenditures and maintenance; and (iii) we generally do not charge our borrowers a fee on long-term unadvanced commitments.

Table 17 presents the amount of unadvanced commitments, by loan type, as of May 31, 2016 and the maturities of the commitment amounts for each of the next five fiscal years and thereafter.

Table 17: Notional Maturities of Unadvanced Loan Commitments

(Dollars in thousands)	Available	Notional Maturities of Unadvanced Commitments					
	Balance	2017	2018	2019	2020	2021	Thereafter
Line of credit	\$8,696,448	\$5,036,881	\$1,141,935	\$974,918	\$793,476	\$613,838	\$135,400
Long-term loans	4,508,562	961,355	695,989	1,061,425	852,481	836,708	100,604
Total	\$13,205,010	\$5,998,236	\$1,837,924	\$2,036,343	\$1,645,957	\$1,450,546	\$236,004

Based on our historical experience, we expect that the majority of the unadvanced commitments will expire without being fully drawn upon. Accordingly, the total unadvanced commitment amount of \$13,205 million as of May 31, 2016 is not necessarily representative of future cash funding requirements.

#### Unadvanced Line of Credit Commitments—Conditional

The substantial majority of our line of credit commitments relate to contracts that include material adverse change clauses. The amount of unadvanced line of credit and long-term loan commitments subject to material adverse change clauses was \$10,757 million and \$11,365 million as of May 31, 2016 and 2015, respectively, and accounted for 81% and 80% of the combined total of unadvanced line of credit and long-term loan commitments as of May 31, 2016 and 2015, respectively. Prior to making advances on these facilities, we confirm that there has been no material adverse change in the borrower's business or condition, financial or otherwise, since the time the loan was approved and confirm that the borrower is currently in compliance with loan terms and conditions. In some cases, the borrower's access to the full amount of the facility is further constrained by use of proceeds restrictions, imposition of borrower-specific restrictions, or by additional conditions that must be met prior to advancing funds. Since we generally do not charge a fee for the borrower to have an unadvanced amount on a loan facility that is subject to a material adverse change clause, our borrowers tend to request amounts in excess of their immediate estimated loan requirements.

#### Unadvanced Line of Credit Commitments—Not Conditional

The amount of unadvanced line of credit commitments not subject to material adverse change clauses at the time of each advance totaled \$2,448 million and \$2,765 million as of May 31, 2016 and 2015, respectively. For contracts not subject to a material adverse change clause, we are generally required to advance amounts on the committed facilities as long as the borrower is in compliance with the terms and conditions of the facility. We record a liability for credit losses on our consolidated balance sheets for unadvanced commitments related to facilities that are not subject to a material adverse change clause because we do not consider these commitments to be conditional.

Loan syndications, where the pricing is set at a spread over a market index as agreed upon by all of the participating banks based on market conditions at the time of syndication, accounted for 78% of line of credit commitments as of May 31, 2016. New advances accounted for the remaining 22% of the committed line of credit loans as of May 31, 2016. Any new advance would be made at rates determined by us based on our cost, and we have the option to pass on to the borrower any cost increase related to the advance.

Table 18 presents the maturities for each of the next five fiscal years and thereafter of the notional amount of unconditional committed lines of credit not subject to a material adverse change clause as of May 31, 2016.

Table 18: Maturities of Notional Amount of Unconditional Committed Lines of Credit

(Dollars in thousands)	Available Balance	Maturities of Notional Amount of Unconditional Committed Lines of Credit					Thereafter
		2017	2018	2019	2020	2021	
Lines of credit	\$2,447,902	\$148,240	\$601,353	\$610,442	\$613,059	\$423,621	\$51,187

## RISK MANAGEMENT

### Overview

We face a variety of risks that can significantly affect our financial performance, liquidity, reputation and ability to meet the expectations of our members, investors and other stakeholders. As a financial services company, the major categories of risk exposures inherent in our business activities include credit risk, liquidity risk, market risk and operational risk. These risk categories are summarized below.

Credit risk is the risk that a borrower or other counterparty will be unable to meet its obligations in accordance with agreed-upon terms.

Liquidity risk is the risk that we will be unable to fund our operations and meet our contractual obligations or that we will be unable to fund new loans to borrowers at a reasonable cost and tenor in a timely manner.

Market risk is the risk that changes in market variables, such as movements in interest rates, may adversely affect the match between the timing of the contractual maturities, re-pricing and prepayments of our financial assets and the related financial liabilities funding those assets.

