

# ***THIRD QUARTER 2016***

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## **Management's Discussion and Analysis of Financial Condition and Results of Operations**

*(dollars in thousands, except as noted)*

The following discussion reviews the financial condition and results of operations of the Farm Credit Bank of Texas (bank) for the nine months ended September 30, 2016. These comments should be read in conjunction with the accompanying financial statements and footnotes, along with the 2015 Annual Report to shareholders. The accompanying financial statements were prepared under the oversight of the bank's audit committee.

The bank is a member of the Farm Credit System (System), a nationwide network of cooperatively owned financial institutions established by and subject to the provisions of the Farm Credit Act of 1971, as amended, and the regulations of the Farm Credit Administration (FCA) promulgated thereunder.

The United States is currently served by three Farm Credit Banks (FCBs), each of which has specific authority to fund affiliated associations and other financing institutions (OFIs) which make loans to agricultural producers, farm-related businesses and rural homeowners within a regional chartered territory (or district), and by one Agricultural Credit Bank (ACB), which has the lending authority of an FCB within its chartered territory and nationwide authority to finance agricultural cooperatives and rural utilities. The FCBs and the ACB are collectively referred to as "System banks." As FCBs, the primary purpose of the System banks is to serve as a source of funding for System associations within their districts. The System associations make loans to or for the benefit of borrowers for qualified purposes.

The bank and its affiliated associations collectively are referred to as the "district." At September 30, 2016, the bank provided financing to 14 district associations and certain OFIs.

### **RESULTS OF OPERATIONS**

#### *Net Income*

Net income for the quarter ended September 30, 2016, was \$44,193, a decrease of \$1,487, or 3.3 percent, over the same period of 2015. The decrease in net income for the three months ended September 30, 2016, consisted of a \$3,489 increase in noninterest expense and a \$2,545 decrease in noninterest income, offset by a \$3,350 increase in net interest income and a \$1,197 increase in negative provision for credit losses.

Net income for the nine months ended September 30, 2016, was \$132,395, a decrease of \$12,551, or 8.7 percent, over the same period of 2015. The decrease in net income for the nine months ended September 30, 2016, consisted of a \$10,104 increase in noninterest expense, a \$2,698 decrease in noninterest income and a \$1,962 increase in provision for credit losses, offset by a \$2,213 increase in net interest income.

#### *Net Interest Income*

Net interest income for the quarter ended September 30, 2016, was \$59,538, an increase of \$3,350, or 6.0 percent, from the three months ended September 30, 2015. The increase in net interest income for the quarter ended September 30, 2016, was attributable to a volume increase of \$2.22 billion in the bank's average earning assets, offset by a 7-basis-point decrease in the bank's interest rate spread to 107 basis points. Effective interest rates on earning assets increased 7 basis points from the third quarter of 2015 to the third quarter of 2016, while the effective rates on interest-bearing liabilities increased 14 basis points. The increase in the bank's average earning assets included growth in its direct notes from associations, investment portfolio and capital markets loan portfolio. Interest expense for the third quarter of 2016 reflected a \$3.8

million increase in concession expenses recognized on callable debt compared to the third quarter of 2015 as a result of a \$2.46 billion increase in debt called in the quarter ended September 30, 2016, compared to the same period in 2015. The bank recognized \$5.2 million in concession expenses on \$3.52 billion of debt called in the three months ended September 30, 2016, as compared to \$1.4 million in concession expenses on \$1.06 billion of debt called in the three months ended September 30, 2015. The ability to call debt and replace it with debt that has lower interest rates provides a long-term benefit to the bank.

Net interest income for the nine months ended September 30, 2016, was \$174,655, an increase of \$2,213, or 1.3 percent, from the nine months ended September 30, 2015. The increase in net interest income for the nine months ended September 30, 2016, was attributable to a volume increase of \$2.16 billion in the bank's average earning assets, offset by a 13-basis-point decrease in the bank's interest rate spread to 108 basis points. Effective interest rates on earning assets increased 2 basis points from the nine months ended September 30, 2015, to the nine months ended September 30, 2016, while the effective rates on interest-bearing liabilities increased 15 basis points. The increase in the bank's average earning assets included growth in its direct notes from associations, investment portfolio and capital markets loan portfolio. Interest expense for the nine months ended September 30, 2016, reflected a \$7.2 million increase in concession expenses recognized on callable debt as a result of a \$4.45 billion increase in debt called in the nine months ended September 30, 2016, compared to the same period in 2015. The bank recognized \$11.6 million in concession expenses on \$7.51 billion of debt called in the nine months ended September 30, 2016, as compared to \$4.4 million in concession expenses on \$3.06 billion of debt called in the nine months ended September 30, 2015. The ability to call debt and replace it with debt that has lower interest rates provides a long-term benefit to the bank.

#### *Provision for Credit Losses*

The bank had a negative provision for credit losses for the quarter ended September 30, 2016, totaling \$1,104, a decrease of \$1,197 from the \$93 provision for credit losses recorded in the third quarter of 2015. The \$1,104 negative provision for the third quarter ended September 30, 2016, included \$1,322 in recoveries on a previously charged off communication loan, offset by a \$201 increase in general provisions on loans.

The bank's provision for credit losses for the nine months ended September 30, 2016, totaled \$388, an increase of \$1,962 from the \$1,574 negative provision for credit losses recorded in the first nine months of 2015. The \$388 provision for the nine months ended September 30, 2016, included a \$1,946 increase in general provisions on loans due primarily to downgrades on two credits, offset by \$1,558 in recoveries.

