

Edgar Filing: CHEVIOT FINANCIAL CORP - Form 10-Q

CHEVIOT FINANCIAL CORP  
Form 10-Q  
August 08, 2007

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

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2007

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 No. 0-50529

CHEVIOT FINANCIAL CORP.

-----  
(Exact name of registrant as specified in its charter)

Federal

56-2423720

-----  
(State or other jurisdiction of incorporation or organization)

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

3723 Glenmore Avenue, Cincinnati, Ohio 45211

-----  
(Address of principal executive office)

Registrant's telephone number, including area code: (513) 661-0457

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Sections 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 is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one.)

Large accelerated filer  Accelerated filer  Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes  No

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As of August 7, 2007, the latest practicable date, 9,025,794 shares of the registrant's common stock, \$.01 par value, were issued and outstanding.

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Cheviot Financial Corp.

#### CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION

(In thousands, except share data)

|   |    | June 30<br>2007<br>(Unaudited) |
|---|----|--------------------------------|
| ASSETS  |    |                                |
| Cash and due from banks   | \$ | 2,7                            |
| Federal funds sold  |    | 1,2                            |
| Interest-earning deposits in other financial institutions   |    | 1,4                            |
| Cash and cash equivalents   |    | 5,4                            |
| Investment securities available for sale - at fair value  |    | 13,9                           |
| Investment securities held to maturity - at cost, approximate<br>market value of \$22,862 and \$24,739 at June 30, 2007 |    |                                |

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|   |         |
|---|---------|
| and December 31, 2006, respectively   | 23,1    |
| Mortgage-backed securities available for sale - at fair value   | 9       |
| Mortgage-backed securities held to maturity - at cost, approximate market value of \$11,760 and \$14,251 at June 30, 2007 and December 31, 2006, respectively | 11,6    |
| Loans receivable - net  | 246,6   |
| Loans held for sale - at lower of cost or market  |         |
| Real estate acquired through foreclosure - net  | 7       |
| Office premises and equipment - at depreciated cost   | 5,2     |
| Federal Home Loan Bank stock - at cost  | 3,2     |
| Accrued interest receivable on loans  | 1,0     |
| Accrued interest receivable on mortgage-backed securities   |         |
| Accrued interest receivable on investments and interest-earning deposits  | 5       |
| Prepaid expenses and other assets   | 4       |
| Bank-owned life insurance   | 3,3     |
| Prepaid federal income taxes  |         |
|   | -----   |
| Total assets  | \$316,4 |
|   | =====   |
|   |         |
| LIABILITIES AND SHAREHOLDERS' EQUITY  |         |
|   |         |
| Deposits  | \$212,3 |
| Advances from the Federal Home Loan Bank  | 32,5    |
| Advances by borrowers for taxes and insurance   | 4       |
| Accrued interest payable  | 1       |
| Accounts payable and other liabilities  | 7       |
| Accrued federal income taxes  |         |
| Deferred federal income taxes   | 5       |
|   | -----   |
| Total liabilities   | 246,7   |
|   |         |
| Shareholders' equity  |         |
| Preferred stock - authorized 5,000,000 shares, \$.01 par value; none issued   |         |
| Common stock - authorized 30,000,000 shares, \$.01 par value; 9,918,751 shares issued at June 30, 2007 and December 31, 2006, respectively                    |         |
| Additional paid-in capital  | 43,2    |
| Shares acquired by stock benefit plans  | (3,9    |
| Treasury stock - at cost, 774,931 and 568,968 shares at June 30, 2007 and December 31, 2006, respectively   | (9,6    |
| Retained earnings - restricted  | 40,0    |
| Accumulated comprehensive loss, unrealized losses on securities available for sale, net of related tax effects  | (1      |
|   | -----   |
| Total shareholders' equity  | 69,7    |
|   | -----   |
| Total liabilities and shareholders' equity  | \$316,4 |
|   | =====   |

See accompanying notes to consolidated financial statements.

Cheviot Financial Corp.

CONSOLIDATED STATEMENTS OF EARNINGS

(In thousands, except per share data)

Six months ended

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|  | June 30, |          |
|--|----------|----------|
|  | 2007     | 2006     |
| Interest income  |          |          |
| Loans  | \$ 7,376 | \$ 6,776 |
| Mortgage-backed securities                               | 365      | 424      |
| Investment securities                                    | 887      | 558      |
| Interest-earning deposits and other                      | 127      | 109      |
|  | -----    | -----    |
| Total interest income                                    | 8,755    | 7,867    |
| Interest expense   |          |          |
| Deposits   | 3,904    | 2,639    |
| Borrowings   | 681      | 789      |
|  | -----    | -----    |
| Total interest expense                                   | 4,585    | 3,428    |
|  | -----    | -----    |
| Net interest income                                      | 4,170    | 4,439    |
| Provision for losses on loans                            | -        | -        |
|  | -----    | -----    |
| Net interest income after provision for losses on loans  | 4,170    | 4,439    |
| Other income (expense)                                   |          |          |
| Rental   | 24       | 22       |
| Gain on sale of loans                                    | 23       | 13       |
| Loss on sale of real estate acquired through foreclosure | -        | (21)     |
| Earnings on bank-owned life insurance                    | 64       | 68       |
| Other operating  | 147      | 141      |
|  | -----    | -----    |
| Total other income                                       | 258      | 223      |
| General, administrative and other expense                |          |          |
| Employee compensation and benefits                       | 2,200    | 2,042    |
| Occupancy and equipment                                  | 273      | 206      |
| Property, payroll and other taxes                        | 449      | 416      |
| Data processing  | 154      | 137      |
| Legal and professional                                   | 225      | 211      |
| Advertising  | 88       | 88       |
| Other operating  | 340      | 282      |
|  | -----    | -----    |
| Total general, administrative and other expense          | 3,729    | 3,382    |
|  | -----    | -----    |
| Earnings before income taxes                             | 699      | 1,280    |
| Federal income taxes                                     |          |          |
| Current  | 58       | 296      |
| Deferred   | 163      | 117      |
|  | -----    | -----    |
| Total federal income taxes                               | 221      | 413      |
|  | -----    | -----    |
| NET EARNINGS   | \$ 478   | \$ 867   |
|  | =====    | =====    |
| EARNINGS PER SHARE                                       |          |          |
| Basic  | \$ .05   | \$ .09   |
|  | =====    | =====    |
| Diluted  | \$ .05   | \$ .09   |
|  | =====    | =====    |

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|                            |        |        |
|----------------------------|--------|--------|
| Dividends per common share | \$ .16 | \$ .14 |
|                            | =====  | =====  |

See accompanying notes to consolidated financial statements.

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Cheviot Financial Corp.

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

For the six and three months ended June 30, 2007 and 2006

(In thousands)

|   | For the six months<br>ended June 30, |         |
|---|--------------------------------------|---------|
|   | 2007                                 | 2006    |
| Net earnings for the period   | \$ 478                               | \$867   |
| Other comprehensive loss, net of benefits:  |                                      |         |
| Unrealized holding losses on securities during the period,<br>net of benefits of \$(53) and \$3 for the six months ended<br>June 30, 2007 and 2006, respectively, and \$(49) and \$(1)<br>for the three months ended June 30, 2007 and 2006, respectively | (103)                                | (5)     |
|   | ----                                 | ----    |
| Comprehensive income  | \$ 375                               | \$862   |
|   | =====                                | =====   |
| Accumulated comprehensive loss  | \$ (111)                             | \$ (13) |
|   | =====                                | =====   |

See accompanying notes to consolidated financial statements.

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Cheviot Financial Corp.

CONSOLIDATED STATEMENTS OF CASH FLOWS

For the six months ended June 30, 2007 and 2006

(In thousands)

Cash flows from operating activities:

|   |    |      |
|---|----|------|
| Net earnings for the period   | \$ | 4    |
| Adjustments to reconcile net earnings to net cash<br>provided by operating activities:      |    |      |
| Amortization of premiums and discounts on investment<br>and mortgage-backed securities, net |    | (    |
| Depreciation  |    | 1    |
| Amortization of deferred loan origination fees - net  |    |      |
| Proceeds from sale of loans in the secondary market   |    | 2,3  |
| Loans originated for sale in the secondary market   |    | (2,0 |
| Gain on sale of loans   |    | (    |
| Loss on sale of real estate acquired through foreclosure                                    |    |      |
| Federal Home Loan Bank stock dividends  |    |      |

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|  |        |
|--|--------|
| Net increase in cash surrender value of bank-owned life insurance        | (      |
| Amortization of expense related to stock benefit plans                   | 4      |
| Increase (decrease) in cash due to changes in:                           |        |
| Accrued interest receivable on loans                                     |        |
| Accrued interest receivable on mortgage-backed securities                |        |
| Accrued interest receivable on investments and interest-earning deposits | (1     |
| Prepaid expenses and other assets  | (2     |
| Accounts payable and other liabilities                                   | (3     |
| Federal income taxes   |        |
| Current  | (1     |
| Deferred   | 1      |
|  | -----  |
| Net cash provided by operating activities                                | 6      |
| Cash flows used in investing activities:                                 |        |
| Principal repayments on loans  | 16,3   |
| Loan disbursements   | (22,8  |
| Purchase of U.S. Government and agency obligations                       | (7,0   |
| Proceeds from maturity of U.S. Government and agency obligations         | 4,0    |
| Principal repayments on mortgage-backed securities                       | 2,6    |
| Proceeds from sale of real estate acquired through foreclosure           |        |
| Purchase of office premises and equipment                                | (      |
|  | -----  |
| Net cash used in investing activities                                    | (6,8   |
| Cash flows provided by financing activities:                             |        |
| Net increase in deposits   | 6,8    |
| Proceeds from Federal Home Loan Bank advances                            | 6,0    |
| Repayments on Federal Home Loan Bank advances                            | (2,7   |
| Advances by borrowers for taxes and insurance                            | (7     |
| Treasury stock repurchases   | (2,7   |
| Stock option expense, net  | 1      |
| Dividends paid on common stock   | (6     |
|  | -----  |
| Net cash provided by financing activities                                | 6,1    |
|  | -----  |
| Net increase in cash and cash equivalents                                | (      |
| Cash and cash equivalents at beginning of period                         | 5,4    |
|  | -----  |
| Cash and cash equivalents at end of period                               | \$ 5,4 |
|  | =====  |

See accompanying notes to consolidated financial statements.

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Cheviot Financial Corp.

CONSOLIDATED STATEMENTS OF CASH FLOWS (CONTINUED)

For the six months ended June 30, 2007 and 2006  
(In thousands)

Supplemental disclosure of cash flow information: Cash paid during the period for:

|                      |       |
|----------------------|-------|
| Federal income taxes | \$ 1  |
|                      | ===== |

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Interest on deposits and borrowings

\$ 4,5  
=====

Supplemental disclosure of noncash investing activities:

Transfer of loans to real estate acquired through foreclosure

\$ 7  
=====

Recognition of mortgage servicing rights in accordance with SFAS No. 140

\$  
=====

See accompanying notes to consolidated financial statements.

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Cheviot Financial Corp.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

For the three and six months ended June 30, 2007 and 2006

1. Basis of Presentation

Cheviot Financial Corp. ("Cheviot Financial" or the "Corporation") is a financial holding company, the principal asset of which consists of its ownership of Cheviot Savings Bank (the "Savings Bank"). The Savings Bank conducts a general banking business in southwestern Ohio which consists of attracting deposits and applying those funds to the origination of primarily real estate loans. The Corporation is 55% owned by Cheviot Mutual Holding Company. Cheviot Savings' profitability is significantly dependent on net interest income, which is the difference between interest income from interest-earning assets and the interest expense paid on interest-bearing liabilities. Net interest income is affected by the relative amount of interest-earning assets and interest-bearing liabilities and the interest received or paid on these balances.

The accompanying unaudited financial statements were prepared in accordance with instructions for Form 10-Q and, therefore, do not include information or footnotes necessary for a complete presentation of financial position, results of operations and cash flows in conformity with accounting principles generally accepted in the United States of America. Accordingly, these consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto of Cheviot Financial included in the Annual Report on Form 10-K for the year ended December 31, 2006. However, in the opinion of management, all adjustments (consisting of only normal recurring accruals) which are necessary for a fair presentation of the consolidated financial statements have been included. The results of operations for the three and six month periods ended June 30, 2007, are not necessarily indicative of the results which may be expected for the entire year.

2. Principles of Consolidation

The accompanying consolidated financial statements as of and for the three and six months ended June 30, 2007, include the accounts of the Corporation and its wholly-owned subsidiary, the Savings Bank. All significant intercompany items have been eliminated.

3. Liquidity and Capital Resources

Liquidity describes our ability to meet the financial obligations that arise in

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the ordinary course of business. Liquidity is primarily needed to meet the borrowing and deposit withdrawal requirements of our customers and to fund current and planned expenditures. Our primary sources of funds are deposits, scheduled amortization and prepayments of loan principal and mortgage-backed securities, maturities and calls of securities and funds provided by our operations. In addition, we may borrow from the Federal Home Loan Bank of Cincinnati. At June 30, 2007 and December 31, 2006, we had \$32.5 million and \$29.2 million, respectively, in outstanding borrowings from the Federal Home Loan Bank of Cincinnati and had the capacity to increase such borrowings at those dates by approximately \$104.0 million and \$110.3 million.

Loan repayments and maturing securities are a relatively predictable source of funds. However, deposit flows, calls of securities and prepayments of loans and mortgage-backed securities are strongly influenced by interest rates, general and local economic conditions and competition in the marketplace. These factors reduce the predictability of these sources of funds.

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### Cheviot Financial Corp.

#### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

For the three and six months ended June 30, 2007 and 2006

#### 3. Liquidity and Capital Resources (continued)

Our primary investing activities are the origination of one- to four-family real estate loans, commercial real estate, construction and consumer loans, and, to a lesser extent, the purchase of securities. For the six months ended June 30, 2007, loan originations totaled \$24.8 million, compared to \$30.3 million for the six months ended June 30, 2006.

Total deposits increased \$6.9 million and \$16.0 million during the six months ended June 30, 2007 and 2006, respectively. Deposit flows are affected by the level of interest rates, the interest rates and products offered by competitors and other factors.

The following table sets forth information regarding the Corporation's obligations and commitments to make future payments under contract as of June 30, 2007.

|   | Less than<br>1 year | Payments due by period<br>More than<br>1-3<br>years | More than<br>4-5<br>years<br>(In thousands) |
|---|---------------------|---|---|
| Contractual obligations:                              |                     |   |   |
| Advances from the Federal Home Loan Bank              | \$ 6,000            | -   | -   |
| Certificates of deposit                               | 125,886             | \$ 18,346   | \$ 5,065                                    |
| Amount of loan commitments and expiration per period: |                     |   |   |
| Commitments to originate one- to four-family<br>loans | 3,043               | -   | -   |
| Home equity lines of credit                           | 11,493              | -   | -   |



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|                               |           |           |          |
|-------------------------------|-----------|-----------|----------|
| Undisbursed loans in process  | 5,414     | -         | -        |
| Lease obligations             | 3         | -         | -        |
|                               | -----     | -----     | -----    |
| Total contractual obligations | \$151,839 | \$ 18,346 | \$ 5,065 |
|                               | =====     | =====     | =====    |

We are committed to maintaining a strong liquidity position. We monitor our liquidity position on a daily basis. We anticipate that we will have sufficient funds to meet our current funding commitments. Based on our deposit retention experience and current pricing strategy, we anticipate that a significant portion of maturing time deposits will be retained.