Operational risk is the risk of loss resulting from inadequate or failed internal controls, processes, systems, human error or external events. Operational risk also includes compliance risk, fiduciary risk, reputational risk and litigation risk.

Effective risk management is critical to our overall operations and in achieving our primary objective of providing cost-based financial products to our rural electric members while maintaining the sound financial results required for investment-grade credit ratings on our debt instruments. Accordingly, we have a risk management framework that is intended to govern the principal risks we assume in conducting our business and the aggregate amount of risk we are willing to accept, referred to as risk appetite, in the context of CFC's mission and strategic objectives and initiatives.

### Risk Management Framework

Our risk management framework consists of defined policies, procedures and risk tolerances that are intended to align with CFC's mission. The CFC Board of Directors is responsible for risk governance by approving the enterprise risk management framework and providing oversight on risk policies, risk appetite and our performance against established goals. In fulfilling its risk governance responsibility, the CFC Board of Directors receives periodic reports on business activities from management. The CFC Board of Directors reviews CFC's risk profile and management's assessment of those risks throughout the year at its periodic meetings. The board also establishes CFC's loan policies and has established a Loan Committee of the board comprising no fewer than 10 directors that reviews the performance of the loan portfolio in accordance with those policies. For additional information about the role of the CFC Board of Directors in risk governance and oversight, see "Item 10. Directors, Executive Officers and Corporate Governance."



Management is responsible for execution of the risk management framework, risk policy formation and daily management of the risks associated with our business. Management executes its responsibility by establishing risk management processes for identifying, measuring, assessing, managing, monitoring and reporting risks. Management and operating groups maintain policies and procedures, specific to each major risk category, to identify and measure our primary risk exposures at the transaction, obligor and portfolio levels and ensure that our exposures remain within prescribed limits. Management also is responsible for establishing and maintaining internal controls to mitigate key risks. We have a number of management-level risk oversight committees across the organization that have a defined set of authorities and responsibilities specific to

one or more risk types, including the Corporate Credit Committee, Credit Risk Management group, Asset Liability Committee, Corporate Compliance group, Internal Audit group and Disclosure Committee. The risk oversight committees collectively help management facilitate enterprise-wide understanding and monitoring of CFC's risk profile and the control processes with respect to our inherent risks. Management and the risk oversight committees periodically report actual results, significant current and emerging risks, initiatives and risk management concerns to the CFC Board of Directors.

#### CREDIT RISK

Our loan portfolio, which represents the largest component of assets on our balance sheet, and guarantees account for the substantial majority of our credit risk exposure. We also engage in certain non-lending activities that may give rise to credit and counterparty settlement risk, including the purchase of investment securities and entering into derivative transactions to manage our interest rate risk.

#### Loan and Guarantee Portfolio Credit Risk

Below we provide information on the credit risk profile of our loan portfolio and guarantees, including security provisions, loan concentration, credit performance and our allowance for loan losses.

#### Security Provisions

Except when providing line of credit loans, we generally lend to our members on a senior secured basis. Long-term loans are generally secured on parity with other secured lenders (primarily RUS), if any, by all assets and revenue of the borrower with exceptions typical in utility mortgages. Line of credit loans are generally unsecured. In addition to the collateral pledged to secure our loans, borrowers also are required to set rates charged to customers to achieve certain financial ratios. Of our total loans outstanding, 92% were secured and 8% were unsecured as of May 31, 2016, compared with 91% and 9%, respectively, as of May 31, 2015. Table 19 presents, by loan type and by company, the amount and percentage of secured and unsecured loans in our loan portfolio as of May 31, 2016 and 2015.

Table 19 : Loan Portfolio Security Profile

(Dollars in thousands)	May 31, 2016				
	Secured	% of Total	Unsecured	% of Total	Total
Loan type:					
Long-term fixed-rate loans	\$20,437,784	96 %	\$779,355	4 %	\$21,217,139
Long-term variable-rate loans	688,495	91	68,928	9	757,423
Loans guaranteed by RUS	173,514	100	—	—	173,514
Line of credit loans	48,256	5	956,185	95	1,004,441
Total loans outstanding <sup>(1)</sup>	\$21,348,049	92	\$1,804,468	8	\$23,152,517
Company:					
CFC	\$20,590,529	93 %	\$1,539,344	7 %	\$22,129,873
RTFC	330,696	97	11,146	3	341,842
NCSC	426,824	63	253,978	37	680,802
Total loans outstanding <sup>(1)</sup>	\$21,348,049	92	\$1,804,468	8	\$23,152,517