#### *Noninterest Income*

Noninterest income for the quarter ended September 30, 2016, was \$7,364, a decrease of \$2,545, or 25.7 percent, over the same period of 2015. The decrease for the third quarter of 2016 over the same period of 2015 was due mainly to a \$3,294 decrease in fees for loan-related services, offset by a \$394 decrease in loss on loans held under the fair value option and a \$238 increase in patronage income.

Noninterest income for the nine months ended September 30, 2016, was \$28,075, a decrease of \$2,698, or 8.8 percent, over the same period of 2015. The decrease included the effects from certain nonrecurring transactions, including a \$5,779 dividend received in 2015 upon the disposition of the preferred stock of an ethanol facility in other property owned (OPO), as well as a \$6,045 decrease in loan-related fees, which included a \$5,895 decrease in prepayment fees. Offsetting these decreases were a 2015 loss of \$3,133 due to the write-off of loan accounting software no longer deemed to be a useable asset, a \$3,096 gain on the sale of a loan in June 2016, a \$2,330 increase in patronage income and a \$671 decrease in loss on loans held under the fair value option.

*Noninterest Expense*

Noninterest expense for the quarter ended September 30, 2016, was \$23,813, an increase of \$3,489, or 17.2 percent, over the same period of 2015. The increase was attributable to a \$1,210 increase in premiums assessed by the Farm Credit System Insurance Corporation (FCSIC), a \$1,137 increase in salaries and employee benefits, a \$631 increase in professional and contract services, a \$439 increase in losses on OPO and a \$362 increase in other operating expenses. The increase in premiums to the FCSIC, that are assessed on the average System debt outstanding, increased due to a rate increase from 13 basis points in 2015 to 16 basis points in the first half of 2016 and to an increase in debt required to fund earning assets. The approved FCSIC premium rate has increased to 18 basis points for the last six months of 2016. The increase in salaries and employee benefits was due primarily to increases in personnel.

Noninterest expense for the nine months ended September 30, 2016, was \$69,947, an increase of \$10,104, or 16.9 percent, over the same period of 2015. The increase was attributable to a \$3,090 gain on sale of OPO in 2015, a \$2,558 increase in premiums assessed by the FCSIC, a \$1,566 increase in salaries and employee benefits, a \$1,081 increase in occupancy and equipment expenses, an \$850 increase in professional and contract services, a \$439 increase in losses on OPO, a \$409 increase in advertising and member relations, and a \$111 increase in other operating expenses. Premiums assessed by the FCSIC increased due to a rate increase on outstanding debt from 13 basis points in 2015 to 16 basis points for the first six months of 2016, and to an increase in debt required to fund earning assets. The approved FCSIC premium rate has increased to 18 basis points for the last six months of 2016. The increase in salaries and employee benefits was due primarily to increases in personnel.

***Key results of operations comparisons:***

|   | <b>Annualized for the<br/>Nine Months Ended<br/>September 30, 2016</b> | Annualized for the<br>Nine Months Ended<br>September 30, 2015 |
|---|--|---|
| Return on average assets  | <b>0.85%</b>   | 1.03%   |
| Return on average shareholders' equity  | <b>10.82%</b>  | 12.26%  |
| Net interest income as a percentage<br>of average earning assets                    | <b>1.16%</b>   | 1.28%   |
| (Recoveries), net of charge-offs, to average loans                                  | <b>&lt; (0.01)%</b>  | 0.02%   |
| Operating expenses as a percentage of<br>net interest income and noninterest income | <b>34.29%</b>  | 30.97%  |
| Operating expenses as a percentage of<br>average earning assets                     | <b>0.46%</b>   | 0.47%   |

*Other Comprehensive Income*

Other comprehensive income consists of certain gains, losses or costs for which values are included in assets or liabilities on the balance sheets, but which have not yet been recognized in earnings. In the balance sheets, they are included in accumulated other comprehensive income in the shareholders' equity section. For the bank, these elements include unrealized gains or losses on the bank's available-for-sale investment portfolio, elements of certain postretirement benefit changes and changes in the value of cash flow derivative instruments.

The table below summarizes the changes in elements included in other comprehensive income for the nine months ended September 30:

|   | <b>2016</b>      | 2015      |
|---|------------------|-----------|
| Change in unrealized gains on available-for-sale securities |                  |           |
| Net increase in unrealized gains on investment securities   | <b>\$ 32,487</b> | \$ 19,338 |
| Change in postretirement benefit plans                      |                  |           |
| Amounts amortized into net periodic expense:                |                  |           |
| Amortization of prior service credits                       | <b>(139)</b>     | (139)     |
| Amortization of net losses                                  | <b>-</b>         | 52        |
| Net change in postretirement benefit plans                  | <b>(139)</b>     | (87)      |
| Change in cash flow derivative instruments                  |                  |           |
| Unrealized losses on cash flow derivative instruments       | <b>(3,827)</b>   | (419)     |
| Reclassification of loss recognized in interest expense     | <b>1,379</b>     | 1,120     |
| Net change in cash flow derivative instruments              | <b>(2,448)</b>   | 701       |
| Other comprehensive income                                  | <b>\$ 29,900</b> | \$ 19,952 |

The increase in unrealized gains on investments is due primarily to the effect of developments in the interest rate market on the bank's fixed rate investment securities.

## **FINANCIAL CONDITION**

### *Loan Portfolio*

Gross loan volume at September 30, 2016, was \$15.68 billion, an increase of \$910.8 million, or 6.2 percent, compared to \$14.77 billion at December 31, 2015. The increase in the loan portfolio is attributable to growth in the bank's direct loans to associations and, to a lesser extent, growth in the bank's capital markets loan portfolio. The growth in direct loans to associations was related to continued strong economic conditions in the district.