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Cheviot Financial Corp.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

For the three and six months ended June 30, 2007 and 2006

3. Liquidity and Capital Resources (continued)

At June 30, 2007 and 2006, we exceeded all of the applicable regulatory capital requirements. Our core (Tier 1) capital was \$52.4 million and \$50.1 million, or 16.6% of total assets at both June 30, 2007 and 2006. In order to be classified as "well-capitalized" under federal banking regulations, we were required to have core capital of at least \$19.0 million, or 6.0% of assets as of June 30, 2007. To be classified as a well-capitalized bank, we must also have a ratio of total risk-based capital to risk-weighted assets of at least 10.0%. At June 30, 2007 and 2006, we had a total risk-based capital ratio of 32.5% and 34.2%, respectively.

4. Earnings Per Share

Basic earnings per share is computed based upon the weighted-average common shares outstanding during the period, less shares in the ESOP that are unallocated and not committed to be released plus shares in the ESOP that have been allocated. Weighted-average common shares deemed outstanding gives effect to 285,661 and 321,368 unallocated shares held by the ESOP for the three and six months ended June 30, 2007 and 2006, respectively.

|   | For the six months ended<br>June 30, |           |     |
|---|--------------------------------------|-----------|-----|
|   | 2007                                 | 2006      |     |
| Weighted-average common shares<br>outstanding (basic)   | 9,042,835                            | 9,312,314 | 9,  |
| Dilutive effect of assumed exercise<br>of stock options | 120,731                              | 21,749    |     |
|   | -----                                | -----     | --- |
| Weighted-average common shares<br>outstanding (diluted) | 9,163,566                            | 9,334,063 | 9,  |
|   | =====                                | =====     | ==  |

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### 5. Stock Option Plan

On April 26, 2005, the Corporation approved a Stock Incentive Plan that provides for grants of up to 486,018 stock options. On May 5, 2005, approximately 384,000 option shares were granted subject to five year vesting. On May 23, 2006, approximately 6,100 option shares were granted subject to five year vesting. On May 22, 2007, approximately 6,500 option shares were granted subject to five year vesting.

In 2004, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standard ("SFAS") No. 123(R), "Share-Based Payment," which revises SFAS No. 123, "Accounting for Stock-Based Compensation," and supersedes Accounting Principles Board ("APB") Opinion No. 25, "Accounting for Stock Issued to Employees." SFAS No. 123(R) requires that cost related to the fair value of all equity-based awards to employees, including grants of employee stock options, be recognized in the financial statements.

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Cheviot Financial Corp.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

For the three and six months ended June 30, 2007 and 2006

### 5. Stock Option Plan (continued)

The Corporation adopted the provisions of SFAS No. 123(R) effective January 1, 2006, using the modified prospective transition method, and therefore has not restated its financial statements for prior periods. Under this method, the Corporation has applied the provisions of SFAS No. 123(R) to new equity-based awards and to equity-based awards modified, repurchased, or cancelled after January 1, 2006. In addition, the Corporation will recognize compensation cost for the portion of equity-based awards for which the requisite service period has not been rendered ("unvested equity-based awards") that are outstanding as of January 1, 2006. The compensation cost recorded for unvested equity-based awards is based on their grant-date fair value. For the six months ended June 30, 2007, the Corporation recorded \$79,000 in after-tax compensation cost for equity-based awards that vested during the six months ended June 30, 2007. The Corporation has \$762,000 unrecognized pre-tax compensation cost related to non-vested equity-based awards granted under its stock incentive plan as of June 30, 2007, which is expected to be recognized over a weighted-average vesting period of approximately 3.0 years.

A summary of the status of the Corporation's stock option plan as of June 30, 2007, and changes during the period then ended is presented below:

|                                    | Six months ended<br>June 30, 2007         |         |
|------------------------------------|---|---------|
| Shares                             | Weighted-<br>average<br>exercise<br>price |         |
| Outstanding at beginning of period | 389,760                                   | \$11.17 |

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|  |         |         |
|--|---------|---------|
| Granted  | 6,460   | \$13.63 |
| Exercised                                      | -       | -       |
| Forfeited                                      | -       | -       |
|  | -----   | -----   |
| Outstanding at end of period                   | 396,220 | \$11.21 |
|  | =====   | =====   |
| Options exercisable at period-end              | 154,692 | \$11.16 |
|  | =====   | =====   |
| Options expected to be exercisable at year-end |         |         |
| Fair value of options granted                  |         | \$2.77  |
|  |         | =====   |

The following information applies to options outstanding at June 30, 2007:

|   |                   |
|---|-------------------|
| Number outstanding                          | 396,220           |
| Exercise price                              | \$11.15 - \$13.63 |
| Weighted-average exercise price             | \$11.21           |
| Weighted-average remaining contractual life | 8.0 years         |
| Aggregate intrinsic value of vested options | \$335,682         |

The expected term of options is based on evaluations of historical and expected future employee exercise behavior. The risk free interest rate is based upon the U.S. Treasury rates at the date of grant with maturity dates approximately equal to the expected life at grant date. Volatility is based upon the historical volatility of the Corporation's stock.

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Cheviot Financial Corp.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

For the three and six months ended June 30, 2007 and 2006

5. Stock Option Plan (continued)

The fair value of each option was estimated on the date of grant using the modified Black-Scholes options pricing model with the following weighted-average assumptions used for grants in 2007: dividend yield of 2.35%, expected volatility of 10.12%, risk-free interest rate of 4.83% and an expected life of 10 years for each grant.

The effects of expensing stock options is reported in "cash provided by financing activities" in the Consolidated Statements of Cash Flows.

6. Income Taxes

The Corporation adopted the provisions of FASB Interpretation 48, "Accounting for Uncertainty in Income Taxes," on January 1, 2007. Previously, the Corporation had accounted for tax contingencies in accordance with Statement of Financial Accounting Standards No. 5, "Accounting for Contingencies." As required by Interpretation 48, which clarifies Statement No. 109, "Accounting for Income Taxes," the Corporation recognizes the financial statement benefit of a tax position only after determining that the relevant tax authority would more likely than not sustain the position following an audit. For tax positions meeting the more-likely-than-not threshold, the amount recognized in the

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financial statements is the largest benefit that has a greater than 50 percent likelihood of being realized upon ultimate settlement with the relevant tax authority. At the adoption date, the Corporation applied Interpretation 48 to all tax positions for which the statute of limitations remained open. As a result of the implementation of Interpretation 48, the Corporation was not required to record any liability for unrecognized tax benefits as of January 1, 2007. There have been no material changes in unrecognized tax benefits since January 1, 2007. As stated in the Annual Report, the only known tax attribute which can influence the Corporation's effective tax rate is the utilization of charitable contribution carryforwards.

The Corporation is subject to income taxes in the U.S. federal jurisdiction, as well as various state jurisdictions. Tax regulations within each jurisdiction are subject to the interpretation of the related tax laws and regulations and require significant judgment to apply. With few exceptions, the Corporation is no longer subject to U.S. federal, state and local, or non U.S. income tax examinations by tax authorities for the years before 2003.

The Corporation will recognize, if applicable, interest accrued related to unrecognized tax benefits in interest expense and penalties in operating expenses.

### 7. Effects of Recent Accounting Pronouncements

In February 2006, the FASB issued SFAS No. 155, "Accounting for Certain Hybrid Instruments - an amendment of FASB Statements No. 133 and 140," to simplify and make more consistent the accounting for certain financial instruments. Specifically, SFAS No. 155 amends SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities," to permit fair value remeasurement for any hybrid financial instrument with an embedded derivative that otherwise would require bifurcation, provided that the whole instrument is accounted for on a fair value basis. SFAS No. 155 amends SFAS No. 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities," to allow a qualifying special purpose entity to hold a derivative instrument that pertains to a beneficial interest other than another derivative financial instrument.

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Cheviot Financial Corp.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

For the three and six months ended June 30, 2007 and 2006

### 7. Effects of Recent Accounting Pronouncements (continued)

SFAS No. 155 is effective for all financial instruments acquired or issued after the beginning of an entity's first fiscal year that begins after September 15, 2006, or January 1, 2007 as to the Corporation, with earlier application allowed. The Corporation adopted SFAS No. 155 as of January 1, 2007 without material effect on the Corporation's financial position or results of operations.

In March 2006, the FASB issued SFAS No. 156, "Accounting for Servicing of Financial Assets - an amendment of SFAS No. 140," to simplify the accounting for separately recognized servicing assets and servicing liabilities. Specifically, SFAS No. 156 amends SFAS No. 140 to require an entity to take the following steps:

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- o Separately recognize financial assets as servicing assets or servicing liabilities, each time it undertakes an obligation to service a financial asset by entering into certain kinds of servicing contracts;
- o Initially measure all separately recognized servicing assets and liabilities at fair value, if practicable, and;
- o Separately present servicing assets and liabilities subsequently measured at fair value in the statement of financial position and additional disclosures for all separately recognized servicing assets and servicing liabilities.

Additionally, SFAS No. 156 permits, but does not require, an entity to choose either the amortization method or the fair value measurement method for measuring each class of separately recognized servicing assets and servicing liabilities. SFAS No. 156 also permits a servicer that uses derivative financial instruments to offset risks on servicing to use fair value measurement when reporting both the derivative financial instrument and related servicing asset or liability.

SFAS No. 156 applies to all separately recognized servicing assets and liabilities acquired or issued after the beginning of an entity's fiscal year that begins after September 15, 2006, or January 1, 2007 as to the Corporation, with earlier application permitted. The Corporation adopted SFAS No. 156 as of January 1, 2007, applying the amortization method without financial statement effect. The Corporation's mortgage servicing rights totaled less than \$75,000 at June 30, 2007, and therefore, the remaining disclosures required under SFAS No. 156 have been omitted based on materiality.

In July 2006, the FASB issued FASB Interpretation No. 48 ("FIN 48"), "Accounting for Uncertainty in Income Taxes." The interpretation clarifies the accounting for uncertainty in income taxes recognized in a company's financial statements in accordance with SFAS No. 109, "Accounting for Income Taxes." Specifically, FIN 48 prescribes a recognition threshold and a measurement attribute for the financial statement recognition and measurement of a tax provision taken or expected to be taken on a tax return. FIN 48 also provides guidance on the related derecognition, classification, interest and penalties, accounting for interim periods, disclosure, and transition of uncertain tax positions. FIN 48 is effective for fiscal years beginning after December 15, 2006, or January 1, 2007 as to the Corporation. The Corporation has adopted FIN 48 without material adverse effect on the Corporation's financial position or results of operations.

In September 2006, the FASB issued SFAS No. 157, "Fair Value Measurements." This Statement defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. This Statement emphasizes that fair value is a market-based measurement and should be determined based on assumptions that a market participant would use when pricing an asset or liability. This Statement clarifies that

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Cheviot Financial Corp.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

For the three and six months ended June 30, 2007 and 2006

### 7. Effects of Recent Accounting Pronouncements (continued)

market participant assumptions should include assumptions about risk as well as

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the effect of a restriction on the sale or use of an asset. Additionally, this Statement establishes a fair value hierarchy that provides the highest priority to quoted prices in active markets and the lowest priority to unobservable data. This Statement is effective for fiscal years beginning after November 15, 2007, or January 1, 2008 as to the Company, and interim periods within those fiscal years. The adoption of this Statement is not expected to have a material adverse effect on the Company's financial position or results of operations.

In September 2006, the FASB ratified the Emerging Issues Task Force's (EITF) Issue 06-4, "Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements," which requires companies to recognize a liability and related compensation costs for endorsement split-dollar life insurance policies that provide a benefit to an employee extending to postretirement periods. The liability should be recognized based on the substantive agreement with the employee. This Issue is effective beginning January 1, 2008. The Issue can be applied as either a change in accounting principle through a cumulative-effect adjustment to retained earnings as of the beginning of the year of adoption, or a change in accounting principle through retrospective application to all periods. The Corporation is in the process of evaluating the impact the adoption of Issue 06-4 will have on the financial statements.

In September 2006, the FASB ratified a consensus opinion reached by the EITF on EITF Issue 06-5, "Accounting for Purchases of Life Insurance - Determining the Amount that Could be Realized in Accordance with FASB Technical Bulletin No. 85-4." The guidance in EITF Issue 06-5 requires policyholders to consider other amounts included in the contractual terms of an insurance policy, in addition to cash surrender value, for purposes of determining the amount that could be realized under the terms of the insurance contract. If it is probable that contractual terms would limit the amount that could be realized under the insurance contract, those contractual limitations should be considered when determining the realizable amounts. The amount that could be realized under the insurance contract should be determined on an individual policy (or certificate) level and should include any amount realized on the assumed surrender of the last individual policy or certificate in a group policy.

The Company holds several life insurance policies, however, the policies do not contain any provisions that would restrict or reduce the cash surrender value of the policies. The consensus in EITF Issue 06-5 is effective for fiscal years beginning after December 15, 2006. The Corporation applied the guidance in EITF Issue 06-5 effective January 1, 2007 which did not have any effect on the Corporation's financial statements.

In February 2007, the FASB issued SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities - Including an Amendment of FASB Statement No. 115." This Statement allows companies the choice to measure many financial instruments and certain other items at fair value. The objective is to improve financial reporting by providing entities with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. This Statement is expected to expand the use of fair value measurement, which is consistent with the Board's long-term measurement objectives for accounting for financial instruments. This Statement is effective as of the beginning of an entity's first fiscal year that begins after November 15, 2007, or January 1, 2008 as to the Corporation, and interim periods within those fiscal years. Early adoption is permitted as of the beginning of a fiscal year that begins on or before November 15, 2007, provided the entity also elects to apply the provisions of SFAS No. 157, "Fair Value Measurements." The Corporation is currently evaluating the impact the adoption of SFAS No. 159 will have on the financial statements.

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Cheviot Financial Corp.

## ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

### Forward Looking Statements -----

This report on Form 10-Q contains forward-looking statements, which can be identified by the use of such words as estimate, project, believe, intend, anticipate, plan, seek, expect and similar expressions. These forward-looking statements are subject to significant risks, assumptions and uncertainties that could affect the actual outcome of future events. Because of these uncertainties, our actual future results may be materially different from the results indicated by these forward-looking statements.