(Dollars in thousands)	May 31, 2015				
	Secured	% of Total	Unsecured	% of Total	Total
Loan type:					
Long-term fixed-rate loans	\$18,526,068	95 %	\$1,017,206	5 %	\$19,543,274
Long-term variable-rate loans	628,115	90	70,380	10	698,495
Loans guaranteed by RUS	179,241	100	—	—	179,241
Line of credit loans	107,781	10	930,429	90	1,038,210
Total loans outstanding <sup>(1)</sup>	\$19,441,205	91	\$2,018,015	9	\$21,459,220
Company:					
CFC	\$18,635,818	92 %	\$1,706,172	8 %	\$20,341,990
RTFC	370,924	96	14,785	4	385,709
NCSC	434,463	59	297,058	41	731,521
Total loans outstanding <sup>(1)</sup>	\$19,441,205	91	\$2,018,015	9	\$21,459,220

<sup>(1)</sup>Excludes deferred loan origination costs of \$10 million as of May 31, 2016 and 2015.

As part of our strategy in managing our credit risk exposure, we entered into a long-term standby purchase commitment agreement with Farmer Mac on August 31, 2015, as amended on May 31, 2016. Under this agreement, we may designate certain loans to be covered under the commitment, as approved by Farmer Mac, and in the event any such loan later goes into material default for at least 90 days, upon request by us, Farmer Mac must purchase such loan at par value. We designated, and Farmer Mac approved loans that had an aggregate outstanding principal balance of \$926 million as of May 31, 2016.

#### Loan Concentration

We serve electric and telecommunications members throughout the United States and its territories, including 49 states, the District of Columbia, American Samoa and Guam. Table 20 presents the number of CFC, RTFC and NCSC borrowers and the percentage of total loans outstanding by state or U.S. territory as of May 31, 2016 and 2015.

Table 20: Loan Concentration

U.S. State/Territory	May 31, 2016			2015		
	Number of Loans	% of Total Borrowing <sup>(1)</sup>	%	Number of Loans	% of Total Borrowing <sup>(1)</sup>	%
Texas	73	14.83	%	73	14.92	%
Georgia	46	5.89		46	5.79	
Missouri	50	5.28		52	5.14	
Colorado	26	5.02		27	5.37	
Kansas	33	4.31		34	4.29	
Alaska	17	3.87		19	4.18	
North Dakota	16	3.60		14	2.26	
Illinois	27	3.58		28	3.65	
Minnesota	56	3.17		57	3.43	
South Carolina	23	3.16		23	3.06	
Florida	16	3.00		16	2.94	
Oklahoma	27	2.92		27	2.96	
North Carolina	28	2.84		29	2.46	
Indiana	41	2.81		45	2.77	
Kentucky	24	2.80		25	2.97	
Arkansas	20	2.44		21	2.44	
Ohio	30	2.44		32	2.28	
Alabama	25	2.43		25	2.36	
Pennsylvania	17	2.25		18	2.24	
Iowa	40	2.02		40	2.03	
Maryland	2	1.88		3	1.72	
Utah	6	1.76		6	2.02	
Wisconsin	26	1.72		25	1.86	
Mississippi	18	1.58		19	2.09	
Oregon	22	1.52		25	1.60	
Nevada	5	1.47		5	1.49	
Virginia	18	1.46		19	1.18	
Washington	11	1.43		11	1.52	
Louisiana	10	1.29		10	1.38	
Wyoming	14	1.18		15	1.17	
South Dakota	32	0.99		32	0.93	
Montana	25	0.77		25	0.75	
Arizona	11	0.59		12	0.70	
Michigan	15	0.58		15	0.55	
Idaho	13	0.57		13	0.64	
Delaware	2	0.49		2	0.56	
New Hampshire	1	0.41		2	0.44	
Tennessee	19	0.40		19	0.31	
New Mexico	16	0.27		16	0.32	
Hawaii	2	0.19		2	0.32	
Vermont	4	0.19		6	0.22	
California	4	0.15		4	0.15	
Nebraska	17	0.13		19	0.16	
New York	5	0.13		6	0.15	

New Jersey	2	0.07		3	0.10	
West Virginia	2	0.07		2	0.08	
Maine	4	0.05		4	0.05	
Total	941	100.00	%	971	100.00	%

<sup>(1)</sup>The percentage of total loans outstanding for each state or territory is based on the aggregate unpaid principal balance of loans to borrowers in the state or territory divided by total loans outstanding as of the end of each period.