The bank's capital markets loan portfolio predominantly includes participations, syndications and purchased whole loans, along with other financing structures within our lending authorities. The bank also refers to the capital markets portfolio as participations purchased. In addition to purchasing loans from our district associations, which may exceed their hold limits, the bank seeks the purchase of participations and syndications originated outside of the district's territory by other System institutions, commercial banks and other lenders. These loans may be held as earning assets of the bank or sub-participated to the associations or to other System entities.

Loans classified under the Farm Credit Administration's Uniform Loan Classification System as "acceptable" or "other assets especially mentioned" were 99.9 percent of total loans and accrued interest at September 30, 2016 and at December 31, 2015.

The table below summarizes the balances of the bank's high-risk assets at September 30, 2016, compared to the balances at December 31, 2015:

|                                      | <b>September 30, 2016</b> | Increase (Decrease) |                 | <b>December 31, 2015</b> |
|--------------------------------------|---------------------------|---------------------|-----------------|--------------------------|
|                                      |                           | \$                  | %               |                          |
| Nonaccrual loans                     | \$ 4,199                  | \$ (473)            | (10.12) %       | \$ 4,672                 |
| Accruing formally restructured loans | 15,569                    | (533)               | (3.31)          | 16,102                   |
| Total impaired loans                 | 19,768                    | (1,006)             | (4.84)          | 20,774                   |
| Other property owned                 | -                         | (438)               | (100.00)        | 438                      |
| Total high-risk assets               | <b>\$ 19,768</b>          | <b>\$ (1,444)</b>   | <b>(6.81) %</b> | <b>\$ 21,212</b>         |

The decrease in nonaccrual loans was due mainly to repayments net of recoveries. The decrease in accruing formally restructured loans was due mainly to repayments. The bank had no loans 90 days past due and still accruing interest for the periods presented. At September 30, 2016, and December 31, 2015, the bank did not have any nonaccrual loans on which cash payments are recognized as interest income. The decrease in OPO was due to the write-off of the remaining OPO balance in August 2016.

Impaired loans, consisting of nonaccrual loans and accruing formally restructured loans, and loans 90 days past due and still accruing interest, constituted 0.1 percent of gross loans at September 30, 2016, and at December 31, 2015.

At September 30, 2016, the bank had reserves for credit losses totaling \$9,122, including an allowance for loan losses of \$7,683 and a reserve for credit losses on unfunded commitments of \$1,439 related to the bank's capital markets loan portfolio. The allowance for loan losses of \$7,683 equated to less than 0.1 percent of total loans outstanding and 0.1 percent of capital market loans outstanding. The \$1,439 reserve for losses on unfunded commitments included a general reserve for losses on unused loan commitments, a general reserve for losses on letters of credit and a specific reserve related to one letter of credit, representing management's estimate of probable credit losses related to unfunded commitments.

The allowance for loan losses as a percentage of impaired loans was 38.9 percent as of September 30, 2016, as compared to 28.1 percent as of December 31, 2015. The nature of the collateral supporting many of the impaired loans (primarily first lien real estate) is considered in the determination of necessary allowances for loan losses.

#### *Liquidity and Funding Sources*

Cash and investment securities totaled \$5.43 billion, or 25.4 percent, of total assets at September 30, 2016, compared to \$5.01 billion, or 25.1 percent, at December 31, 2015, an increase of \$412,527, or 8.2 percent. Cash held at the Federal Reserve Bank at September 30, 2016, totaled \$489,429, compared to \$512,229 at December 31, 2015. The bank diversified its liquidity position during the second quarter of 2016 with the purchase of U.S. Treasury securities. Levels of cash and other highly liquid assets are maintained to meet loan demand, debt servicing and other liquidity needs. At September 30, 2016, the bank had 198 days of liquidity to cover maturing debt obligations. Interest-bearing liabilities, consisting of bonds and notes, increased by \$1.30 billion, or 7.1 percent, from December 31, 2015, to September 30, 2016.

#### *Subordinated Debt*

In September 2008, the bank issued \$50.0 million of 8.406 percent unsecured subordinated notes due in 2018, generating proceeds of \$49.4 million. The proceeds were used to increase regulatory permanent capital and total surplus pursuant to FCA regulations and for general corporate purposes. This debt was unsecured and subordinate to all other categories of creditors, including general creditors, and senior to all classes of shareholders.

On March 10, 2016, the FCA approved a final rule to modify the regulatory capital requirements for System banks and associations, effective January 1, 2017. The final rule to modify regulatory capital requirements changes the favorable capital treatment of the subordinated debt, and, therefore, qualifies as a regulatory event. On March 30, 2016, the bank's board approved a resolution authorizing the redemption of all outstanding subordinated debt at par. The redemption occurred on June 6, 2016.

*Investments*

The bank's investments are all considered available for sale, and include a liquidity portfolio and a portfolio of other investments. The liquidity portfolio had a fair value of \$4.84 billion at September 30, 2016, and consisted primarily of mortgage-backed securities (MBS), corporate debt, agency-guaranteed debt, U.S. Treasury securities and asset-backed securities (ABS). All of the liquidity portfolio's MBS were federal agency-guaranteed collateralized MBS, including Government National Mortgage Association (GNMA), Federal National Mortgage Association (FNMA) and Federal Home Loan Mortgage Corporation (FHLMC) securities. The bank's other investments, totaling \$55.6 million, consisted of agricultural mortgage-backed securities (AMBS) purchased from district associations. The Federal Agricultural Mortgage Corporation (Farmer Mac) securities are backed by loans originated by the associations.