### Critical Accounting Policies -----

We consider accounting policies involving significant judgments and assumptions by management that have, or could have, a material impact on the carrying value of certain assets or on income to be critical accounting policies. We consider the accounting method used for the allowance for loan losses to be a critical accounting policy.

The allowance for loan losses is the estimated amount considered necessary to cover inherent, but unconfirmed credit losses in the loan portfolio at the balance sheet date. The allowance is established through the provision for losses on loans which is charged against income. In determining the allowance for loan losses, management makes significant estimates and has identified this policy as one of the most critical for Cheviot Financial.

Management performs a quarterly evaluation of the allowance for loan losses. Consideration is given to a variety of factors in establishing this estimate including, but not limited to, current economic conditions, delinquency statistics, geographic and industry concentrations, the adequacy of the underlining collateral, the financial strength of the borrower, results of internal loan reviews and other relevant factors. This evaluation is inherently subjective as it requires material estimates that may be susceptible to significant change.

The analysis has two components, specific and general allocations. Specific percentage allocations can be made for unconfirmed losses related to loans that are determined to be impaired. Impairment is measured by determining the present value of expected future cash flows or, for collateral-dependent loans, the fair value of the collateral adjusted for market conditions and selling expenses. If the fair value of the loan is less than the loan's carrying value, a charge-off is recorded for the difference. The general allocation is determined by segregating the remaining loans by type of loan, risk weighting (if applicable) and payment history. We also analyze historical loss experience, delinquency trends, general economic conditions and geographic and industry concentrations. This analysis establishes factors that are applied to the loan groups to determine the amount of the general reserve. Actual loan losses may be significantly more than the allowances we have established which could result in a material negative effect on our financial results.

Discussion of Financial Condition Changes at December 31, 2006 and  
at June 30, 2007

-----  
Total assets increased \$6.7 million, or 2.2%, to \$316.5 million at June 30, 2007, from \$309.8 million at December 31, 2006. The increase in total assets reflects an increase in investment securities and loans receivable, which were partially offset by a decrease in mortgage-backed securities.

Cash, federal funds sold and interest-earning deposits decreased \$48,000, or 0.9%, to \$5.4 million at June 30, 2007, from \$5.5 million at December 31, 2006. The decrease in cash and cash equivalents at June 30, 2007, was due to a \$1.4 million decrease in federal funds sold, which was partially offset by a \$23,000 increase in cash and due from banks and a \$1.4 million increase in interest earning deposits. Investment securities increased \$2.9 million to \$37.0 million at June 30, 2007. At June 30, 2007, \$23.1 million of investment securities were classified as held to maturity, while \$13.9 million were classified as available for sale.

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Cheviot Financial Corp.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION  
AND RESULTS OF OPERATIONS (CONTINUED)

Discussion of Financial Condition Changes at December 31, 2006 and at  
June 30, 2007 (continued)

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Mortgage-backed securities decreased \$2.7 million, or 17.5%, to \$12.6 million at June 30, 2007, from \$15.3 million at December 31, 2006. The decrease in mortgage-backed securities was due primarily to principal prepayments and repayments totaling \$2.7 million. At June 30, 2007, \$11.7 million of mortgage-backed securities were classified as held to maturity, while \$933,000 were classified as available for sale. Management has focused on investing in shorter term instruments in an effort to enhance the Corporation's liquidity in the current interest rate environment.

Loans receivable, including loans held for sale, increased \$5.5 million, or 2.3%, to \$246.7 million at June 30, 2007, from \$241.2 million at December 31, 2006. The increase reflects loan originations totaling \$24.8 million, partially offset by loan principal repayments of \$16.3 million and sales of \$2.3 million.

The allowance for loan losses totaled \$723,000 and \$833,000 at June 30, 2007 and December 31, 2006, respectively. In determining the adequacy of the allowance for loan losses at any point in time, management and the board of directors apply a systematic process focusing on the risk of loss in the portfolio. First, the loan portfolio is segregated by loan types to be evaluated collectively and loan types to be evaluated individually. Delinquent multi-family and commercial loans are evaluated individually for potential impairments in their carrying value. Second, the allowance for loan losses entails utilizing our historic loss experience by applying such loss percentage to the loan types to be collectively evaluated in the portfolio. This segment of the loss analysis resulted in no addition to the provision for loss for the three or six months ended June 30, 2007. The analysis of the allowance for loan losses requires an element of judgment and is subject to the possibility that the allowance may need to be increased, with a corresponding reduction in earnings. To the best of management's knowledge, all known and inherent losses that are probable and that can be reasonably estimated have been recorded at June 30, 2007.

Non-performing and impaired loans totaled \$737,000 and \$281,000 at June 30, 2007 and December 31, 2006, respectively. At June 30, 2007, non-performing and impaired loans were comprised solely of 8 loans secured by one- to four-family



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residential real estate. The allowance for loan losses represented 98.1% and 296.4% of non-performing and impaired loans and 0.30% and 0.12% of total loans at June 30, 2007 and December 31, 2006, respectively. Although management believes that the Corporation's allowance for loan losses conforms with generally accepted accounting principles based upon the available facts and circumstances, there can be no assurance that additions to the allowance will not be necessary in future periods, which would adversely affect our results of operations.

Deposits increased \$6.9 million, or 3.3%, to \$212.3 million at June 30, 2007, from \$205.5 million at December 31, 2006. Advances from the Federal Home Loan Bank of Cincinnati increased by \$3.3 million, or 11.2%, to \$32.5 million at June 30, 2007, from \$29.2 million at December 31, 2006.

Shareholders' equity decreased \$2.5 million, or 3.4%, to \$69.7 million at June 30, 2007, from \$72.2 million at December 31, 2006. The decrease primarily resulted from the repurchase of treasury shares of \$2.8 million and dividends paid of \$602,000, which were partially offset by net earnings of \$478,000. At June 30, 2007, Cheviot Financial had the ability to purchase an additional 192,146 shares under its announced stock repurchase plan.

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Cheviot Financial Corp.

### MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)

Comparison of Operating Results for the Six-Month Periods Ended  
June 30, 2007 and 2006

-----  
General  
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Net earnings for the six months ended June 30, 2007 totaled \$478,000, a \$389,000 decrease from the \$867,000 net earnings reported for the same period in 2006. The decrease in net earnings reflects a decrease in net interest income of \$269,000 and an increase of \$347,000 in general, administrative and other expenses, which were partially offset by an increase in other income of \$35,000 and a decrease of \$192,000 in federal income taxes for the 2007 period.

Net Interest Income  
-----

Total interest income increased \$888,000, or 11.3%, to \$8.8 million for the six-months ended June 30, 2007, from the comparable period in 2006. Interest income on loans increased \$600,000, or 8.9%, to \$7.4 million during the 2007 period from \$6.8 million for the 2006 period. This increase was due primarily to a \$15.2 million, or 6.6%, increase in the average balance of loans outstanding, and a 13 basis point increase in the weighted-average yield on loans to 6.06% for the 2007 period from 5.93% for the six months ended June 30, 2006.

Interest income on mortgage-backed securities decreased \$59,000, or 13.9%, to \$365,000 for the six months ended June 30, 2007, from \$424,000 for the same

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period in 2006, due primarily to a \$6.0 million decrease in the average balance of securities outstanding, which was partially offset by a 103 basis point increase in the average yield period to period. Interest income on investment securities increased \$329,000, or 59.0%, to \$887,000 for the six months ended June 30, 2007, compared to \$558,000 for the same period in 2006, due primarily to a 135 basis point increase in the average yield to 5.47% in the 2007 period, and an increase of \$5.4 million, or 19.8% in the average balance of investment securities outstanding. Interest income on other interest-earning deposits increased \$18,000, or 16.5% to \$127,000 for the six months ended June 30, 2007, as compared to the same period in 2006.

Interest expense increased \$1.2 million, or 33.8% to \$4.6 million for the six months ended June 30, 2007, from \$3.4 million for the same period in 2006. Interest expense on deposits increased by \$1.3 million, or 47.9%, to \$3.9 million for the six months ended June 30, 2007, from \$2.6 million for the same period in 2006 due primarily to an 87 basis point increase in the weighted average costs of deposits to 3.76 % during the 2007 period and a \$25.3 million, or 13.9%, increase in the weighted-average balance outstanding. Interest expense on borrowings decreased by \$108,000, or 13.7%, due primarily to a \$4.2 million, or 12.6%, decrease in the average balance outstanding and a 7 basis point decrease in the average cost of borrowings. The increase in the yields on interest-earning assets and costs of interest-bearing liabilities were due primarily to the overall increase in interest rates during the 2007 period.

As a result of the foregoing changes in interest income and interest expense, net interest income decreased by \$269,000, or 6.1%, to \$4.2 million for the six months ended June 30, 2007. The average interest rate spread decreased to 2.06% for the six months ended June 30, 2007 from 2.44% for the six months ended June 30, 2006. The net interest margin decreased to 2.83% for the six months ended June 30, 2007 from 3.17% for the six months ended June 30, 2006.

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Cheviot Financial Corp.

### MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)

Comparison of Operating Results for the Six-Month Periods Ended June 30, 2007  
and 2006 (continued)

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Provision for Losses on Loans  
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As a result of the allowance for loan losses analysis described elsewhere in this document, management concluded that the allowance for loan loss was adequate, and therefore, did not record a provision for losses on loans for the six-months ended June 30, 2007 and 2006. There can be no assurance that the loan loss allowance will be sufficient to cover losses on non-performing loans in the future, however management believes they have identified all known and inherent losses that are probable and that can be reasonably estimated within the loan portfolio, and that the allowance for loan losses is adequate to absorb such losses.

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### Other Income

-----  
Other income increased \$35,000, or 15.7%, to \$258,000 for the six months ended June 30, 2007, compared to the same period in 2006, due primarily to an increase in the gain on the sale of loans of \$10,000 and an increase of \$6,000 in other operating income, which were partially offset by a decrease in earnings on bank owned life insurance of \$4,000.

### General, Administrative and Other Expense

-----  
General, administrative and other expense increased \$347,000, or 10.3%, to \$3.7 million for the six months ended June 30, 2007, from \$3.4 million for the comparable period in 2006. This increase is a result of an increase of \$158,000 in employee compensation and benefits, a \$67,000 increase in occupancy and equipment, a \$14,000 increase in legal and professional services and an increase of \$58,000 in other operating expense. The increase in employee compensation and benefits is due primarily to an increase in the number of employees reflecting the full quarter's operation of two more branches than the comparable period in 2006. The increase in occupancy and equipment is due primarily to expense incurred for the operation of the two new branches opened in the latter quarters of 2006. The increase in legal and professional services was due primarily to expenses incurred for litigation proceedings wherein the Corporation was defending its security interest in collateral. The Corporation has reached a settlement regarding this litigation of \$50,000, accounting for the majority of the increase in other operating expense for the 2007 six month period.

### Federal Income Taxes

-----  
The provision for federal income taxes decreased \$192,000, or 46.5%, to \$221,000 for the six months ended June 30, 2007, from \$413,000 for the same period in 2006, due primarily to a \$581,000, or 45.4%, decrease in pre-tax earnings. The effective tax rate was 31.6% and 32.3% for the six month periods ended June 30, 2007 and 2006. The difference between the Corporation's effective tax rate in the 2007 and 2006 periods and the 34% statutory corporate rate is due primarily to the tax-exempt earnings on bank-owned life insurance.

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Cheviot Financial Corp.

### MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)

Comparison of Operating Results for the Three-Month Periods Ended June 30,  
2007 and 2006

### Net Interest Income

-----  
Total interest income increased \$394,000, or 9.8%, to \$4.4 million for the three-months ended June 30, 2007, from the comparable quarter in 2006. Interest income on loans increased \$239,000, or 6.9%, to \$3.7 million during the 2007 quarter from \$3.5 million for the 2006 quarter. This increase was due primarily

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to a \$13.5 million, or 5.8%, increase in the average balance of loans outstanding, and a 6 basis point increase in the weighted-average yield on loans to 6.04% for the 2007 quarter from 5.98% for the three months ended June 30, 2006.

Interest income on mortgage-backed securities decreased \$31,000, or 14.8%, to \$178,000 for the three months ended June 30, 2007, from \$209,000 for the comparable 2006 quarter, due primarily to a \$5.9 million decrease in the average balance of securities outstanding, which was partially offset by a 105 basis point increase in the average yield period to period. Interest income on investment securities increased \$196,000, or 66.7%, to \$490,000 for the three months ended June 30, 2007, compared to \$294,000 for the same quarter in 2006, due primarily to a 138 basis point increase in the average yield to 5.72% in the 2007 quarter, and an increase of \$7.2 million, or 26.5% in the average balance of investment securities outstanding. Interest income on other interest-earning deposits decreased \$10,000, or 14.7% to \$58,000 for the three months ended June 30, 2007.

Interest expense increased \$515,000, or 28.3% to \$2.3 million for the three months ended June 30, 2007, from \$1.8 million for the same quarter in 2006. Interest expense on deposits increased by \$581,000, or 41.0%, to \$2.0 million from \$1.4 million due primarily to a 79 basis point increase in the weighted average costs of deposits to 3.83% during the 2007 quarter due to the total composition of deposits shifting to higher rate certificates of deposit and a \$22.5 million, or 12.0%, increase in the weighted-average balance outstanding. Interest expense on borrowings decreased by \$66,000, or 16.4%, due primarily to a \$3.7 million, or 1.1%, decrease in the average balance outstanding and a 28 basis point decrease in the average cost of borrowings. The increase in the yields on interest-earning assets and costs of interest-bearing liabilities were due primarily to the overall increase in interest rates during the June 2007 quarter.

As a result of the foregoing changes in interest income and interest expense, net interest income decreased by \$121,000, or 5.5%, to \$2.1 million for the three months ended June 30, 2007, as compared to the same quarter in 2006. The average interest rate spread decreased to 2.05% for the three months ended June 30, 2007 from 2.37% for the three months ended June 30, 2006. The net interest margin decreased to 2.81% for the three months ended June 30, 2007 from 3.11% for the three months ended June 30, 2006.

### Provision for Losses on Loans

-----

As a result of the allowance for loan losses analysis described elsewhere in this document, management concluded that the allowance for loan loss was adequate, and therefore, did not record a provision for losses on loans for the three-months ended June 30, 2007 and 2006. There can be no assurance that the loan loss allowance will be sufficient to cover losses on non-performing loans in the future, however management believes they have identified all known and inherent losses that are probable and that can be reasonably estimated within the loan portfolio, and that the allowance for loan losses is adequate to absorb such losses.

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### Other Income

Other income increased \$26,000, or 25.2%, to \$129,000 for the three months ended June 30, 2007, compared to the same quarter in 2006, due primarily to an increase in the gain on the sale of loans of \$3,000, which was partially offset by a decrease in the loss on sale of real estate acquired through foreclosure of \$21,000.