Texas had the largest concentration of loans to borrowers in any one state, with 73 borrowers that accounted for approximately 15% of total loans outstanding as of May 31, 2016 and 2015. Texas has the largest concentration of borrowers because 10 of our 71 power supply system borrowers are located in Texas. Power supply system borrowers generally require significantly more capital than distribution and telecommunications systems.

Table 21 displays the outstanding exposure of the 20 largest borrowers, by exposure type and by company, as of May 31, 2016 and 2015. The 20 largest borrowers as of May 31, 2016 consisted of 11 distribution systems and 9 power supply systems. In comparison, the 20 largest borrowers as of May 31, 2015 consisted of 12 distribution systems and 8 power supply systems. The largest total outstanding exposure to a single borrower or controlled group accounted for approximately 2% of total loans and guarantees outstanding as of both May 31, 2016 and 2015.

Table 21: Credit Exposure to 20 Largest Borrowers

(Dollars in thousands)	May 31,	2015		Increase/	
	2016	% of	Amount	% of	
	Amount	Total	Amount	Total	
By exposure type:					
Loans	\$5,638,217	23 %	\$5,478,977	24 %	\$159,240
Guarantees	365,457	2	374,189	2	(8,732 )
Total exposure to 20 largest borrowers	6,003,674	25	5,853,166	26	150,508
Less: Loans covered under Farmer Mac standby purchase commitment <sup>(1)</sup>	(402,244 )	(2 )	—	—	(402,244 )
Net exposure to 20 largest borrowers	\$5,601,430	23 %	\$5,853,166	26 %	\$(251,736)
By company:					
CFC <sup>(1)</sup>	\$5,991,674	25 %	\$5,837,463	26 %	\$154,211
NCSC	12,000	—	15,703	—	(3,703 )
Total exposure to 20 largest borrowers	6,003,674	25	5,853,166	26	150,508
Less: Loans covered under Farmer Mac standby purchase commitment <sup>(1)</sup>	(402,244 )	(2 )	—	—	(402,244 )
Net exposure to 20 largest borrowers	\$5,601,430	23 %	\$5,853,166	26 %	\$(251,736)

<sup>(1)</sup> The stand-by purchase commitment agreement with Farmer Mac entered into during fiscal year 2016 covered \$402 million of this total as of May 31, 2016.

### Credit Performance

As part of our credit risk management process, we monitor and evaluate each borrower and loan in our loan portfolio and assign numeric internal risk ratings based on quantitative and qualitative assessments. Our ratings are aligned to regulatory definitions of pass and criticized categories with criticized divided between special mention, substandard and doubtful. Internal risk rating and payment status trends are indicators, among others, of the level of credit risk in our loan portfolio. As displayed in “Note 4—Loans and Commitments,” 0.2% of the loans in our portfolio were classified as criticized as of

May 31, 2016 and 2015. Below we provide information on certain additional credit quality indicators, including modified loans classified as troubled debt restructurings (“TDRs”) and nonperforming loans.

### Troubled Debt Restructurings

We actively monitor underperforming loans and, from time to time, attempt to work with borrowers to manage such exposures through loan workouts or modifications that better align with the borrower's current ability to pay. Modified loans in which we grant one or more concessions to a borrower experiencing financial difficulty are accounted for and reported as a TDR. Loans modified in a TDR are generally initially placed on nonaccrual status, although in many cases such loans

were already on nonaccrual status prior to modification. Interest accrued but not collected at the date a loan is placed on nonaccrual status is reversed against earnings. These loans may be returned to performing status and the accrual of interest resumed if the borrower performs under the modified terms for an extended period of time, and we expect the borrower to continue to perform in accordance with the modified terms. In certain limited circumstances in which a modified loan is current at the modification date, the loan is not placed on nonaccrual status at the time of modification. Table 22 presents the carrying value of modified loans, all of which met the definition of a TDR, as of the end of each of the last five fiscal years. These loans were considered individually impaired as of the end of each period presented.