Farmer Mac is a government-sponsored enterprise and is examined and regulated by the FCA. It provides a secondary market for agricultural and rural home mortgage loans that meet certain underwriting standards. Farmer Mac is authorized to provide loan guarantees and to be a direct pooler of agricultural mortgage loans. Farmer Mac is owned by both System and non-System investors, and its board of directors has both System and non-System representation. Farmer Mac is not liable for any debt or obligation of any System institution and no System institution other than Farmer Mac is liable for any debt or obligation of Farmer Mac.

The following table summarizes the bank's liquidity portfolio holdings:

|  | <u>September 30, 2016</u> |                     | <u>December 31, 2015</u> |                     |
|--|---------------------------|---------------------|--------------------------|---------------------|
|  | <u>Amortized Cost</u>     | <u>Fair Value</u>   | <u>Amortized Cost</u>    | <u>Fair Value</u>   |
| Agency-guaranteed debt   | \$ 233,543                | \$ 234,200          | \$ 252,436               | \$ 248,355          |
| Corporate debt   | 202,356                   | 202,663             | 201,332                  | 200,602             |
| Federal agency-guaranteed collateralized mortgage-backed securities: |                           |                     |                          |                     |
| GNMA   | 1,811,037                 | 1,813,660           | 1,740,411                | 1,731,756           |
| FNMA and FHLMC   | 2,224,816                 | 2,229,602           | 2,008,449                | 1,998,669           |
| U.S. Treasury securities   | 199,508                   | 200,023             | -                        | -                   |
| Asset-backed securities  | 162,579                   | 162,614             | 200,485                  | 200,073             |
| Total liquidity investments  | <u>\$ 4,833,839</u>       | <u>\$ 4,842,762</u> | <u>\$ 4,403,113</u>      | <u>\$ 4,379,455</u> |

The bank's other investments portfolio consisted of Farmer Mac AMBS securities as follows:

|   | <u>September 30, 2016</u> |                   | <u>December 31, 2015</u> |                   |
|---|---------------------------|-------------------|--------------------------|-------------------|
|   | <u>Amortized Cost</u>     | <u>Fair Value</u> | <u>Amortized Cost</u>    | <u>Fair Value</u> |
| Agricultural mortgage-backed securities | \$ 57,346                 | \$ 55,634         | \$ 67,268                | \$ 65,650         |

During the nine months ended September 30, 2016, there was an increase in unrealized gains on investments totaling \$32,487, due primarily to the effect of developments in the interest rate market on the bank's fixed rate investment securities.

FCA regulations define eligible investments by specifying credit rating criteria, final maturity limit, percentage of investment portfolio limit and certain other requirements for each investment type. At the time the investments are purchased, they must be highly rated by at least one Nationally Recognized Statistical Rating Organization (NRSRO), such as Moody's Investors Service, Standard & Poor's or Fitch Ratings. U.S. Treasury securities, U.S. agency securities and other obligations fully insured or guaranteed by the U.S. government, its agencies, instrumentalities and corporations are considered eligible investments under the FCA's regulations, even if downgraded. If an investment no longer meets the credit rating criteria, the investment becomes ineligible; however, FCA regulations do not require disposition of any of these securities. While these investments do not meet the FCA's standards for liquidity, they are included in the net collateral calculation at the lower of market or book value.

At September 30, 2016, the bank did not hold any investments that were ineligible for liquidity purposes by FCA regulations due to credit ratings by all NRSROs.

*Capital Resources*

At September 30, 2016, the bank's capital totaled \$1,679,740, and consisted of \$600,000 of Class B non-cumulative subordinated perpetual preferred stock, \$255,823 of capital stock, \$821,348 in retained earnings and \$2,569 in accumulated other comprehensive income. The bank's capital reflected an increase of \$126,162 from December 31, 2015 to September 30, 2016, due primarily to net income of \$132,395 and other comprehensive income of \$29,900, offset by preferred stock dividends of \$30,187 and \$5,946 in patronage declared and paid. The balance in accumulated other comprehensive income of \$29,900 resulted from an increase in unrealized gains on investments of \$32,487, net of a \$2,448 increase in unrealized losses on cash flow derivative instruments and a \$139 amortization of other postretirement benefits. The increase in unrealized gains on investment securities was due primarily to the effect of developments in the interest rate market on the bank's fixed rate investment securities.

As of September 30, 2016, the bank exceeded the minimum permanent capital, core surplus, total surplus and net collateral ratio requirements under FCA regulations. At September 30, 2016, the bank's permanent capital ratio was 17.11 percent, core surplus ratio was 9.62 percent, total surplus ratio was 14.68 percent and the net collateral ratio was 107.56 percent. The decrease in the permanent capital ratio from December 31, 2015, to September 30, 2016, based on 90-day average balances, is related primarily to annual patronage distributions made at year-end 2015 and to asset growth at the bank during the nine months ended September 30, 2016.

*Key financial condition comparisons:*

|  | <u>September 30, 2016</u> | <u>December 31, 2015</u> |
|--|---------------------------|--------------------------|
| Permanent capital ratio                                | <b>17.11%</b>             | 17.74%                   |
| Net collateral ratio                                   | <b>107.56%</b>            | 107.70%                  |
| Allowance and reserve for credit losses to total loans | <b>0.06%</b>              | 0.05%                    |



## **OTHER**

### **CONDITIONS IN THE DISTRICT**

In the majority of the district, timely precipitation during the quarter contributed to topsoil and subsoil moisture conditions, which have remained supportive of field crops throughout much of the growing season. However, in August there was substantial flooding across some areas of southern Louisiana. The historic flooding in the region reduced the yield potential for rice, delayed soybean harvest progress and severely impacted the sugarcane crop. Also, drought conditions intensified during the quarter in northern Alabama and, to a lesser extent, Mississippi. However, approximately 70 percent of the land area within the district is unaffected by drought, which is the highest percentage observed at this point in the season in the past seven years.