### General, Administrative and Other Expense

General, administrative and other expense increased \$100,000, or 5.9%, to \$1.8 million for the three months ended June 30, 2007, from \$1.7 million for the comparable quarter in 2006. This increase is a result of an increase of \$61,000 in employee compensation and benefits, a \$19,000 increase in occupancy and equipment, a \$21,000 increase in property, payroll and other taxes. The increase in employee compensation and benefits is due primarily to an increase in the number of employees reflecting the increase in our branch franchise during the 2007 period as compared with the 2006 period. The increase in occupancy and equipment is due primarily to expense incurred for the operation of the two new branches opened in the latter quarters of 2006. The increase in property, payroll and other taxes is due primarily to an increase in Ohio franchise tax.

### Federal Income Taxes

The provision for federal income taxes decreased \$61,000, or 30.8%, to \$137,000 for the three months ended June 30, 2007, from \$198,000 for the same quarter in 2006, due primarily to a \$195,000, or 32.3%, decrease in pre-tax earnings. The effective tax rate was 33.5% and 32.8% for the three month periods ended June 30, 2007 and 2006, respectively. The difference between the Corporation's effective tax rate in the 2007 and 2006 periods and the 34% statutory corporate rate is due primarily to the tax-exempt earnings on bank-owned life insurance.

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Cheviot Financial Corp.

### MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)

#### ITEM 3 QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

There has been no material change in the Corporation's market risk since the Form 10-K filed with the Securities and Exchange Commission for the year ended December 31, 2006.

#### ITEM 4 CONTROLS AND PROCEDURES

The Corporation's Chief Executive Officer and Chief Financial Officer evaluated the disclosure controls and procedures (as defined under Rules 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934, as amended) as of the end of the period covered by this quarterly report. Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer have concluded that the Corporation's disclosure controls and procedures are effective.

There were no changes in the Corporation's internal controls or in other factors

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that could materially affect, or could reasonably be likely to materially affect, these controls subsequent to the date of their evaluation by the Corporation's Chief Executive Officer and Chief Financial Officer.

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Cheviot Financial Corp.

### PART II

#### ITEM 1. Legal Proceedings

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None.

#### ITEM 1A. Risk Factors

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There have been no changes to the Corporation's risk factors since the filing of the Corporation's Annual Report on Form 10-K for the year ended December 31, 2006.

#### ITEM 2. Unregistered Sales of Equity Securities, Use of Proceeds and Issuer Purchases of Equity Securities

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The Corporation announced a repurchase plan on September 13, 2006 which provides for the repurchase of 5% or 471,140 shares of our common stock. As of June 30, 2007, the Corporation had purchased 278,994 shares pursuant to the program.

| Period            | Total<br># of shares<br>purchased | Average<br>price paid<br>per share | Total<br>shares<br>as part<br>of annou<br>or |
|-------------------|-----------------------------------|------------------------------------|--|
| -----             | -----                             | -----                              | -----  |
| April 1-30, 2007  | 32,908                            | \$13.50                            | 1  |
| May 1-31, 2007    | 13,200                            | \$13.59                            | 1  |
| June 1 - 30, 2007 | 118,250                           | \$13.64                            | 2  |

#### ITEM 3. Defaults Upon Senior Securities

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Not applicable.

#### ITEM 4. Submission of Matters to a Vote of Security Holders

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The Corporation held its Annual Meeting of Shareholders on April 24, 2007. Two matters were presented to the shareholders for a vote: The shareholders elected two directors by the following votes: For Against Abstain

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|                     |           |   |         |
|---------------------|-----------|---|---------|
| Edward L. Kleemeier | 8,754,133 | - | 189,537 |
| James E. Williamson | 8,633,341 | - | 310,329 |

The shareholders ratified the selection of Grant Thornton LLP as the Company's auditors for the 2007 calendar year by the following vote:

For: 8,937,285                      Against: 4,085                      Abstain: 2,300

Consistent with Form 8-K filed on July 12, 2007, as amended by Form 8-K/A filed on July 16, 2007 the Company changed auditors to Clark, Schaefer, Hackett & Co. for the remainder of the 2007 calendar year with approval of the Company's Audit Committee.

ITEM 5. Other Information

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None.

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Cheviot Financial Corp.

PART II (CONTINUED)

ITEM 6. Exhibits

- 31.1 Certification of Principal Executive Officer Pursuant to Rule 13a-14 of the Securities Exchange Act of 1934, As Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certification of Principal Financial Officer Pursuant to Rule 13a-14 of the Securities Exchange Act of 1934, As Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1 Certification of Principal Executive Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 32.2 Certification of Principal Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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Cheviot Financial Corp.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

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Date: August 7, 2007  
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By: /s/ Thomas J. Linneman  
-----  
Thomas J. Linneman  
President and Chief Executive Officer

Date: August 7, 2007  
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By: /s/ Scott T. Smith  
-----  
Scott T. Smith  
Chief Financial Officer

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Exhibit 31.1

CERTIFICATION PURSUANT TO RULE 13A-14  
OF THE SECURITIES EXCHANGE ACT OF 1934  
AS ADOPTED PURSUANT TO SECTION 302 OF THE  
SARBANES-OXLEY ACT OF 2002

I, Thomas J. Linneman, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Cheviot Financial Corp.;
2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:
  - a. Designed such disclosure controls and procedures or caused such disclosure controls to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;
  - b. Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this quarterly report based on such evaluation; and
  - c. Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in



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the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):
  - a. All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - b. Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: August 7, 2007

/s/Thomas J. Linneman

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Thomas J. Linneman  
President and Chief Executive Officer  
(principal executive officer)

Exhibit 31.2

CERTIFICATION PURSUANT TO RULE 13A-14  
OF THE SECURITIES EXCHANGE ACT OF 1934  
AS ADOPTED PURSUANT TO SECTION 302 OF THE  
SARBANES-OXLEY ACT OF 2002

I, Scott T. Smith, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Cheviot Financial Corp.;
2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:
  - a. Designed such disclosure controls and procedures or caused such disclosure controls to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those

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entities, particularly during the period in which this quarterly report is being prepared;

- b. Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this quarterly report based on such evaluation; and
  - c. Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):
- a. All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - b. Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: August 7, 2007

/s/ Scott T. Smith

-----  
Scott T. Smith  
Chief Financial Officer  
(principal financial officer)

Exhibit 32.1

CERTIFICATION PURSUANT TO  
18 U.S.C. SECTION 1350  
AS ADOPTED PURSUANT TO  
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the Quarterly Report of Cheviot Financial Corp. (the "Company"), on Form 10-Q for the period ended June 30, 2007, as filed with the Securities and Exchange Commission on the date of this Certification (the "Report"), I, Thomas J. Linneman, President and Chief Executive Officer of the Company, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that, to my knowledge:

- 1. The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- 2. The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

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A signed original of this written statement required by Section 906 has been provided to Cheviot Financial Corporation and will be retained by Cheviot Financial Corporation and furnished to the Securities and Exchange Commission or its staff upon request.

/s/Thomas J. Linneman  
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Thomas J. Linneman  
President and Chief Executive Officer

Date: August 7, 2007

Exhibit 32.2

CERTIFICATION PURSUANT TO  
18 U.S.C. SECTION 1350  
AS ADOPTED PURSUANT TO  
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the Quarterly Report of Cheviot Financial Corp. (the "Company"), on Form 10-Q for the period ended June 30, 2007, as filed with the Securities and Exchange Commission on the date of this Certification (the "Report"), I, Scott T. Smith, Chief Financial Officer of the Company, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that, to my knowledge:

1. The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
2. The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

A signed original of this written statement required by Section 906 has been provided to Cheviot Financial Corporation and will be retained by Cheviot Financial Corporation and furnished to the Securities and Exchange Commission or its staff upon request.

/s/Scott T. Smith  
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Scott T. Smith  
Chief Financial Officer

Date: August 7, 2007

ing your status is false.

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An intermediary through which you hold the bonds fails to comply with the procedures necessary to avoid withholding taxes on the bonds. In particular, an intermediary is generally required to forward a copy of your Form W-8BEN (or other documentary information concerning your status) to the withholding agent for the bonds. However, if you hold your bonds through a qualified intermediary or if there is a qualified intermediary in the chain of title between you and the withholding agent for the bonds the qualified intermediary will not generally forward this information to the withholding agent.

You are a bank making a loan in the ordinary course of business. In this case, you will be exempt from withholding taxes only if you are eligible for a treaty exemption or if the interest income is effectively connected with your conduct of a trade or business in the U.S., as discussed above.

Interest payments made to you will generally be reported to the IRS and to you on Form 1042-S. However, this reporting does not apply to you if you hold your bonds directly through a qualified intermediary and the applicable procedures are complied with.

The rules regarding withholding are complex and vary depending on your individual situation. They are also subject to change. In addition, special rules apply to certain types of Non-U.S. holders of the bonds, including partnerships, trusts and other entities treated as pass-through entities for U.S. federal income tax purposes. We suggest that you consult with your tax advisor regarding the specific methods for satisfying these requirements.

### *Sale or Retirement of Bonds*

If you sell the bonds or the bonds are redeemed, you will not be subject to federal income tax on any gain unless one of the following applies:

The gain is connected with a trade or business that you conduct in the U.S.

You are an individual, you were present in the U.S. for at least 183 days during the year in which you disposed of the bonds and certain other conditions are satisfied.

The gain represents accrued interest, in which case the rules for interest would apply.

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### *U.S. Trade or Business*

If you hold your bonds in connection with a trade or business that you are conducting in the U.S. and, if required by an applicable income tax treaty, you maintain a U.S. permanent establishment to which the holding of the bonds is attributable:

Any interest on the bonds, and any gain from disposing of the bonds, generally will be subject to U.S. federal income tax as if you were a U.S. holder.

If you are a corporation, you may also be subject to the branch profits tax on your earnings that are connected with your U.S. trade or business (subject to certain adjustments), including earnings from the bonds. This tax generally is imposed at a rate of 30% but may be reduced or eliminated by an applicable income tax treaty.

### *Estate Taxes*

If you are an individual, your bonds will not be subject to U.S. estate tax when you die. However, this rule only applies if, at your death, payments on the bonds were not connected to a trade or business that you were conducting in the U.S.

### *Information Reporting and Backup Withholding*

U.S. rules concerning information reporting and backup withholding are described above. These rules apply to Non-U.S. holders as follows:

Principal and interest payments you receive will be automatically exempt from the usual rules if you are a Non-U.S. holder exempt from withholding tax on interest, as described above. The exemption does not apply if the withholding agent or an intermediary knows or has reason to know that you should be subject to the usual information reporting or backup withholding rules. In addition, as described above, interest payments made to you may be reported to the IRS on Form 1042-S.

Sale proceeds you receive on a sale of your bonds through a broker may be subject to information reporting and/or backup withholding if you are not eligible for an exemption. In particular, information reporting and backup withholding may apply if you use the U.S. office of a broker and information reporting (but not backup withholding) may apply if you use the foreign office of a broker that has certain connections to the U.S. In general, you may provide one of the forms described under *Withholding Taxes* to claim an exemption from information reporting and backup withholding on a sale. We suggest that you consult your tax advisor concerning information reporting and backup withholding on a sale.

### *Withholdable Payments to Foreign Financial Entities and Other Foreign Entities*

The Foreign Account Tax Compliance Act, or FATCA, imposes a U.S. federal withholding tax of 30% on certain payments to foreign financial institutions and other non-U.S. persons that fail to comply with information reporting requirements in respect of their direct and indirect U.S. shareholders and/or U.S. accountholders. However, under recently issued Treasury Regulations, the FATCA withholding tax described above does not apply to payments on, and gross proceeds from the disposition of, obligations outstanding on January 1, 2014. Thus, it is expected that the bonds generally would not be subject to such provisions. However, it is possible that a significant modification of such bonds occurring after January 1, 2014 could result in the bonds being treated as newly issued and therefore subject to FATCA. Prospective investors are encouraged to consult with their own tax advisors regarding the possible implication of this legislation on their investment in the bonds.

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**UNDERWRITING**

The underwriters named below have severally agreed to purchase, and CFC has agreed to sell to them, severally, the principal amounts of the bonds indicated below. CFC has entered into an underwriting agreement with the underwriters for whom J.P. Morgan Securities LLC, Mitsubishi UFJ Securities (USA), Inc., Mizuho Securities USA Inc. and RBC Capital Markets, LLC are acting as representatives. The underwriting agreement, dated the date hereof, provides that the several obligations of the underwriters are subject to certain conditions as therein set forth. The underwriters will be obligated to purchase all the bonds being underwritten or sold by them if any of the bonds are purchased.

| <b>Underwriter</b>                    | <b>Principal Amount</b> |
|---------------------------------------|-------------------------|
| J.P. Morgan Securities LLC            | \$                      |
| Mitsubishi UFJ Securities (USA), Inc. |                         |
| Mizuho Securities USA Inc.            |                         |
| RBC Capital Markets, LLC              |                         |
| RBS Securities Inc.                   |                         |
|                                       |                         |
|                                       |                         |
|                                       |                         |
| <b>Total</b>                          | <b>\$</b>               |

CFC has been advised by the underwriters that the underwriters propose to offer the bonds to the public initially at the offering price set forth on the cover of this prospectus supplement and may offer the bonds to certain dealers at such price less a selling concession of % of the principal amount of the bonds. The underwriters may allow and each such dealer may reallocate a concession not exceeding % of the principal amount of the bonds. After the initial public offering, such public offering price and such concessions and reallocations may be changed.

The following table shows the underwriting discounts and commissions to be paid to the underwriters by CFC in connection with the offering:

|   | <b>Per Bond</b> | <b>Total</b> |
|---|-----------------|--------------|
|   | %               | \$           |
| Underwriting discounts and commissions payable by us                              |                 |              |
| Expenses associated with this offering, to be paid by CFC, are estimated to be \$ |                 |              |

In connection with the offering made hereby, the underwriters may purchase and sell such bonds in the open market. These transactions may include over-allotment and stabilizing transactions and purchases to cover short positions created by the underwriters in connection with the offering. Stabilizing transactions consist of certain bids or purchases for the purpose of preventing or retarding a decline in the market price of the bonds, and short positions created by the underwriters involve the sale by the underwriters of a greater aggregate principal amount of the bonds than they are required to purchase from CFC. The underwriters also may impose a penalty bid, whereby selling concessions allowed to broker-dealers in respect of the bonds sold in the offering may be reclaimed by the underwriters if such bonds are repurchased by the underwriters in stabilizing or covering transactions. These activities may stabilize, maintain or otherwise affect the market price of the bonds, which may be higher than the price that might otherwise prevail in the open market. These activities, if commenced, may be discontinued at any time. These transactions may be effected in the over-the-counter market or otherwise.

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The bonds are a new issue of securities with no established trading market. CFC has been advised by the representatives that they intend to make a market in the bonds, but are not obligated to do so, and may discontinue any market making at any time without notice. No assurance can be given as to the liquidity of the trading market for the bonds.

CFC has agreed to indemnify the underwriters against certain civil liabilities, including liabilities under the Securities Act of 1933, as amended, or to contribute to payments the underwriters may be required to make in respect of any of these liabilities.