Table 22: TDR Loans

(Dollars in thousands)	May 31, 2016		2015		2014		2013		2012	
	Amount	% of Total Loans	Amount	% of Total Loans	Amount	Total Loans	Amount	% of Total Loans	Amount	% of Total Loans
TDR loans:										
CFC	\$6,716	0.03%	\$7,221	0.03%	\$7,584	0.04%	\$46,953	0.23%	\$455,689	2.41%
RTFC	10,598	0.04	4,221	0.02	—	—	—	—	—	—
NCSC	—	—	294	—	—	—	—	—	—	—
Total TDR loans	\$17,314	0.07%	\$11,736	0.05%	\$7,584	0.04%	\$46,953	0.23%	\$455,689	2.41%
TDR loans performance status:										
Performing TDR loans	\$13,808	0.06%	\$11,736	0.05%	\$7,584	0.04%	\$46,953	0.23%	\$455,689	2.41%
Nonperforming TDR loans	3,506	0.01	—	—	—	—	—	—	—	—
Total TDR loans	\$17,314	0.07%	\$11,736	0.05%	\$7,584	0.04%	\$46,953	0.23%	\$455,689	2.41%

Loans classified as performing TDR loans as of each fiscal year end, as disclosed in Table 22, were performing in accordance with the terms of their respective restructured loan agreement as of the respective reported dates. All TDR loans classified as performing as of May 31, 2016 were on accrual status as of that date. Of the TDR loans classified as performing in Table 22 above, \$12 million, \$8 million, \$8 million and \$29 million as of May 31, 2015, 2014, 2013 and 2012, respectively, were on nonaccrual status as of that date.

All TDR loans classified as nonperforming as of May 31, 2016 were on nonaccrual status as of that date. As indicated in Table 22 above, there were no TDR loans classified as nonperforming as of May 31, 2015, 2014, 2013 or 2012.

### Nonperforming Loans

In addition to nonperforming TDR loans, we also have nonperforming loans that have not been modified and classified as a TDR. We classify such loans as nonperforming at the earlier of the date when we determine: (i) interest or principal payments on the loan is past due 90 days or more; (ii) as a result of court proceedings, the collection of interest or principal payments based on the original contractual terms is not expected; or (iii) the full and timely collection of interest or principal is otherwise uncertain. Once a loan is classified as nonperforming, we generally place the loan on nonaccrual status. Interest accrued but not collected at the date a loan is placed on nonaccrual status is reversed against earnings.



Table 23 below presents nonperforming loans as of the end of each of the last five fiscal years.

Table 23: Nonperforming Loans

(Dollars in thousands)	May 31,		2014	2013		2012		
	2016	2015		2013	2012			
	% of Total Loans	% of Total Loans	% of Total Loans	% of Total Loans	% of Total Loans	% of Total Loans	% of Total Loans	
Nonperforming loans: <sup>(1)</sup>								
CFC	\$—%	\$—%	\$—	— %	\$5,000	0.02 %	\$34,243	0.18 %
RTFC	—	—	1,695	0.01	10,497	0.06	6,970	0.04
NCSC	—	—	400	—	—	—	—	—
Total	\$—%	\$—%	\$2,095	0.01 %	\$15,497	0.08 %	\$41,213	0.22 %

<sup>(1)</sup>Foregone interest on nonperforming loans, including nonperforming TDR loans presented above in Table 22, was less than \$1 million for fiscal years 2016, 2015 and 2014.

We provide additional information on the credit quality of our loan portfolio in “Note 4—Loans and Commitments.”

#### Allowance for Loan Losses

The allowance for loan losses is determined based upon evaluation of the loan portfolio, past loss experience, specific problem loans, economic conditions and other pertinent factors that, in management’s judgment, could affect the risk of loss in the loan portfolio. We review and adjust the allowance quarterly to cover estimated probable losses in the portfolio. All loans are written off in the period that it becomes evident that collectability is highly unlikely; however, our efforts to recover all charged-off amounts may continue. Management believes the allowance for loan losses is appropriate to cover estimated probable portfolio losses.

Table 24 summarizes activity in the allowance for loan losses for the last five fiscal years and a comparison of the allowance by company as of the end of each of those years.

Table 24: Allowance for Loan Losses

(Dollars in thousands)	Year Ended May 31,				
	2016	2015	2014	2013	2012
Beginning balance	\$33,690	\$56,429	\$54,325	\$143,326	\$161,177
Provision (benefit) for loan losses	(646 )	(21,954 )	3,498	(70,091 )	(18,108 )
Net (charge-offs) recoveries	214	(785 )	(1,394 )	(18,910 )	257
Ending balance	\$33,258	\$33,690	\$56,429	\$54,325	\$143,326