Prices for row crops fell during the quarter, as the U.S. Department of Agriculture forecasted record corn and soybean yields for the 2016 growing season. Corn yields are expected to surpass existing records in eight states across many regions, including the Southeast, Midwest and Pacific Northwest. Within the district, about three-quarters of the corn crop had been harvested through the end of September. In Texas, where over 50 percent of the district's corn is grown, yields are expected to be well above the five-year average. Approximately half of the soybeans in the district have been harvested, and anticipated yields are comparable to those achieved in the prior year. The cotton crop is progressing as expected, and yields in the district, where the majority of the nation's cotton is grown, are likely to be in line with the previous season.

In the protein sectors, increased production in the beef industry is pressuring cattle prices, a trend that is expected to persist over the medium-term. Beef packers are likely to capture a relatively high share of industry profitability in the short-term, while cattle producers will experience lower margins. Although lean hog prices fell by about one-third during the quarter, prices are comparable to those observed at the start of the year. Hog values are projected to move lower through the next few months, as slaughter peaks seasonally in the fourth quarter. The effects of the late 2014 outbreak of highly-pathogenic avian influenza continue to linger, and U.S. agencies are still working to re-open trade channels with some foreign countries. Though broiler production will increase only slightly this year, poultry supplies in cold storage remain at historically high levels.

Supported by seasonal increases in demand for fluid milk, dairy prices improved during the quarter. Margins for dairy producers have benefitted from improving revenues and declining feed costs, but record cheese stocks may affect the market for the next several months.

In August, unemployment rates in district states ranged from a low of 4.7 percent in Texas to a high of 6.6 percent in New Mexico. Oil prices fluctuated between \$40 and \$50 per barrel in the past three months, and the stability in the market encouraged drillers to increase production. According to Baker Hughes, the number of active rotary rigs in the U.S. increased by over 100 during the quarter, with about 50 percent of the new activity occurring in Texas. Consequently, the rate of job loss in the mining and logging and manufacturing sectors slowed. Employment conditions in the district were relatively unchanged during the quarter and, in general, remain positive.

Preliminary data suggests that the national economy may have expanded at an annualized rate of two to three percent in the third quarter, as consumer confidence rose to its highest level in nine years. The national unemployment rate held steady at 4.9 percent in August. In the fourth quarter, the focus will shift to the elections and the Federal Reserve, which may consider raising its benchmark interest rate before year-end.

Land values in all states in the district increased on a year-over-year basis in the third quarter. Despite the strong historic correlation between oil prices and land values in Texas, statewide declines in rural land

values have not yet been observed. The conservative advance rates on real estate loans in the district would mitigate the impact of potential land value declines in the short to medium term. The bank continues to monitor economic conditions and other factors influencing collateral values and credit quality in the district.

## **RATING AGENCY ACTIONS**

### *Fitch Ratings Actions*

On April 13, 2016, Fitch Ratings affirmed the bank's long-term and short-term issuer default ratings (IDRs) at "AA-" and "F1+," respectively, with a stable outlook. Fitch also affirmed the bank's subordinated debt rating at "A+," its noncumulative perpetual preferred stock rating at "BBB" and its support floor at "AA-." Fitch also affirmed the Farm Credit System's long-term and short-term IDRs at "AAA" and "F1+," respectively, with a stable outlook, and its support floor at "AAA." As a government-sponsored entity, the System benefits from implicit government support, and thus, the ratings and rating outlook are directly linked to the U.S. sovereign rating. The affirmation of the System banks' IDRs reflect their prudent, conservative credit culture, their unique funding advantage and their structural second-loss position on the majority of their loan portfolio.

### *Moody's Investors Service Rating Actions*

On October 3, 2016, Moody's Investors Service affirmed the bank's issuer rating at "Aa3" and its noncumulative preferred stock rating at "Baa1 (hyb)," with a stable outlook. The Aa3 issuer rating reflects the bank's "a1" baseline credit assessment (BCA), very high cooperative support from the other Federal Farm Credit Banks and moderate support from the U.S. Government, which has an "Aaa," stable outlook. The bank's preferred stock rating incorporated the bank's BCA, very high cooperative support from the other Federal Farm Credit Banks and notching reflecting the debt's relative positions in the bank's capital structure. The bank's BCA incorporates its solid capital levels, adequate risk-adjusted profitability and liquidity as well as the benefits associated with its lending to related associations and their strong capital levels. The "a1" BCA is one of Moody's highest assessments of any financial institution, both domestically and globally.

## **REGULATORY MATTERS**

At September 30, 2016, there were no district associations under written agreements with the FCA.

On July 28, 2016, the Farm Credit Administration published a final regulation to modify the regulatory capital requirements for System Banks and Associations. The stated objectives of the rule are as follows:

- To modernize capital requirements while ensuring that System institutions continue to hold sufficient regulatory capital to fulfill the system's mission as a government-sponsored enterprise,
- To ensure that the System's capital requirements are comparable to the Basel III framework and the standardized approach that the federal banking regulatory agencies have adopted, but also to ensure that the rules recognize the cooperative structure and the organization of the System,
- To make System regulatory capital requirements more transparent, and
- To meet the requirements of section 939A of the Dodd-Frank Act.

The final rule will replace existing core surplus and total surplus requirements with Common Equity Tier 1, Tier 1 and Total Capital risk-based capital ratio requirements. The final rule will also replace the existing net collateral ratio with a Tier 1 Leverage ratio and is applicable to all Banks and Associations. The Permanent Capital Ratio will continue to remain in effect with the final rule.

The effective date of the new capital requirements is anticipated to be January 1, 2017, with a three-year phase-in of the capital conservation buffer applied to the risk-adjusted capital ratios. Based on the Farm Credit Administration's analysis, System institutions are well-positioned to be in compliance with the new requirements at adoption.