In the ordinary course of their respective businesses, the underwriters and their affiliates have engaged, and may in the future engage, in commercial banking and/or investment banking transactions (including acting as underwriters, initial purchasers or dealers with respect to other securities offerings) with CFC and its affiliates, for which they have received, and in the future expect to receive, customary compensation. In addition, affiliates of the underwriters from time to time have acted or in the future may continue to act as lenders to CFC and its affiliates, for which they have received or expect to receive customary compensation.

In addition, in the ordinary course of their business activities, the underwriters and their affiliates may make or hold a broad array of investments and actively trade debt and equity securities (or related derivative securities) and financial instruments (including bank loans) for their own account and for the accounts of their customers. Such investments and securities activities may involve securities and/or instruments of CFC or its affiliates. The underwriters and their affiliates may also make investment recommendations and/or publish or express independent research views in respect of such securities or financial instruments and may hold, or recommend to clients that they acquire, long and/or short positions in such securities and instruments.

It is expected that delivery of the bonds will be made against payment therefor on or about \_\_\_\_\_, 2013 which is the fifth trading day following the date hereof (such settlement cycle being referred to as T+5). Purchasers of bonds should note that the ability to settle secondary market trades of the bonds effected on the date of pricing and the next succeeding business day may be affected by the T+5 settlement. Accordingly, purchasers who wish to trade the bonds on the date of this prospectus supplement or the following day will be required to specify an alternative settlement cycle at the time of any such trade to prevent a failed settlement and should consult their own legal advisors.

See Plan of Distribution on page 12 of the accompanying prospectus for further information regarding distribution of the bonds.

**Notice to Prospective Investors in the European Economic Area**

In relation to each Member State of the European Economic Area which has implemented the Prospectus Directive (each, a Relevant Member State), each underwriter has represented and agreed that with effect from and including the date on which the Prospectus Directive is implemented in that Relevant Member State (the Relevant Implementation Date) it has not made and will not make an offer of the bonds which are the subject of the offering contemplated by this prospectus supplement to the public in that Relevant Member State except that it may, with effect from and including the Relevant Implementation Date, make an offer of such bonds to the public in the Relevant Member State:

at any time to any legal entity which is a qualified investor as defined in the Prospectus Directive;

at any time to fewer than 100 or, if the Relevant Member State has implemented the relevant provision of the 2010 PD Amending Directive, 150 natural or legal persons (other than qualified investors as defined in the Prospectus Directive) as permitted under the Prospectus Directive, subject to obtaining the prior consent of the relevant underwriter or underwriters nominated by us for any such offer; or

at any time in any other circumstances falling within Article 3(2) of the Prospectus Directive,

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provided that no such offer of the bonds shall require us or any underwriter to publish a prospectus pursuant to Article 3 of the Prospectus Directive or supplement a prospectus pursuant to Article 16 of the Prospectus Directive.

For the purposes of this provision, the expression an offer to the public in relation to any bonds in any Relevant Member State means the communication in any form and by any means of sufficient information on the terms of the offer and the bonds to be offered so as to enable an investor to decide to purchase or subscribe to the bonds, as the same may be varied in that Relevant Member State. For the purposes of this provision, the expression Prospectus Directive means Directive 2003/71/EC (and amendments thereto including that Directive as amended by the 2010 PD Amending Directive, to the extent implemented in the Relevant Member State in question), and includes any relevant implementing measure in the Relevant Member State in question; and the expression 2010 PD Amending Directive means Directive 2010/73/EU.

The seller of the bonds has not authorized and does not authorize the making of any offer of the bonds through any financial intermediary on its behalf, other than offers made by the underwriters with a view to the final placement of the bonds as contemplated in this prospectus supplement. Accordingly, no purchaser of the bonds, other than the underwriters, is authorized to make any further offer of the bonds on behalf of the seller or the underwriters.

### **Notice to Prospective Investors in the United Kingdom**

Each underwriter has advised us that it has only communicated and caused to be communicated and will only communicate or cause to be communicated any invitation or inducement to engage in investment activity (within the meaning of section 21 of the Financial Services and Markets Act 2000 (FSMA)) received by it in connection with the issue or sale of any bonds included in this offering:

to persons outside the United Kingdom (and not located in, nor residents or citizens of any excluded jurisdictions);

to persons having professional experience in matters relating to investments falling within the definition investment professionals in Article 19(5) of The Financial Services and Markets Act 2000 (Financial Promotion) Order 2005 (Order);

to high net worth bodies corporate, unincorporated associations and partnerships and trustees of high value trusts as described in Article 49(2) of the Order; or

a person to whom an invitation or inducement to engage in investment activity may be communicated without contravening section 21 of FSMA,

and each underwriter has complied and will comply with all applicable provisions of the FSMA with respect to anything done by it in relation to the bonds included in this offering in, from or otherwise involving the United Kingdom.



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**LEGAL MATTERS**

The validity of the bonds offered hereby and certain United States tax matters relating to the bonds will be passed upon for CFC by Hogan Lovells US LLP, Columbia Square, 555 Thirteenth Street, NW, Washington, DC. The underwriters will be represented by Hunton & Williams LLP, 200 Park Avenue, New York, New York. Hunton & Williams LLP from time to time has performed and may perform legal services for CFC.

**EXPERTS**

The consolidated financial statements incorporated in this prospectus supplement by reference from CFC's Annual Report on Form 10-K for the year ended May 31, 2012 have been audited by Deloitte & Touche LLP, an independent registered public accounting firm, as stated in their report, which is incorporated herein by reference. Such consolidated financial statements have been so incorporated in reliance upon the report of such firm given upon their authority as experts in accounting and auditing.

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PROSPECTUS

**National Rural Utilities  
Cooperative Finance Corporation  
Collateral Trust Bonds**

We plan to issue from time to time collateral trust bonds. We will provide the specific terms of the collateral trust bonds and the offering in one or more supplements to this prospectus. A prospectus supplement may also add, change or update information contained in this prospectus. You should read this prospectus and any applicable supplement carefully before you invest.

Neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved these bonds, or determined if this prospectus is truthful or complete. Any representation to the contrary is a criminal offense.

**Investing in the collateral trust bonds involves risks. See Risk Factors on page 2.**

This prospectus may not be used to consummate sales of collateral trust bonds unless accompanied by a prospectus supplement.

The date of this prospectus is September 17, 2010

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**ABOUT THIS PROSPECTUS**

To understand the terms of the collateral trust bonds (the "bonds") offered by this prospectus, you should carefully read this prospectus and any prospectus supplement. You should also read the documents referred to under the heading "Where You Can Find More Information" and "Incorporation By Reference" for information on National Rural Utilities Cooperative Finance Corporation ("CFC" or the Company, also referred to as we, us and our), including its financial statements. Certain capitalized terms used in this prospectus are defined elsewhere in this prospectus.

This prospectus is part of a registration statement that we have filed with the U.S. Securities and Exchange Commission (the "SEC"), using a shelf registration procedure. Under this procedure, we may offer and sell bonds from time to time. Each time we offer bonds, we will provide you with a prospectus supplement that will describe the specific amounts, prices and terms of the bonds being offered, including the names of any underwriters, dealers or agents, the compensation of any underwriters, dealers or agents and the net proceeds to us. The prospectus supplement may contain information about any material U.S. federal income tax considerations relating to the bonds covered by the prospectus supplement. The prospectus supplement may also add, update or change information contained in this prospectus.

We are not making an offer of these bonds in any state or jurisdiction where the offer is not permitted.

**RISK FACTORS**

Investing in the bonds involves significant risks. Before you invest in the bonds, in addition to the other information contained in this prospectus and in the accompanying prospectus supplement, you should carefully consider the risks and uncertainties discussed below and under Item 1A, "Risk Factors," or otherwise discussed in the 2010 Form 10-K and in other filings we may make from time to time with the SEC after the date of the registration statement of which this prospectus is a part.

**The Trustee May Experience Difficulty Liquidating or Enforcing Payment on Mortgage Notes Pledged as Collateral After an Event of Default**

If an event of default occurs under the indenture and is continuing 30 days following notice from the trustee requiring us to remedy such event of default, the trustee may sell any or all of the mortgage notes or other property pledged as collateral.

If the trustee attempts to sell any or all of the mortgage notes or any other pledged property, the trustee may be unable to find a purchaser for such notes or property, or be unable to liquidate such notes or property in an

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orderly or timely manner. Additionally, the market value of such notes or property realized in any sale may not be sufficient to make bondholders whole. The amount to be received upon such sale would depend on many factors, including, but not limited to, the time and manner of sale.

### **The Bonds May have Limited or No Liquidity**

There is currently no secondary market for the bonds to be issued and there can be no assurance that a secondary market will develop for such bonds. If a secondary market does develop, there can be no assurance that it will continue or that it will be sufficiently liquid to allow you to resell your bonds when you want or at a price that you wish to receive for your bonds. Unless the applicable prospectus supplement indicates otherwise, the bonds are not, and will not be, listed on any securities exchange. Future trading prices of the bonds, if any, will depend on many factors including, among other things, prevailing interest rates, our operating results and the market for similar securities.

### **WHERE YOU CAN FIND MORE INFORMATION**

We file annual, quarterly and current reports and other information with the SEC. You may read and copy any document we file at the SEC's Public Reference Room located at 100 F Street, N.E., Washington, D.C. 20549. Please call the SEC at 1-800-SEC-0330 for further information about the operation of the Public Reference Room. Our SEC filings are also available to the public at the SEC's website at <http://www.sec.gov>.

As permitted by SEC rules, this prospectus may not contain all of the information we have included in the registration statement and the accompanying exhibits and schedules we file with the SEC. You may refer to the registration statement, exhibits and schedules for more information about us and the bonds. The registration statement, exhibits and schedules are available through the SEC's public reference room or website.

### **INCORPORATION BY REFERENCE**

The SEC allows us to incorporate by reference into this prospectus information we have filed with the SEC, which means that we can disclose important information to you by referring you to those filed documents. The information incorporated by reference is an important part of this prospectus, and the information we subsequently file with the SEC will automatically update and supersede the information in this prospectus. Absent unusual circumstances, we will have no obligation to amend this prospectus, other than filing subsequent information with the SEC. We incorporate by reference the documents listed below and any future filings made with the SEC under Section 13(a), 13(c), 14 or 15(d) of the Securities Exchange Act of 1934, as amended (the Exchange Act) until this offering is completed:

Annual Report on Form 10-K for the year ended May 31, 2010 (filed August 30, 2010); and

Current Reports on Form 8-K, dated May 27, 2010 (filed June 3, 2010) and July 28, 2010 (filed July 28, 2010).

We are not incorporating by reference any document or information that is deemed to be furnished and not filed in accordance with SEC rules.

Any statement contained in a document incorporated or deemed to be incorporated by reference into this prospectus will be deemed to be modified or superseded for purposes of this prospectus to the extent that a statement contained in this prospectus or any other subsequently filed document that is deemed to be incorporated by reference into this prospectus modifies or supersedes the statement. Any statement so modified or superseded will not be deemed, except as so modified or superseded, to constitute a part of this prospectus.

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You may also request, at no cost, a copy of these filings (other than an exhibit to these filings, unless we have specifically incorporated that exhibit by reference into such filings) by writing to or telephoning us at the following address:

National Rural Utilities Cooperative Finance Corporation

Woodland Park, 2201 Cooperative Way

Herndon, VA 20171-3025

(703) 709-6700

Attn: J. Andrew Don

Senior Vice President of Treasury

These filings are also available through the Financial Reporting subsection of the Investor Relations section of our website: [www.nrucfc.coop](http://www.nrucfc.coop). Information on our website does not constitute a part of this prospectus.

**You should rely only on the information contained or incorporated by reference in this prospectus or any prospectus supplement. We have not authorized anyone, including any salesman or broker, to provide you with different information. You should not assume that the information contained or incorporated by reference in this prospectus or any prospectus supplement is accurate as of any date other than the date on the front cover of the document in question.**

## **FORWARD-LOOKING STATEMENTS**

The SEC encourages companies to disclose forward-looking information so that investors can better understand a company's future prospects and make informed investment decisions. This prospectus and the documents incorporated by reference in this prospectus contain forward-looking statements within the meaning of Section 27A of the Securities Act and Section 21E of the Exchange Act.

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, expect, opportunity and similar expressions, whether in the negative or affirmative. All statements about future expectations or projections, including statements about loan volume, the adequacy of the loan loss allowance, net income growth, 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 could materially differ. Factors that could cause future results to vary from current expectations include, but are not limited to, general economic conditions, legislative changes, governmental monetary and fiscal policies, changes in tax policies, changes in interest rates, demand for our loan products, lending competition, changes in the quality or composition of our loan and investment portfolios, changes in accounting principles, policies or guidelines, changes in our ability to access external financing, valuations of collateral supporting impaired loans, non-performance of counterparties to our derivative agreements, and other economic and governmental factors affecting our operations. Some of these and other factors are discussed in our annual and quarterly reports previously filed with the SEC.

Although we believe that the expectations reflected in such forward-looking statements are based on current reasonable assumptions, actual results and performance could differ materially from those set forth in the forward-looking statements due to a variety of known and unknown factors. All subsequent written and oral forward-looking statements attributable to us or any person acting on our behalf are qualified by the cautionary statements in this section. Except as required by law, we undertake no obligation to update or publicly release any revisions to forward-looking statements to reflect events or changes in expectations after the date on which the statement is made.

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**THE COMPANY**

CFC is a member-owned cooperative association incorporated under the laws of the District of Columbia in April 1969. The principal purpose of CFC 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. 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. 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 to offer its members cost-based financial products and services consistent with sound financial management and is not to maximize net income. The Company s headquarters are located at 2201 Cooperative Way, Herndon, VA 20171-3025 and its telephone number is (703) 709-6700.

Rural Telephone Finance Cooperative ( RTFC ) is a 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 and arrange financing for its rural telecommunications members and their affiliates. As a member-owned cooperative, RTFC s objective is to offer its members cost-based financial products and services consistent with sound financial management and is not to maximize net income. RTFC s membership consists of a combination of not-for-profit entities and for profit entities. RTFC s results of operations and financial condition are consolidated with those of CFC. RTFC is headquartered with CFC in Herndon, Virginia. RTFC is a taxable cooperative that pays income tax based on its net income, excluding patronage-sourced net earnings allocated to its patrons, as permitted under Subchapter T of the Internal Revenue Code.

National Cooperative Services Corporation ( NCSC ) was incorporated in 1981 in the District of Columbia as a member-owned cooperative association. NCSC s principal purpose is to provide financing to members of CFC and the for-profit and non-profit entities that are owned, operated or controlled by or provide substantial benefit to certain members of CFC. As a member-owned cooperative, NCSC s objective is to offer its members cost-based financial products and services consistent with sound financial management and is not to maximize net income. NCSC s membership consists of CFC and distribution systems that are members of CFC or are eligible for such membership. NCSC s results of operations and financial condition are consolidated with those of CFC. NCSC is headquartered with CFC in Herndon, Virginia. NCSC is a taxable cooperative, which to date, has not allocated its patronage-sourced net earnings to members, thus NCSC pays income tax on the full amount of its net income.