(Dollars in thousands)	May 31,				
Allowance for loan losses by company:	2016	2015	2014	2013	2012
CFC	\$24,559	\$23,716	\$45,600	\$41,246	\$126,941
RTFC	5,565	4,533	4,282	9,158	8,562
NCSC	3,134	5,441	6,547	3,921	7,823
Total	\$33,258	\$33,690	\$56,429	\$54,325	\$143,326

## Allowance coverage ratios:

Percentage of total loans outstanding	0.14	% 0.16	% 0.28	% 0.27	% 0.76	%
Percentage of total nonperforming loans outstanding	—	—	2,693.51	350.55	347.77	
Percentage of total performing TDR loans outstanding	240.86	287.07	744.05	115.70	31.45	
Percentage of total nonperforming TDR loans outstanding	948.60	—	—	—	—	
Percentage of total loans on nonaccrual	948.60	287.07	583.00	235.37	347.77	

The allowance for loan losses decreased by a modest amount during fiscal year 2016 to \$33 million as of May 31, 2016, from \$34 million as of the prior fiscal year end. Although total loans outstanding increased by \$1.7 billion, or 8%, from fiscal year-end 2015, the allowance coverage ratio decreased to 0.14% as of May 31, 2016, from 0.16% as of May 31, 2015. The decrease in the allowance coverage ratio was due in part to the Farmer Mac long-term standby purchase commitment agreement entered into during fiscal year 2016. The outstanding balance of loans covered under this agreement was \$926 million as of May 31, 2016. This agreement resulted in a reduction in the collective allowance attributable to these loans because our exposure to loss has been substantially mitigated. In addition, there was an overall improvement in the historical default rates used in calculating our allowance, which contributed to the reduction in the allowance. The favorable impact of these items was partially offset by an increase in the specific reserve for loans individually evaluated for impairment. Loans designated as individually impaired totaled \$17 million and \$12 million, respectively, as of May 31, 2016 and 2015, and the specific allowance for these loans totaled \$3 million and \$0.4 million, respectively.

We discuss our methodology for determining the allowance for loan losses above in “Critical Accounting Policies and Estimates” and in “Note 1—Summary of Significant Accounting Policies.” Also see “Results of Operations—Provision for Loan Losses” and “Note 4—Loans and Commitments” for additional information on our allowance for loan losses.

## Counterparty Credit Risk

We are exposed to counterparty risk related to the performance of the parties with which we entered into financial transactions, primarily for derivative instruments and cash and time deposits that we have with various financial institutions. To mitigate this risk, we only enter into these transactions with financial institutions with investment-grade ratings. Our cash and time deposits with financial institutions generally have an original maturity of less than one year.

We manage our derivative counterparty credit risk by requiring that derivative counterparties participate in one of our revolving credit agreements, monitoring the overall credit worthiness of each counterparty, using counterparty-specific credit risk limits, executing master netting arrangements and diversifying our derivative transactions among multiple counterparties. Our derivative counterparties had credit ratings ranging from Aa3 to Baa3 by Moody’s Investors Service (“Moody’s”) and from AA-to BBB+ by S&P Global Ratings (“S&P”) as of May 31, 2016. Our largest counterparty exposure, based on the outstanding notional amount, represented approximately 25% and 19% of the total outstanding notional amount of derivatives as of May 31, 2016 and 2015, respectively.

## Credit Risk-Related Contingent Features

Our derivative contracts typically contain mutual early termination provisions, generally in the form of a credit rating trigger. Under the mutual credit rating trigger provisions, either counterparty may, but is not obligated to, terminate and settle the agreement if the credit rating of the other counterparty falls to a level specified in the agreement. If a derivative

contract is terminated, the amount to be received or paid by us would be equal to the mark-to-market value, as defined in the agreement, as of termination date.

Our senior unsecured credit ratings from Moody's and S&P were A2 and A, respectively, as of May 31, 2016. Both Moody's and S&P had our ratings on stable outlook as of May 31, 2016. Table 25 displays the notional amounts of our derivative contracts with rating triggers as of May 31, 2016 and the payments that would be required if the contracts were terminated as of that date because of a downgrade of our unsecured credit ratings or the counterparty's unsecured credit ratings below A3/A-, below Baa1/BBB+ to or below Baa2/BBB, below Baa3/BBB- or to or below Ba2/BB+ by Moody's or S&P, respectively. In calculating the payment amounts that would be required upon termination of the derivative contracts, we assumed that the amounts for each counterparty would be netted in accordance with the provisions of the master netting agreements for each counterparty. The net payment amounts are based on the fair value of the underlying derivative instrument, excluding the credit risk valuation adjustment, plus any unpaid accrued interest amounts.