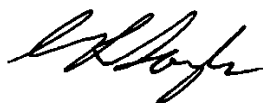
The final rule to modify regulatory capital requirements changes the capital treatment of our subordinated debt and, therefore, qualifies as a regulatory event, triggering a right of redemption. On March 30, 2016, the bank's board approved a resolution authorizing the redemption of all outstanding subordinated debt at par. The redemption occurred on June 6, 2016.

On June 12, 2014, the Farm Credit Administration approved a proposed rule to revise the requirements governing the eligibility of investments for System banks and associations. The stated objectives of the proposed rule are as follows:

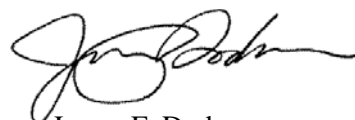
- To strengthen the safety and soundness of System banks and associations,
- To ensure that System banks hold sufficient liquidity to continue operations and pay maturing obligations in the event of market disruption,
- To enhance the ability of the System banks to supply credit to agricultural and aquatic producers,
- To comply with the requirements of section 939A of the Dodd-Frank Act,
- To modernize the investment eligibility criteria for System banks, and
- To revise the investment regulation for System associations to improve their investment management practices so they are more resilient to risk.

The public comment period ended on October 23, 2014. FCA anticipates releasing a final rule in the first quarter of 2017.

The undersigned certify that we have reviewed the September 30, 2016, quarterly report of the Farm Credit Bank of Texas, that the report has been prepared in accordance with all applicable statutory or regulatory requirements and that the information included herein is true, accurate and complete to the best of our knowledge and belief.



Larry R. Doyle  
Chief Executive Officer



James F. Dodson  
Chairman of the Board



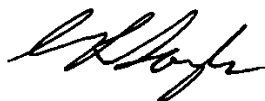
Amie Pala  
Chief Financial Officer

November 9, 2016

## Controls and Procedures

The Farm Credit Bank of Texas (bank) maintains a system of disclosure controls and procedures. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information disclosed by us in our quarterly and annual reports is accumulated and communicated to our management, including our chief executive officer and our chief financial officer, as appropriate, to allow timely decisions to be made regarding disclosure. With management's input, the chief executive officer and the chief financial officer have evaluated our disclosure controls and procedures as of the end of and for the period covered by this quarterly report, and have concluded that our disclosure controls and procedures are effective as of that date.

The bank also maintains a system of internal controls. The "internal controls" as defined by the American Institute of Certified Public Accountants' Codification of Statement on Auditing Standards, AU Section 319, means a process — effected by the board of directors, management and other personnel — designed to provide reasonable assurance regarding the achievement of objectives in the reliability of our financial reporting, the effectiveness and efficiency of operations, and of compliance with applicable laws and regulations. We continually assess the adequacy of our internal control over financial reporting and enhance our controls in response to internal control assessments, and internal and external audit and regulatory recommendations. There have been no significant changes in our internal controls or in other factors that could significantly affect such controls subsequent to the date we carried out our evaluations.



Larry R. Doyle  
Chief Executive Officer



Amie Pala  
Chief Financial Officer

November 9, 2016

## Balance Sheets

| (dollars in thousands)  | September 30,<br>2016<br>(Unaudited) | December 31,<br>2015 |
|---|--------------------------------------|----------------------|
| <b>Assets</b>   |                                      |                      |
| Cash  | \$ 504,708                           | \$ 545,090           |
| Federal funds sold and overnight investments  | 22,031                               | 22,413               |
| Investment securities   | 4,898,396                            | 4,445,105            |
| Loans (includes \$26,884 and \$27,506 at fair value, held<br>under fair value option) | 15,681,830                           | 14,771,006           |
| Less allowance for loan losses  | 7,683                                | 5,833                |
| Net loans   | 15,674,147                           | 14,765,173           |
| Accrued interest receivable   | 52,317                               | 47,816               |
| Other property owned  | -                                    | 438                  |
| Premises and equipment, net   | 35,509                               | 27,835               |
| Other assets  | 154,709                              | 135,705              |
| <b>Total assets</b>   | <b>\$ 21,341,817</b>                 | <b>\$ 19,989,575</b> |
| <b>Liabilities and shareholders' equity</b>   |                                      |                      |
| <b>Liabilities</b>  |                                      |                      |
| Bonds and notes, net  | \$ 19,506,829                        | \$ 18,206,726        |
| Subordinated debt, net  | -                                    | 49,801               |
| Accrued interest payable  | 45,456                               | 44,766               |
| Reserve for credit losses   | 1,439                                | 1,342                |
| Preferred stock dividends payable   | 20,063                               | 20,063               |
| Other liabilities   | 88,290                               | 113,299              |
| <b>Total liabilities</b>  | <b>19,662,077</b>                    | <b>18,435,997</b>    |
| <b>Commitments and contingent liabilities (Note 4)</b>                                |                                      |                      |
| <b>Shareholders' equity</b>   |                                      |                      |
| Preferred stock   | 600,000                              | 600,000              |
| Capital stock   | 255,823                              | 255,823              |
| Allocated retained earnings   | 27,205                               | 27,203               |
| Unallocated retained earnings   | 794,143                              | 697,883              |
| Accumulated other comprehensive income (loss)   | 2,569                                | (27,331)             |
| <b>Total shareholders' equity</b>   | <b>1,679,740</b>                     | <b>1,553,578</b>     |
| <b>Total liabilities and shareholders' equity</b>                                     | <b>\$ 21,341,817</b>                 | <b>\$ 19,989,575</b> |