At May 31, 2010, after taking into consideration systems that are members of both CFC and NCSC and eliminating memberships between CFC, RTFC and NCSC, the Company s consolidated membership totaled 1,456 members and 64 associates. CFC s membership includes 832 distribution systems, 68 power supply systems, 490 telecommunications members, 65 statewide and regional associations, and 1 national association of cooperatives. CFC s members and associates are located in 49 states, the District of Columbia and two U.S. territories.

**RATIO OF EARNINGS TO FIXED CHARGES**

The ratios of earnings to fixed charges for the Company for each of the five years ended May 31, 2010, 2009, 2008, 2007 and 2006 are included in Exhibit 12 to the Annual Report on Form 10-K for the year ended May 31, 2010, and are incorporated by reference into this prospectus.

**USE OF PROCEEDS**

Unless otherwise specified in a prospectus supplement, the net proceeds from the sale of the bonds will be added to the general funds of CFC and will be available for loans and for use in connection with the retirement of debt.

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**DESCRIPTION OF THE COLLATERAL TRUST BONDS**

The following description summarizes the general terms and provisions that may apply to the bonds. Each prospectus supplement will state the particular terms of the bonds and the extent, if any, to which the general provisions may apply to the bonds included in the prospectus supplement.

**General**

The bonds will be issued under an indenture between CFC and U.S. Bank National Association as trustee, or other trustee to be named, dated as of October 25, 2007 (the "indenture"). The statements in this prospectus concerning the indenture, one or more supplemental indentures, board resolutions or officers' certificates establishing the bonds, and the bonds are merely an outline and do not purport to be complete. We refer you to the indenture and any supplemental indenture, each of which is or will be incorporated by reference into this prospectus, for further information.

Reference is made to the prospectus supplement relating to any particular issue of bonds for the following terms:

the title and any limit on the aggregate principal amount of the bonds to be issued;

the persons to whom interest on the bonds is payable, if other than the persons in whose names the bonds are registered on the regular record date;

the date or dates on which the bonds will mature;

the annual rate or rates (which may be fixed or variable) at which such bonds will bear interest or any formula or method by which such rate or rates will be determined;

the date or dates from which the interest will accrue and the date or dates at which interest will be payable;

the place or places where payments may be made on the bonds, registration of transfer may be effected, exchanges of bonds may be effected and notices to or demands upon the Company may be served;

any redemption or sinking fund terms;

the denominations in which the bonds will be issuable, if other than \$1,000 and any integral multiple thereof;

the currency or currencies in which payment of the principal of and premium, if any, and interest, if any, on the bonds will be payable (if other than U.S. dollars), and, if to be payable in a currency or currencies other than that in which the bonds are denominated, the period or periods within which, and the terms and conditions upon which, the election may be made, and if denominated or payable in any currency or currencies other than U.S. dollars, the method by which the bonds will be valued;

if the principal of or premium, if any, or interest, if any, on the bonds is to be payable in securities or other property at the election of CFC or a holder, the type and amount of the securities or other property, or the formula or method by which the amount will be determined, and the periods within which, and the terms and conditions upon which, any election may be made;

if the amount payable in respect of principal of or any premium, if any, or interest, if any, on such bonds may be determined with reference to an index or other fact or event ascertainable outside the indenture, the manner in which the amounts will be determined;

if other than the principal amount of the bonds, the portion of the principal amount of the bonds payable upon declaration of the acceleration of the maturity;

the terms, if any, on which bonds may be converted into or exchanged for securities of CFC or any other person;



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any events of default, in addition to those specified under Events of Default in the indenture, with respect to the bonds, and any covenants of CFC for the benefit of the holders of the bonds, in addition to those set forth in Article 7 of the indenture;

if the bonds are to be issued in global form, the depositary with respect to the global bond or bonds, any limitations on the rights of the holders of the bonds to transfer or exchange them or to obtain the registration of transfer or to obtain certificates in definitive form in lieu of temporary form, and any and all other matters incidental to such bonds;

if the bonds are to be issuable as bearer securities, any and all matters incidental thereto;

any limitations on the rights of a holder to transfer or exchange the bonds or to obtain the registration of transfer thereof, and the amount or terms of any service charge for the registration of transfer or exchange of the bonds;

the right, if any, of CFC to limit or discharge the indenture as to the bonds;

whether and under what circumstances CFC will pay additional amounts on the bonds held by a person who is not a U.S. person in respect of any tax, assessment or governmental charge withheld or deducted and, if so, whether and on what terms CFC will have the option to redeem the bonds rather than pay the additional amounts; and

any other terms of the bonds, not inconsistent with the provisions of the indenture. *(Section 2.03)*

The bonds may be issued in registered form, a form registered as to principal only, or any combination thereof. In addition, all or a portion of the bonds may be issued in temporary or definitive global form.

Unless stated otherwise in any supplemental indenture, CFC may also re-open a previous series of bonds of any series without the consent of the holders of the bonds of any series and issue additional bonds of the same series, which additional bonds will have the same terms as the original series except for the issue price and the issue date. CFC will not issue any additional bonds of the same series unless the additional bonds will be fungible with all bonds of the same series for United States Federal income tax purposes.

## **Security**

The bonds will be secured equally with outstanding bonds issued under the indenture, by the pledge with the trustee of eligible collateral having an allowable amount at least equal to the aggregate principal amount of bonds outstanding. The indenture provides that eligible collateral will consist of cash, eligible mortgage notes of distribution system members and permitted investments. The allowable amount of cash is 100% thereof, the allowable amount of eligible mortgage notes is the amount advanced and not repaid and the allowable amount of permitted investments is their cost to CFC (exclusive of accrued interest and brokerage commissions). However, the allowable amount of permitted investments traded on a national securities exchange or in any over-the-counter market is their fair market value as determined by CFC. For purposes of the indenture and as used in describing the bonds herein, a member is any person which is a member of CFC, and a distribution system member is a member 50% or more of whose gross operating revenues are derived from sales of electricity to end users, as determined as of the end of the last completed calendar year. *(Sections 1.01 and 3.01)*

CFC has previously issued collateral trust bonds under indentures dated as of February 15, 1994 and December 1, 1972, each between CFC and U.S. Bank National Association, as successor trustee. The collateral under those indentures secures only those bonds, and will not secure bonds issued hereby.

As a condition to the authentication and delivery of bonds or to the withdrawal of collateral, and in any event at least once a year, CFC must certify to the trustee that:

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the allowable amount of eligible collateral pledged under the indenture is at least equal to the aggregate principal amount of bonds to be outstanding immediately after the authentication and delivery of such bonds;

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the allowable amount of eligible collateral pledged under the indenture after any withdrawal of collateral is at least equal to the aggregate principal amount of bonds to be outstanding immediately after such withdrawal;

each eligible mortgage note included in the eligible collateral so certified is an eligible mortgage note of a member having an Equity Ratio (defined below) of at least 20% and an Average Coverage Ratio (defined below) of at least 1.35; and

the aggregate allowable amount of all eligible mortgage notes of any one member so certified does not exceed 10% of the aggregate allowable amount of all eligible collateral so certified. (*Sections 3.01, 6.01 and 7.13*)

CFC is also entitled to the authentication and delivery of bonds on the basis of the retirement of outstanding bonds at their final maturity or by redemption at the option of CFC. (*Section 3.02*)

The indenture provides that bonds may be issued without limitation as to aggregate principal amount so long as the allowable amount of eligible collateral pledged under the indenture at least equals the aggregate principal amount of bonds to be outstanding and meets the other requirements set forth herein. (*Sections 2.03 and 13.01*) Eligible mortgage note means a mortgage note of a distribution system member which is secured by a validly existing mortgage under which no event of default as defined in the mortgage shall have occurred and shall have resulted in the exercise of any right or remedy described in the mortgage. (*Section 1.01*)

Equity Ratio of any member means the ratio determined by dividing such member's equities and margins at the end of the last completed calendar year by such member's total assets and other debits at such date, in each case computed in accordance with the Uniform System of Accounts prescribed by RUS, or if such member does not prepare its financial statements in accordance with the Uniform System of Accounts prescribed by RUS, then in accordance with Generally Accepted Accounting Principles ( GAAP ). (*Section 1.01*)

Coverage Ratio of any member for any completed calendar year of such member means the ratio determined by adding such member's patronage capital and operating margins, non-operating margins interest, interest expense with respect to long-term debt and depreciation and amortization expense for such year, and dividing the sum so obtained by the sum of all payments of principal and interest required to be made during such year on account of such member's long-term debt (but in the event any portion of such member's long-term debt was refinanced during such year, the payments of principal and interest required to be made during such year in respect thereof shall be based (in lieu of actual payments thereon) upon the larger of (x) an annualization of such payments required to be made with respect to the refinancing debt during the portion of such year such refinancing debt is outstanding and (y) the payments of principal and interest required to be made during the following year on account of such refinancing debt); patronage capital and operating margins, interest expense with respect to long-term debt, depreciation and amortization expense, non-operating margins interest and long-term debt being determined in accordance with the Uniform System of Accounts prescribed at the time by RUS or, if such member does not maintain its accounts in accordance with said Uniform System of Accounts, otherwise determined in accordance with GAAP, except that (i) in computing interest expense with respect to long-term debt, and payments of interest required to be made on account of long-term debt, for the purpose of the foregoing definition, there shall be added, to the extent not otherwise included, an amount equal to  $33\frac{1}{3}\%$  of the excess of the restricted rentals paid by such member for such year over 2% of such member's equities and margins for such year as defined in the Uniform System of Accounts prescribed by RUS or, if such member does not maintain its accounts in accordance with said Uniform System of Accounts, otherwise determined in accordance with GAAP, and (ii) in computing such member's patronage capital and operating margins for the purpose of the foregoing definition, all cash received in respect of generation and transmission and other capital credits shall be included. The Average Coverage Ratio of any member means the average of the two higher coverage ratios of a member for each of the last three completed calendar years. (*Section 1.01*) The effect of these provisions is to exclude from the computation of the coverage ratio capital credits, except to the extent received by the member in the form of cash.

The indenture requires that each mortgage securing an eligible mortgage note be consistent with CFC's standard lending practices from time to time. (*Section 1.01*) There are no requirements in the indenture as to the value of the property subject to the lien of a mortgage.

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The indenture provides that, unless an event of default under the indenture exists, and other than certain limited duties specified in the indenture, the trustee shall have no duties or responsibilities with regard to any mortgage, and no responsibilities with regard to the value of any property subject thereto. (*Section 4.03*)

Permitted investments are defined to include:

obligations of or guaranteed by the United States or any agency thereof for which the full faith and credit of the obligor shall be pledged and which shall mature, except in the case of obligations guaranteed by RUS, not more than two years after purchase;

obligations of any state or municipality, or subdivision or agency of either thereof, which shall mature not more than two years after the purchase thereof and are rated AA (or equivalent) or better by at least two nationally recognized statistical rating organizations or having a comparable rating in the event of any future change in the rating system of such agencies;

certificates of deposit or time deposits of any bank or trust company organized under the laws of the United States or any state thereof, having at least \$500,000,000 of capital and surplus and maturing not more than two years after purchase; and

commercial paper of bank holding companies or other issuers, other than CFC, generally rated in the highest category by at least two nationally recognized statistical rating agencies and maturing not more than one year after purchase. (*Section 5.03*)

### **Exercise of Rights under Pledged Mortgage Notes; Receipt of Payments**

Until the occurrence of an event of default under the indenture, CFC retains the right to control the exercise of rights and powers under mortgage notes pledged under the indenture. (*Section 15.01*) Unless an event of default under the indenture occurs, CFC will be entitled to receive and retain all payments on account of principal, premium and interest on the eligible mortgage notes and permitted investments on deposit with the trustee. (*Section 4.02*)

### **Modification of the Indenture**

Modifications of the provisions of the indenture may be made with the consent of the holders of not less than a majority in aggregate principal amount of the then outstanding bonds, but, without the consent of the holder of each bond affected thereby, no such modification may:

effect a reduction, or a change of the stated time of payment, of the principal of or interest on any bond or of any premium payable on redemption, change the coin or currency in which the bond is payable, or impair the right to take legal action for the enforcement of any such payment;

permit the creation of any prior or equal lien on pledged property under the indenture, terminate the lien under the indenture, or deprive the holder of any bond of the lien created by the indenture;

reduce the above-stated percentage of holders of bonds whose consent is required to modify the indenture or the percentage of holders of bonds whose consent is required for any waiver under the indenture; or

modify any of the provisions of certain sections of the indenture, except to increase any percentage of holders or to provide that certain provisions of the indenture cannot be modified or waived without the consent of the holder of each bond affected. (*Section 13.02*)

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The indenture provides that CFC and the trustee may, without the consent of any holders of bonds, enter into supplemental indentures for the purposes of:

evidencing the succession of another company to the indenture and the assumption of all covenants of the indenture by such company;

adding to CFC's covenants or events of default;

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changing or eliminating any restriction on the payment of principal of bonds, provided any such action does not adversely affect the interests of the holders of bonds in any material respect;

conveying, transferring and assigning to the trustee, and subjecting to the lien of the indenture, additional properties of CFC, and correcting or amplifying the description of any property at any time;

establishing the form or terms of bonds of any series;

modifying, eliminating or adding to the indenture for purposes of maintaining qualification under the Trust Indenture Act;

curing ambiguities or inconsistencies in the indenture or, provided the action does not adversely affect the interests of the holders of any series of bonds in any material respect, making other provisions with respect to matters arising under the indenture; or

providing for mortgage notes, mortgages and/or loan agreements to be deposited with a depository or an agency and/or permitting the addition to and withdrawal from the pledged property of such instruments, to be evidenced by a book-entry or other notation not requiring physical delivery of such instruments. *(Section 13.01)*

### **Waiver of Certain Covenants**

Under the indenture, CFC will not be required to comply with certain covenants and conditions if the holders of at least a majority in principal amount of the then outstanding bonds waive compliance with such covenant or condition in such instance or generally, but no such waiver shall extend to or affect such covenant or condition except to the extent so expressly waived. *(Section 7.16)*

### **Events of Default**

Each of the following will constitute an event of default under the indenture:

failure to pay interest on any bonds for 30 days after the interest becomes due;

failure to pay principal or any premium on any bonds at their maturity or upon redemption;

default in the making of any sinking fund payment;

default in the performance or breach of specified covenants in the indenture for 60 days after such default is known to any officer of CFC, including the covenant to maintain eligible collateral outlined above;

failure to perform any other covenant or warranty in the indenture for 60 days after notice from the trustee to CFC or from holders of at least 25% in principal amount of the then outstanding bonds to CFC and the trustee; and

specified events of bankruptcy, reorganization or insolvency. *(Section 9.01)*

CFC is required to file annually with the trustee a written statement as to CFC compliance with the conditions and covenants under the indenture. *(Section 7.15)* In case an event of default should occur and be continuing, the trustee or the holders of at least 25% in principal