Table 25: Rating Triggers for Derivatives

(Dollars in thousands)	Notional Amount <sup>(1)</sup>	Payable Due From CFC	Receivable Due to CFC	Net (Payable)/Receivable
Impact of rating downgrade trigger:				
Falls below A3/A- <sup>(2)</sup>	\$ 63,295	\$(18,232 )	\$ —	—\$ (18,232 )
Falls below Baa1/BBB+	6,516,255	(316,969 )	—	(316,969 )
Falls to or below Baa2/BBB <sup>(3)</sup>	160,467	(2,930 )	—	(2,930 )
Falls below Baa3/BBB-	392,068	(30,244 )	—	(30,244 )
Total	\$ 7,132,085	\$(368,375)	\$ —	—\$ (368,375 )

<sup>(1)</sup> Excludes \$40 million notional amount of forward starting swaps, with an effective start date of June 30, 2016, outstanding as of May 31, 2016.

<sup>(2)</sup> Rating trigger for CFC falls below A3/A-, while rating trigger for counterparty falls below Baa1/BBB+ by Moody's or S&P, respectively.

<sup>(3)</sup> Rating trigger for CFC falls to or below Baa2/BBB, while rating trigger for counterparty falls to or below Ba2/BB+ by Moody's or S&P, respectively.

The aggregate amount, excluding the credit risk valuation adjustment, of all derivatives with rating triggers that were in a net liability position was \$368 million as of May 31, 2016. There were no interest rate swaps with rating triggers that were in a net asset position as of May 31, 2016. There were no counterparties that fell below the rating trigger levels in our interest swap contracts as of May 31, 2016. If a counterparty has a credit rating that falls below the rating trigger level specified in the interest swap contract, we have the option to terminate all derivatives with the counterparty. However, we generally do not terminate such agreements early because our interest rate swaps are critical to our matched funding strategy.

See "Item 1A. Risk Factors" for additional information about credit risk related to our business.

#### LIQUIDITY RISK

Our liquidity risk management framework is designed to meet our liquidity objectives of providing a reliable source of funding to members, meet maturing debt and other obligations, issue new debt and fund our operations on a cost-effective basis under normal operating conditions as well as under CFC-specific and/or market stress conditions. We engage in various activities to manage liquidity risk and achieve our liquidity objectives. Our Asset Liability Committee establishes liquidity guidelines that are intended to ensure that we maintain sufficient, diversified sources of liquidity to cover potential funding requirements as well as unanticipated contingencies. Our Treasury group develops strategies to manage our targeted liquidity position, projects our funding needs under various scenarios,

including adverse circumstances, and monitors our liquidity position on an ongoing basis.

#### Short-Term Borrowings

We rely primarily on cash flows from our operations along with short-term borrowings, which we refer to as our short-term funding portfolio, as quick sources of funding to meet our near-term, day-to-day liquidity needs. Our short-term funding portfolio consists of commercial paper, which we offer to members and dealers, select notes and daily liquidity fund notes to

members, bank-bid notes and medium-term notes to members and dealers. Table 26 presents the year-end, maximum month-end and average outstanding amounts, together with the weighted average interest rate and weighted average maturity, for each respective category of our short-term funding portfolio for fiscal years 2016, 2015 and 2014.

Table 26: Short-Term Borrowings

(Dollars in thousands)	May 31, 2016			Maximum Month-End Outstanding Amount	Average Outstanding Amount
	Amount Outstanding	Weighted-Average Interest Rate	Weighted-Average Maturity		
Short-term borrowings:					
Commercial paper	\$1,507,942	0.44 %	17 days	\$2,445,894	\$1,734,651
Select notes to members	701,849	0.62	43 days	845,805	709,285
Daily liquidity fund notes to members	525,959	0.34	1 day	740,142	551,594
Medium-term notes to members	203,098	1.05	161 days	213,260	199,078
Total short-term borrowings	\$2,938,848	0.51 %	31 days		\$3,194,608
(Dollars in thousands)	May 31, 2015			Maximum Month-End Outstanding Amount	Average Outstanding Amount
	Amount Outstanding	Weighted-Average Interest Rate	Weighted-Average Maturity		
Short-term borrowings:					
Commercial paper	\$1,721,116	0.15 %	19 days	\$3,184,166	\$2,493,040
Select notes to members	671,635	0.29	41 days	671,635	587,971
Daily liquidity fund notes to members	509,131	0.08	1 day	588,872	505,060
Bank bid notes	—	—	—	—	438
Medium-term notes to members	225,872	0.65	160 days	229,160	216,335
Total short-term borrowings	\$3,127,754	0.20 %	31 days		\$3,802,844
(Dollars in thousands)	May 31, 2014			Maximum Month-End Outstanding Amount	Average Outstanding Amount
	Amount Outstanding	Weighted-Average Interest Rate	Weighted-Average Maturity		
Short-term borrowings:					
Commercial paper	\$2,831,946	0.14 %	17 days	\$3,723,948	\$3,083,849
Select notes	548,610	0.27	41 days	605,536	485,839
Daily liquidity fund notes	486,501	0.06	1 day	715,539	585,104
Bank bid notes	20,000	0.60	9 days	150,000	127,315
Medium-term notes sold to members	212,274	0.63	135 days	218,535	200,833
Medium-term notes sold to dealers	—	—	—	325,000	54,167
Total short-term borrowings	\$4,099,331	0.17 %	25 days		\$4,537,107