*The accompanying notes are an integral part of these financial statements.*

## Statements of Comprehensive Income

(unaudited)

| (dollars in thousands)  | Quarter Ended<br>September 30, |           | Nine Months Ended<br>September 30, |            |
|---|--------------------------------|-----------|------------------------------------|------------|
|   | 2016                           | 2015      | 2016                               | 2015       |
| <b>Interest Income</b>  |                                |           |                                    |            |
| Loans   | \$ 104,231                     | \$ 91,863 | \$ 306,238                         | \$ 271,042 |
| Investment securities   | 18,253                         | 14,406    | 51,367                             | 44,180     |
| <b>Total interest income</b>  | <b>122,484</b>                 | 106,269   | <b>357,605</b>                     | 315,222    |
| <b>Interest Expense</b>   |                                |           |                                    |            |
| Bonds, notes and subordinated debt  | 62,946                         | 50,081    | 182,950                            | 142,780    |
| <b>Total interest expense</b>   | <b>62,946</b>                  | 50,081    | <b>182,950</b>                     | 142,780    |
| <b>Net interest income</b>  | <b>59,538</b>                  | 56,188    | <b>174,655</b>                     | 172,442    |
| (Negative provision) provision for credit losses                                      | (1,104)                        | 93        | 388                                | (1,574)    |
| <b>Net interest income after<br/>(negative provision) provision for credit losses</b> | <b>60,642</b>                  | 56,095    | <b>174,267</b>                     | 174,016    |
| <b>Noninterest Income</b>   |                                |           |                                    |            |
| Patronage income  | 4,384                          | 4,146     | 16,031                             | 13,701     |
| Fees for services to associations   | 724                            | 800       | 3,250                              | 3,357      |
| Fees for loan-related services  | 2,302                          | 5,596     | 5,700                              | 11,745     |
| Loss on loans held under fair value option  | (92)                           | (486)     | (14)                               | (685)      |
| Other income, net   | 46                             | (147)     | 3,108                              | 2,655      |
| <b>Total noninterest income</b>   | <b>7,364</b>                   | 9,909     | <b>28,075</b>                      | 30,773     |
| <b>Noninterest Expenses</b>   |                                |           |                                    |            |
| Salaries and employee benefits  | 9,197                          | 8,060     | 27,197                             | 25,631     |
| Occupancy and equipment   | 3,789                          | 3,641     | 12,310                             | 11,229     |
| Insurance Fund premiums   | 3,455                          | 2,245     | 9,198                              | 6,640      |
| Loss (gain) on other property owned   | 439                            | -         | 439                                | (3,090)    |
| Other operating expenses  | 6,933                          | 6,378     | 20,803                             | 19,433     |
| <b>Total noninterest expense</b>  | <b>23,813</b>                  | 20,324    | <b>69,947</b>                      | 59,843     |
| <b>Net Income</b>   | <b>44,193</b>                  | 45,680    | <b>132,395</b>                     | 144,946    |
| <b>Other comprehensive (loss) income</b>  |                                |           |                                    |            |
| Change in unrealized gain on investments  | (11,688)                       | 10,793    | 32,487                             | 19,338     |
| Change in postretirement benefit plans  | (46)                           | (29)      | (139)                              | (87)       |
| Change in cash flow derivative instruments  | 1,462                          | 297       | (2,448)                            | 701        |
| <b>Total other comprehensive (loss) income</b>  | <b>(10,272)</b>                | 11,061    | <b>29,900</b>                      | 19,952     |
| <b>Comprehensive Income</b>   | <b>\$ 33,921</b>               | \$ 56,741 | <b>\$ 162,295</b>                  | \$ 164,898 |

*The accompanying notes are an integral part of these financial statements.*

## Statements of Changes in Shareholders' Equity

(unaudited)

| (dollars in thousands)               | Preferred<br>Stock | Capital Stock     | Retained Earnings |                   | Accumulated<br>Other<br>Comprehensive<br>Income (Loss) | Total<br>Shareholders'<br>Equity |
|--------------------------------------|--------------------|-------------------|-------------------|-------------------|--|----------------------------------|
|                                      |                    |                   | Allocated         | Unallocated       |  |                                  |
| Balance at December 31, 2014         | \$ 600,000         | \$ 233,468        | \$ 22,508         | \$ 643,067        | \$ (19,822)  | \$ 1,479,221                     |
| Net income                           | -                  | -                 | -                 | 144,946           | -  | 144,946                          |
| Other comprehensive gain             | -                  | -                 | -                 | -                 | 19,952   | 19,952                           |
| Preferred stock dividends            | -                  | -                 | -                 | (30,187)          | -  | (30,187)                         |
| Patronage distributions              |                    |                   |                   |                   |  |                                  |
| Cash                                 | -                  | -                 | -                 | (3,014)           | -  | (3,014)                          |
| <b>Balance at September 30, 2015</b> | <b>\$ 600,000</b>  | <b>\$ 233,468</b> | <b>\$ 22,508</b>  | <b>\$ 754,812</b> | <b>\$ 130</b>  | <b>\$ 1,610,918</b>              |
| Balance at December 31, 2015         | \$ 600,000         | \$ 255,823        | \$ 27,203         | \$ 697,883        | \$ (27,331)  | \$ 1,553,578                     |
| Net income                           | -                  | -                 | -                 | 132,395           | -  | 132,395                          |
| Other comprehensive gain             | -                  | -                 | -                 | -                 | 29,900   | 29,900                           |
| Preferred stock dividends            | -                  | -                 | -                 | (30,187)          | -  | (30,187)                         |
| Patronage distributions              |                    |                   |                   |                   |  |                                  |
| Cash                                 | -                  | -                 | -                 | (5,946)           | -  | (5,946)                          |
| Shareholders' equity                 | -                  | -                 | 2                 | (2)               | -  | -                                |
| <b>Balance at September 30, 2016</b> | <b>\$ 600,000</b>  | <b>\$ 255,823</b> | <b>\$ 27,205</b>  | <b>\$ 794,143</b> | <b>\$ 2,569</b>  | <b>\$ 1,679,740</b>              |