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amount of the bonds then outstanding may declare the principal of the bonds to be immediately due and payable. Each declaration may, under certain circumstances, be rescinded by the holders of a majority in principal amount of the bonds at the time outstanding. (*Section 9.02*)

Further, if an event of default shall have occurred and be continuing for 30 days following notice and demand for remedy of such event of default from the trustee, the trustee may sell any or all of the mortgage notes or other property pledged as collateral under the indenture. (*Section 9.03*)

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Additionally, if an event of default shall have occurred and be continuing for 30 days following notice and demand for remedy of such event of default from the trustee, the trustee shall, upon the written request of the holders of a majority in aggregate principal amount of the bonds then outstanding and the offering of indemnity as discussed below, proceed by suit or other action to enforce payment of the bonds or the underlying mortgage notes or other property pledged as collateral. (*Sections 9.03 and 9.08*)

Subject to the provisions of the indenture relating to the duties of the trustee in case an event of default shall occur and be continuing, the trustee will be under no obligation to exercise any of its rights or powers under the indenture at the request or direction of any of the holders of the bonds, unless the holders have offered to the trustee reasonable security or indemnity against the costs, expenses and liabilities which might be incurred by compliance. Subject to the provisions for indemnification and certain limitations contained in the indenture, the holders of a majority in principal amount of the bonds then outstanding will have the right to direct the time, method and place of conducting any proceeding for any remedy available to the trustee, or exercising any trust or power conferred on the trustee. The trustee is not required to expend or risk its own funds or incur financial liability if it has reasonable grounds for believing that repayment of such funds or adequate indemnity against such risk or liability is not reasonably assured. (*Sections 9.08, 10.01 and 10.03*)

The indenture provides that on receipt by the trustee of notice of an event of default, declaring an acceleration or directing the time, method or place of conducting a proceeding at law if an event of default has occurred and is continuing, the trustee shall, with respect to any series of bonds represented by a global bond or bonds, and may, with respect to any other series of bonds, establish a record date for the purpose of determining holders of outstanding bonds of the series entitled to join in the notice. (*Sections 9.01, 9.02 and 9.08*)

## **Satisfaction and Discharge; Defeasance**

At the request of CFC, the indenture will cease to be in effect as to CFC, except for certain obligations to register the transfer or exchange of bonds and hold moneys for payment in trust with respect to the bonds, when the principal of and interest on bonds have been paid and/or CFC has deposited with the trustee, in trust, money or U.S. government obligations which, through the payment of interest and principal in accordance with their terms, will provide money in an amount sufficient to pay all the principal of, and interest on, the bonds in accordance with the terms of the bonds, or such bonds are deemed paid and discharged in the manner described in the next paragraph. (*Section 14.01*)

Unless the prospectus supplement relating to the bonds provides otherwise, CFC at its option will be discharged from any and all obligations in respect of the bonds, except for certain obligations to register the transfer or exchange of bonds, replace stolen, lost or mutilated bonds, maintain paying agencies and hold moneys for payment in trust, or need not comply with certain restrictive covenants of the indenture, in each case after CFC deposits with the trustee, in trust, money and U.S. government obligations, or, in the case of bonds denominated in a foreign currency, foreign government securities, which, through the payment of interest and principal in accordance with their terms, will provide money in an amount sufficient to pay in the currency, currencies or currency unit or units in which the bonds are payable all the principal of, and interest on, the bonds on the dates on which payments are due in accordance with the terms of the bonds. Among the conditions to CFC's exercising this option, CFC is required to deliver to the trustee an opinion of counsel to the effect that the deposit and related defeasance would not cause the holders of the bonds to recognize income, gain or loss for United States Federal income tax purposes and that such holders will be subject to United States Federal income tax in the same amounts, in the same manner and at the same times as would have been the case if such deposit and related defeasance had not occurred. (*Section 14.02*)

At the request of CFC, the trustee will deliver or pay to CFC any U.S. government obligations, foreign government securities or money deposited with the trustee by CFC for the purposes described in the preceding two paragraphs and which, in the opinion of an independent accountant, are in excess of the amount which would then have been required to be deposited for such purposes. In addition, the trustee, in exchange for other U.S. government obligations, foreign government securities or money, will deliver or pay to CFC, at CFC's request, U.S. government obligations, foreign government securities or money deposited with the trustee for the



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purposes described in the preceding two paragraphs, so long as the exchange occurs simultaneously, CFC has delivered to the trustee an officers certificate and opinion of counsel stating that all related conditions precedent have been complied with, and in the opinion of an independent accountant, immediately after the exchange, the obligations, securities or money then held by the trustee will be in the amount as would then have been required to be deposited with the trustee for these purposes. (*Section 14.02*)

### **Governing Law**

The indenture is, and the bonds will be, governed by and construed in accordance with the laws of the State of New York.

### **The Trustee**

U.S. Bank National Association is the trustee with respect to all bonds issued under the indenture.

## **PLAN OF DISTRIBUTION**

Bonds of any series may be sold to the public through dealers, agents, an underwriter or an underwriting syndicate. The dealers, agents or underwriters with respect to an offering of bonds will be named in the prospectus supplement relating to the offering. If a dealer is utilized in the sale of any bonds, CFC will sell such bonds to the dealer, as principal. The dealer may then resell the bonds to the public at varying prices to be determined by the dealer at the time of resale. The initial public offering price and any discounts or concessions allowed or reallocated or paid to any dealers set forth in the prospectus supplement may change from time to time.

If an agent is utilized in the sale, unless otherwise indicated in the prospectus supplement, any such agent will be acting on a reasonable best-efforts basis for the period of its appointment.

If underwriters are utilized in the sale, CFC will enter into an underwriting agreement with those underwriters and the underwriters will use the prospectus supplement to make resales of the bonds. Unless otherwise set forth in the prospectus supplement, the obligations of any underwriters to purchase bonds will be subject to conditions precedent and the underwriters will be obligated to purchase all of the bonds if any are purchased.

Any dealers, agents and underwriters may be deemed to be underwriters and any discounts, commissions or concessions received by them from CFC or any profit on the resale of the bonds by them may be deemed to be underwriting discounts and commissions under the Securities Act. Any such person who may be deemed to be an underwriter and any such compensation received from CFC will be described in the prospectus supplement.

Under agreements entered into with CFC, dealers, agents and underwriters who participate in the distribution of the bonds may be entitled to indemnification by CFC against certain civil liabilities, including liabilities under the Securities Act, or to contribution with respect to payments which the agents or underwriters may be required to make in respect thereof.

The place and time of delivery for the bonds in respect of which this prospectus is delivered will be set forth in the prospectus supplement.

Certain of the underwriters, dealers or agents and their associates may engage in transactions with and perform services for CFC in the ordinary course of business.

In connection with offerings made hereby, the underwriters or agents may purchase and sell the bonds in the open market. These transactions may include over-allotment and stabilizing transactions and purchases to cover short positions created by the underwriters or agents in connection with the offering. Stabilizing transactions consist of certain bids or purchases for the purpose of preventing or retarding a decline in the market price of the bonds, and short positions created by the underwriters or agents involve the sale by the underwriters or agents of

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a greater aggregate principal amount of bonds than they are required to purchase from CFC. The underwriters or agents also may impose a penalty bid, whereby selling concessions allowed to broker-dealers in respect of the bonds sold in an offering may be reclaimed by the underwriters or agents if such bonds are repurchased in stabilizing or covering transactions. These activities may stabilize, maintain or otherwise affect the market price of the bonds, which may be higher than the price that might otherwise prevail in the open market. These activities, if commenced, may be discontinued at any time. These transactions may be effected in the over-the-counter market or otherwise.

### **UNITED STATES TAXATION**

#### **General**

This section summarizes the material U.S. tax consequences to beneficial owners of the bonds. However, the discussion is limited in the following ways:

The discussion only covers you if you buy your bonds in the initial offering of a particular issuance of bonds.

The discussion only covers you if you hold your bonds as a capital asset (that is, for investment purposes), your functional currency is the U.S. dollar and you do not have a special tax status.

The discussion does not cover tax consequences that depend upon your particular tax situation in addition to your ownership of bonds, such as your holding bonds in connection with a hedging, straddle or conversion transaction. We suggest that you consult your tax advisor about the consequences of holding bonds in your particular situation.

The discussion does not cover you if you are a partner in a partnership (or an entity treated as a partnership for U.S. tax purposes). If a partnership holds bonds, the tax treatment of a partner will generally depend upon the status of the partner and upon the activities of the partnership. If you are a partner of a partnership holding bonds, we suggest that you consult your tax advisor.

The discussion is based on current law. Changes in the law may change the tax treatment of the bonds, possibly retroactively.

The discussion does not cover state, local or foreign law.

The discussion does not cover every type of bond that we might issue. If we intend to issue a bond of a type not described in this summary, additional tax information will be provided in the prospectus supplement for the bond.

We have not requested a ruling from the IRS on the tax consequences of owning the bonds. As a result, the IRS could disagree with portions of this discussion.

**If you are considering buying bonds, we suggest that you consult your tax advisors about the tax consequences of holding the bonds in your particular situation.**

#### **Tax Consequences to U.S. Holders**

This section applies to you if you are a U.S. holder. A U.S. holder is a beneficial owner of bonds that is:

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an individual U.S. citizen or resident alien;

a corporation or entity taxable as a corporation for U.S. Federal income tax purposes that was created under U.S. law (federal or state);

an estate whose worldwide income is subject to U.S. Federal income tax; or

a trust if a court within the U.S. is able to exercise primary supervision over the administration of the trust and if one or more U.S. persons have the authority to control all substantial decisions of the trust, or if it has validly elected to be treated as a U.S. person.

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### *Interest*

The tax treatment of interest paid on the bonds depends upon whether the interest is qualified stated interest. A bond may have some interest that is qualified stated interest and some that is not.

Qualified stated interest is any interest that meets all the following conditions:

It is payable at least once each year.

It is payable over the entire term of the bond.

It is payable at a single fixed rate or at certain specified variable rates.

The bond has a maturity of more than one year from its issue date.

If any interest on a bond is qualified stated interest, then:

If you are a cash method taxpayer (as are most individual holders), you must report that interest in your income when you receive it.

If you are an accrual method taxpayer, you must report that interest in your income as it accrues.

If any interest on a bond is not qualified stated interest, it is subject to the rules for original issue discount (OID) described below.

### *Determining Amount of OID*

Bonds that have OID are subject to additional tax rules. The amount of OID on a bond is determined as follows:

The amount of OID on a bond is the stated redemption price at maturity of the bond minus the issue price of the bond. If this amount is zero or negative, there is no OID.

The stated redemption price at maturity of a bond is the total amount of all principal and interest payments to be made on the bond, other than qualified stated interest.

The issue price of a bond is the first price at which a substantial amount of the bonds are sold to the public (excluding bondhouses, brokers and persons acting in a similar capacity).

Under a special rule, if the OID determined under the general formula is very small, it is disregarded and not treated as OID. This disregarded OID is called *de minimis* OID. If all the stated interest on a bond is qualified stated interest, this rule applies if the amount of OID is less than the following items multiplied together: (a) .25% (1/4 of 1%), (b) the number of full years from the issue date to the maturity date of the bond and (c) the principal amount.

### *Accrual of OID Into Income*

If a bond has OID, the following consequences arise:

You must include the total amount of OID as ordinary income over the life of the bond.

You must include OID in income as the OID accrues on the bonds, even if you are on the cash method of accounting. This means that you are required to report OID income, and in some cases pay tax on that income, before you receive the cash that corresponds to that income.

OID accrues on a bond on a constant yield method. This method takes into account the compounding of interest. Under this method, the accrual of OID on a bond, combined with the inclusion into income of any qualified stated interest on the bond, will result in you being taxable at approximately a constant percentage of your unrecovered investment in the bond.

The accruals of OID on a bond will generally be less in the early years and more in the later years.

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If any of the interest paid on the bond is not qualified stated interest, that interest is taxed solely as OID. It is not separately taxed when it is paid to you.

Your tax basis in the bond is initially your cost. It increases by any OID (not including qualified stated interest) you report as income. It decreases by any principal payments you receive on the bond, and by any interest payments you receive that are not qualified stated interest.

### *Bonds Subject to Additional Tax Rules*

Additional or different tax rules apply to several types of bonds that we may issue.

*Short-term bonds:* We may issue bonds with a maturity of one year or less. These are referred to as short-term bonds.

No interest on these bonds is qualified stated interest. Otherwise, the amount of OID is calculated in the same manner as described above.

You may make certain elections concerning the method of accrual of OID on short-term bonds over the life of the bonds.

If you are an accrual method taxpayer, a bank, a bond dealer, or in certain other categories, you must include OID or short-term bonds in income as it accrues.

If you are a cash method taxpayer not subject to the accrual rule described above, you do not include OID or short-term bonds in income until you actually receive payments on the bond. Alternatively, you can elect to include OID in income as it accrues.

Two special rules apply if you are a cash method taxpayer and you do not include OID or short-term bonds in income as it accrues. First, if you sell the bond or it is paid at maturity, and you have a taxable gain, then the gain is ordinary income to the extent of the accrued OID on the bond at the time of the sale that you have not yet taken into income. Second, if you borrow money (or do not repay outstanding debt) to acquire or hold the bond, then while you hold the bond you cannot deduct any interest on the borrowing that corresponds to accrued OID on the bond until you include the OID in your income.

*Floating rate bonds:* Floating rate bonds are subject to special OID rules.

If the interest rate is based on a single fixed formula based on the cost of newly borrowed funds or other objective financial information (which in either case may include a fixed interest rate for the initial period), all the stated interest will be qualified stated interest. The amount of OID (if any), and the method of accrual of OID, will then be calculated by converting the bond's initial floating rate into a fixed rate and by applying the general OID rules described above.

If the bond has more than one formula for interest rates, it is possible that the combination of interest rates might create OID. We suggest that you consult your tax advisor concerning the OID accruals on any floating rate bond.

*Foreign currency bonds:* A foreign currency bond is a bond denominated in a currency other than U.S. dollars. Special tax rules apply to these bonds:

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If you are a cash method taxpayer, you will be taxed on the U.S. dollar value of any foreign currency you receive as interest. The dollar value will be determined as of the date on which you receive the payments.

If you are an accrual method taxpayer, you must report interest income as it accrues. You can use the average foreign currency exchange rate during the relevant interest accrual period (or, if that period spans two taxable years, during the portion of the interest accrual period in the relevant taxable year).

In this case, you will make an adjustment upon receipt of the foreign currency to reflect actual exchange rates at that time. Certain alternative elections may also be available.

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Any OID on foreign currency bonds will be determined in the relevant foreign currency. You must accrue OID in the same manner that an accrual basis holder accrues interest income.