Our short-term borrowings totaled \$2,939 million and accounted for 13% of total debt outstanding as of May 31, 2016, compared with \$3,128 million, or 15%, of total debt outstanding as of May 31, 2015. The weighted average maturity and weighted average cost of our short-term borrowings was 31 days and 0.51%, respectively, as of May 31, 2016, compared with 31 days and 0.20%, respectively, as of May 31, 2015. Commercial paper issued through dealers totaled \$660 million and represented 3% of total debt outstanding as of May 31, 2016. During fiscal year 2015, we began reducing the level of dealer commercial paper to an amount below \$1,250 million to manage our short-term

wholesale funding risk. We expect to continue to maintain our outstanding dealer commercial paper at a level below this amount for the foreseeable future.

On June 15, 2016 we redeemed an aggregate principal amount of \$87 million of our dealer medium-term notes at par plus accrued interest. The principal and accrued interest at the redemption date was paid with a combination of cash on hand and

58

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other sources of liquidity, including the issuance of short-term debt. This early redemption was initiated by us for asset-liability management purposes.

### Liquidity Reserve

As part of our strategy in meeting our liquidity objectives, we seek to maintain a liquidity reserve in the form of both on-balance sheet and off-balance sheet funding sources that are readily accessible for immediate liquidity needs. Table 27 below presents the components of our liquidity reserve and a comparison of the amounts available as of May 31, 2016 and 2015.

Table 27: Liquidity Reserve

(Dollars in millions)	May 31, 2016			2015		
	Total	Accessed	Available	Total	Accessed	Available
Cash and cash equivalents and time deposits	\$545	\$ —	\$ 545	\$734	\$ —	\$ 734
Committed bank revolving line of credit agreements—unsecured	3,310	1	(2) 3,309	3,420	1	3,419
Guaranteed Underwriter Program committed facilities—secured	600	—	600	750	—	750
Farmer Mac revolving note purchase agreement, dated March 24, 2011—secured	4,500	2,303	2,197	4,500	1,911	2,589
Farmer Mac revolving note purchase agreement, dated July 31, 2015—secured	300	—	300	—	—	—
Total	\$9,255	\$ 2,304	\$ 6,951	\$9,404	\$ 1,912	\$ 7,492

(1)The accessed amount of \$1 million relates to a letter of credit issued pursuant to the line of credit agreement.

(2)Availability subject to market conditions.

Cash and time deposits are a source of liquidity available to support our operations. Cash and time deposits totaled \$545 million as of May 31, 2016, compared with \$734 million as of May 31, 2015. The interest rate earned on time deposits provides an overall benefit to our net interest yield.

### Borrowing Capacity

In addition to cash and time deposits, our liquidity reserve includes access to funds under committed revolving line of credit agreements with banks, committed loan facilities under the Guaranteed Underwriter Program of the USDA and our revolving note purchase agreements with Farmer Mac. Below, we discuss our borrowing capacity under each of these facilities.

#### Committed Bank Revolving Line of Credit Agreements—Unsecured

Our bank revolving lines of credit may be used for general corporate purposes; however, we generally rely on them as a backup source of liquidity to our short-term funding portfolio. Our short-term funding portfolio consists of member and dealer commercial paper, select notes to members and daily liquidity fund investments by members. On November 19, 2015, we amended and restated the \$1,665 million three-year and \$1,645 million five-year revolving credit agreements to extend the maturity dates to November 19, 2018 and