Your initial tax basis in a foreign currency bond is the amount of U.S. dollars you pay for the bond (or, if you pay in foreign currency, the U.S. dollar value of that foreign currency on the purchase date). Adjustments are made to reflect OID and other items as described above.

If you collect foreign currency upon the maturity of the bond, or if you sell the bond for foreign currency, your gain or loss will be based on the U.S. dollar value of the foreign currency you receive. For a publicly traded foreign currency bond, this value is determined for cash basis taxpayers on the settlement date for the sale of the bond, and for accrual basis taxpayers on the trade date for the sale (although such taxpayers can also elect the settlement date). You will then have a tax basis in the foreign currency equal to the value reported on the sale.

Any gain or loss on the sale or retirement of a bond will be ordinary income or loss to the extent it arises from currency fluctuations between your purchase date and sale date. Any gain or loss on the sale of foreign currency will also be ordinary income or loss.

In general, any foreign currency loss claimed by you will be treated as a reportable transaction for U.S. federal income tax purposes to the extent that the amount of the loss in a single taxable year from a single transaction equals or exceeds certain threshold amounts (\$50,000 in the case of individuals or trusts, whether or not the loss flows through from an S corporation or partnership, and \$10 million in the case of corporate taxpayers). You should consult your own tax advisors concerning the application of the reportable transaction regulations to your investment in the bond, including any requirement to file IRS Form 8886.

*Other categories of bonds:* Additional rules may apply to certain other categories of bonds. The prospectus supplement for these bonds may describe these rules. In addition, we suggest that you consult your tax advisor in these situations. These categories of bonds include:

bonds with contingent payments;

bonds that you can put to CFC before their maturity;

bonds that are callable by CFC before their maturity, other than typical calls at a premium;

indexed bonds with an index tied to currencies; and

bonds that are extendable at your option or at the option of CFC.

### *Premium and Discount*

Additional special rules apply in the following situations involving discount or premium:

If you buy a bond in the initial offering for more than its stated redemption price at maturity, the excess amount you pay will be bond premium. You can elect to use bond premium to reduce your taxable interest income over the life of your bond.



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Similarly, if a bond has OID and you buy it in the initial offering for more than the issue price, the excess (up to the total amount of OID) is called acquisition premium. The amount of OID you are required to include in income will be reduced by this amount over the life of the bond.

If you buy a bond in the initial offering for less than the initial offering price to the public, special rules concerning market discount may apply.

Appropriate adjustments to tax basis are made in these situations. We suggest that you consult your tax advisor if you are in one of these situations.

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### *Accrual Election*

You can elect to be taxed on the income from the bond in a different manner than described above. Under the election:

No interest is qualified stated interest.

You include amounts in income as it economically accrues to you. The accrual of income is in accordance with the constant yield method, based on the compounding of interest. The accrual of income takes into account stated interest, OID (including *de minimis* OID), market discount and premium.

Your tax basis is increased by all accruals of income and decreased by all payments you receive on the bond.

### *Sale or Retirement of Bonds*

On your sale or retirement of your bond:

You will have taxable gain or loss equal to the difference between the amount received by you and your tax basis in the bond. Your tax basis in the bond is your cost, subject to certain adjustments.

Your gain or loss will generally be capital gain or loss, and will be long-term capital gain or loss if you held the bond for more than one year. If you are not a corporation for U.S. federal income tax purposes, the maximum tax rate on long-term capital gains is 15% for gains realized by you in taxable years beginning prior to January 1, 2011 and 20% for gains realized thereafter. The deductibility of capital losses is subject to certain limitations.

If (a) you purchased the bond with *de minimis* OID, (b) you did not make the election to accrue all OID into income, and (c) you receive the principal amount of the bond upon the sale or retirement, then you will generally have capital gain equal to the amount of the *de minimis* OID.

If you sell the bond between interest payment dates, a portion of the amount you receive reflects interest that has accrued on the bond but has not yet been paid by the sale date. That amount is treated as ordinary interest income and not as sale proceeds.

All or part of your gain may be ordinary income rather than capital gain in certain cases. These cases include sales of short-term bonds, bonds with market discount, bonds with contingent payments or foreign currency bonds.

### *Medicare Tax on Unearned Income.*

For taxable years beginning after December 31, 2012, if you are a U.S. holder that is an individual or estate, or a trust that does not fall into a special class of trusts that is exempt from the tax described in this paragraph, you will be subject to a 3.8% tax on the lesser of (1) your net investment income (if you are an individual) or undistributed net investment income (if you are an estate or trust) for the relevant taxable year and (2) the excess of your modified adjusted gross income (if you are an individual) or adjusted gross income (if you are an estate or trust) for the taxable year over a certain threshold (which, if you are an individual, will be between \$125,000 and \$250,000, depending on your particular circumstances). Your net investment income generally will include your interest income on the bonds and your net gains from the disposition of the bonds, unless such interest income or net gains are derived in the ordinary course of the conduct of a trade or business (other than a trade or business that consists of certain passive or trading activities). If you are an individual, estate or trust, you should consult your own tax advisors regarding the applicability of the Medicare tax to your income and gains in respect of your investment in the bonds.



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### *Information Reporting and Backup Withholding*

Under the tax rules concerning information reporting to the IRS:

Assuming you hold your bonds through a broker or other bond intermediary, the intermediary must provide information to the IRS concerning interest, OID and retirement or sale proceeds on your bonds, unless an exemption applies.

Similarly, unless an exemption applies, you must provide the intermediary with your taxpayer identification number for its use in reporting information to the IRS. If you are an individual, this is your social security number. You are also required to comply with other IRS requirements concerning information reporting.

Even if you do not hold your bonds through a broker or other bond intermediary, payments in respect of your bonds may be subject to information reporting and backup withholding by CFC or its paying agent, if any, unless you provide your taxpayer identification number and comply with certain other IRS requirements or an exemption applies.

If you are subject to these requirements but do not comply, the intermediary must withhold at a rate currently equal to 28% (which rate is scheduled to increase to 31% for reportable payments made in taxable years beginning on or after January 1, 2011) of all amounts payable to you this year on the bonds (including principal payments). If the intermediary withholds, you may claim the withheld amount as a credit against your federal income tax liability.

All individuals are subject to these requirements. Some holders, including all corporations, tax-exempt organizations and individual retirement accounts, are exempt from these requirements.

### **Tax Consequences to Non-U.S. Holders**

This section applies to you if you are a Non-U.S. holder. A Non-U.S. holder is a beneficial owner of bonds, other than a partnership or other entity treated as a partnership for U.S. federal income tax purposes, that is not a U.S. holder.

#### *Withholding Taxes*

Generally, payments of principal and interest (including OID) on the bonds will not be subject to U.S. withholding taxes.

However, for the exemption from withholding taxes to apply to you, you must meet one of the following requirements:

You provide a completed Form W-8BEN (or substitute form) to the bank, broker or other intermediary through which you hold your bonds. The Form W-8BEN contains your name, address and a statement that you are the beneficial owner of the bonds and that you are a Non-U.S. holder.

You hold your bonds directly through a qualified intermediary, and the qualified intermediary has sufficient information in its files indicating that you are not a U.S. holder. A qualified intermediary is a bank, broker or other intermediary that (1) is either a U.S. or non-U.S. entity, (2) is acting out of a non-U.S. branch or office and (3) has signed an agreement with the IRS providing that it will administer all or part of the U.S. tax withholding rules under specified procedures.

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You are entitled to an exemption from withholding tax on interest under a tax treaty between the U.S. and your country of residence. To claim this exemption, you must generally complete Form W-8BEN and claim this exemption on the form. In some cases, you may instead be permitted to provide documentary evidence of your claim to the intermediary, or a qualified intermediary may already have some or all of the necessary evidence in its files.

The interest income on the bonds is effectively connected with the conduct of your trade or business in the U.S., and is not exempt from U.S. tax under a tax treaty. To claim this exemption, you must complete

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Form W-8ECI and be subject to U.S. federal income tax as described below under U.S. Trade or Business. Even if you meet one of the above requirements, interest paid to you will be subject to withholding tax under any of the following circumstances:

The withholding agent or an intermediary knows or has reason to know that you are not entitled to an exemption from withholding tax. Specific rules apply for this test.

The IRS notifies the withholding agent that information that you or an intermediary provided concerning your status is false.

An intermediary through which you hold the bonds fails to comply with the procedures necessary to avoid withholding taxes on the bonds. In particular, an intermediary is generally required to forward a copy of your Form W-8BEN (or other documentary information concerning your status) to the withholding agent for the bonds. However, if you hold your bonds through a qualified intermediary or if there is a qualified intermediary in the chain of title between you and the withholding agent for the bonds the qualified intermediary will not generally forward this information to the withholding agent.

The amount of interest payable on a bond is based on the earnings of CFC or certain other contingencies, unless you are eligible for a treaty exemption or if the interest income is effectively connected with your conduct of a trade or business in the U.S., as discussed above. If interest on the bonds is described in this bullet, additional information will be provided in the prospectus supplement.

You are a bank making a loan in the ordinary course of its business, unless you are eligible for a treaty exemption or if the interest income is effectively connected with your conduct of a trade or business in the U.S., as discussed above. Interest payments made to you will generally be reported to the IRS and to you on Form 1042-S. However, this reporting does not apply to you if one of the following conditions applies:

You hold your bonds directly through a qualified intermediary and the applicable procedures are complied with.

The bonds have an original maturity of 183 days or less from their issue date. The rules regarding withholding are complex and vary depending on your individual situation. They are also subject to change, possibly retroactively. In addition, special rules apply to certain types of Non-U.S. holders of bonds, including partnerships, trusts and other entities treated as pass-through entities for U.S. federal income tax purposes. We suggest that you consult with your tax advisor regarding the specific methods for satisfying these requirements.

### *Sale or Retirement of Bonds*

If you sell a bond or it is redeemed, you will not be subject to Federal income tax on any gain unless one of the following applies:

The gain is connected with a trade or business that you conduct in the U.S.

You are an individual, you were present in the U.S. for at least 183 days during the year in which you disposed of the bond, and certain other conditions are satisfied.

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The gain represents accrued interest or OID, in which case the rules for interest would apply.

*U.S. Trade or Business*

If you hold your bond in connection with a trade or business that you are conducting in the U.S. and, if required by an applicable income tax treaty, you maintain a U.S. permanent establishment to which the holding of the notes is attributable:

Any interest on the bond, and any gain from disposing of the bond, generally will be subject to U.S. Federal income tax as if you were a U.S. holder.

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If you are a corporation, you may be subject to the branch profits tax on your earnings that are connected with your U.S. trade or business, including earnings from the bond. This tax is 30%, but may be reduced or eliminated by an applicable income tax treaty.

### *Estate Taxes*

If you are an individual, your bonds will not be subject to U.S. estate tax when you die. However, this rule only applies if, at your death, payments on the bonds were not connected to a trade or business that you were conducting in the U.S. Legislation enacted in 2001 repealed the U.S. estate tax for the estates of those dying during 2010. However, under the same legislation, the estate tax is scheduled to be fully reinstated, as in effect prior to the 2001 legislation, for the estates of those dying during 2011 and thereafter unless further legislative action is taken. No prediction can be made as to whether these scheduled changes will in fact occur or whether such changes will be affected by subsequent legislation. You should consult your own tax advisor regarding the potential implications of the U.S. estate tax rules to your investment in the bonds.

### *Information Reporting and Backup Withholding*

U.S. rules concerning information reporting and backup withholding are described above. These rules apply to Non-U.S. holders as follows:

Principal and interest payments you receive will be automatically exempt from the usual rules if you are a Non-U.S. holder that is exempt from or eligible for a reduced rate of the withholding tax on interest, as described above. The exemption does not apply if the withholding agent or an intermediary knows or has reason to know that you should be subject to the usual information reporting or backup withholding rules. In addition, as described above, interest payments made to you may be reported to the IRS on Form 1042-S.

Sale proceeds you receive on a sale of your bonds through a broker may be subject to information reporting and/or backup withholding if you are not eligible for an exemption. In particular, information reporting and backup withholding may apply if you use the U.S. office of a broker, and information reporting (but not backup withholding) may apply if you use the foreign office of a broker that has certain connections to the U.S. We suggest that you consult your tax advisor concerning information reporting and backup withholding on a sale.

### *European Union Tax Reporting and Withholding*

Directive 2003/48/EC (the Directive) of the Council of the European Union, relating to the taxation of savings income, became effective on July 1, 2005. Under the Directive, if a paying agent for interest on a debt claim is resident in one member state of the European Union and an individual who is the beneficial owner of the interest is a resident of another member state, then the former member state is required to provide information (including the identity of the recipient) to authorities of the latter member state. Paying agent is defined broadly for this purpose and generally includes any agent of either the payor or payee. Belgium, Luxembourg and Austria have opted instead to withhold tax on the interest during a transitional period (initially at a rate of 15% but rising in steps to 35% after six years), subject to the ability of the individual to avoid withholding taxes through voluntary disclosure of the investment to the individual's Member State. In addition, certain non-members of the European Union (Switzerland, Liechtenstein, Andorra, Monaco and San Marino), as well as dependent and associated territories of the United Kingdom and the Netherlands, have adopted equivalent measures effective on the same date, and some (including Switzerland) have exercised the option to apply withholding taxes as described above.

### **Recently Enacted Legislation**

Recently enacted legislation regarding foreign account tax compliance, effective for payments made after December 31, 2012, imposes a U.S. withholding tax of 30% on interest and gross proceeds from the disposition of certain debt instruments paid to certain foreign entities unless various information reporting and certain other requirements are satisfied. However, the withholding tax will not be imposed on payments pursuant to



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obligations outstanding as of March 18, 2012. Nonetheless, certain account information with respect to U.S. holders who hold bonds through certain foreign financial institutions may be reportable to the IRS. Investors should consult with their own tax advisors regarding the possible implications of this recently enacted legislation on their investment in the bonds.

**LEGAL OPINIONS**

The validity of the bonds offered hereby and certain other matters in connection with an offering of bonds will be passed upon for CFC by Hogan Lovells US LLP, Columbia Square, 555 Thirteenth Street NW, Washington, D.C. The dealers, agents or underwriters, if any, will be represented by counsel that will be named in the applicable prospectus supplement.

**EXPERTS**

The consolidated financial statements incorporated in this Prospectus by reference from the Company's Annual Report on Form 10-K have been audited by Deloitte & Touche LLP, an independent registered public accounting firm, as stated in their report, which is incorporated herein by reference. Such consolidated financial statements have been so incorporated in reliance upon the report of such firm given upon their authority as experts in accounting and auditing.

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**National Rural Utilities  
Cooperative Finance Corporation**

**\$ % Collateral Trust Bonds due**

**Prospectus Supplement**

*Joint Book-Running Managers*

**J.P. Morgan**

**Mitsubishi UFJ Securities**

**Mizuho Securities**

**RBC Capital Markets**

**RBS**