*The accompanying notes are an integral part of these financial statements.*

## Statements of Cash Flows

(unaudited)

| (dollars in thousands)   | Nine Months Ended September 30, |             |
|--|---------------------------------|-------------|
|  | 2016                            | 2015        |
| <b>Operating activities</b>  |                                 |             |
| Net income   | \$ 132,395                      | \$ 144,946  |
| Reconciliation of net income to net cash provided by operating activities  |                                 |             |
| Provision (negative provision) for credit losses                           | 388                             | (1,574)     |
| Depreciation and amortization on premises and equipment                    | 4,473                           | 4,178       |
| Amortization of net premium on loans                                       | 3,809                           | 6,405       |
| Amortization and accretion on debt instruments                             | 14,411                          | (2,550)     |
| Amortization of net premium on investments                                 | 2,586                           | 1,739       |
| Decrease in fair value on loans under fair value option                    | 14                              | 685         |
| Loss (gain) on sales of other property owned                               | 438                             | (3,090)     |
| Gain on sale of loans  | (3,001)                         | -           |
| Loss on other earning assets   | 149                             | -           |
| Loss on sales of premises and equipment                                    | -                               | 3,124       |
| Allocated equity patronage from System bank                                | (13,847)                        | (13,498)    |
| Increase in accrued interest receivable                                    | (4,501)                         | (4,688)     |
| Decrease in other assets, net  | 6,392                           | 24,424      |
| Increase in accrued interest payable                                       | 691                             | 6,141       |
| Decrease in other liabilities, net   | (562)                           | (20,856)    |
| Net cash provided by operating activities                                  | 143,835                         | 145,386     |
| <b>Investing activities</b>  |                                 |             |
| Net increase (decrease) in federal funds sold                              | 382                             | (156)       |
| Investment securities  |                                 |             |
| Purchases  | (1,258,631)                     | (1,032,809) |
| Proceeds from maturities, calls and prepayments                            | 835,241                         | 789,998     |
| Increase in loans, net   | (925,585)                       | (1,140,621) |
| Proceeds from sales of other property owned                                | -                               | 12,962      |
| Proceeds from sales of premises and equipment                              | -                               | 59          |
| Expenditures for premises and equipment                                    | (12,147)                        | (8,828)     |
| Investment in other earning assets   | (1,243)                         | -           |
| Net cash used in investing activities                                      | (1,361,983)                     | (1,379,395) |
| <b>Financing activities</b>  |                                 |             |
| Bonds and notes issued   | 16,599,444                      | 9,702,595   |
| Bonds and notes retired  | (15,312,849)                    | (8,446,407) |
| Redemption of subordinated debt  | (50,000)                        | -           |
| Repayments on capital lease obligations                                    | (281)                           | -           |
| Cash dividends on preferred stock  | (30,188)                        | (30,187)    |
| Cash patronage distributions paid  | (28,360)                        | (22,712)    |
| Net cash provided by financing activities                                  | 1,177,766                       | 1,203,289   |
| Net decrease in cash   | (40,382)                        | (30,720)    |
| Cash at beginning of year  | 545,090                         | 428,361     |
| Cash at end of quarter   | \$ 504,708                      | \$ 397,641  |
| <b>Supplemental schedule of noncash investing and financing activities</b> |                                 |             |
| Net increase in unrealized gains on investment securities                  | \$ 32,487                       | \$ 19,339   |
| Preferred stock dividend payable   | 20,063                          | 20,063      |
| Capital lease obligation   | 748                             | -           |
| <b>Supplemental information</b>  |                                 |             |
| Interest paid  | \$ 182,260                      | \$ 136,639  |

*The accompanying notes are an integral part of these financial statements.*



## Notes to Financial Statements

*Unaudited (dollar amounts in thousands unless otherwise noted)*

### **NOTE 1 — ORGANIZATION AND SIGNIFICANT ACCOUNTING POLICIES**

The accompanying financial statements include the accounts of the Farm Credit Bank of Texas (bank). The significant accounting policies followed and the financial condition and results of operations of the bank as of and for the year ended December 31, 2015, are contained in the 2015 Annual Report to shareholders (Annual Report). These unaudited third quarter 2016 financial statements should be read in conjunction with the Annual Report.

In the opinion of management, the accompanying unaudited financial statements contain all adjustments necessary for a fair presentation of the interim financial condition and results of operations of the bank, and conform to generally accepted accounting principles. The preparation of these financial statements requires the use of management's estimates. The results of operations for any interim period are not necessarily indicative of the results to be expected for the entire year.

The bank and its affiliated associations (district) are part of the federally chartered Farm Credit System (System). The bank provides funding to district associations, which, in turn, provide credit to their borrower-shareholders. At September 30, 2016, the bank provided financing to 14 district associations and certain other financing institutions.

In August 2016, the Financial Accounting Standards Board (FASB) issued guidance entitled "Classification of Certain Cash Receipts and Cash Payments." The guidance addresses specific cash flow issues with the objective of reducing the diversity in the classification of these cash flows. Included in the cash flow issues are debt prepayment or debt extinguishment costs and settlement of zero-coupon debt instruments or other debt instruments with coupon interest rates that are insignificant in relation to the effective interest rate of the borrowing. This guidance becomes effective for interim and annual periods beginning after December 15, 2017. The adoption of this guidance is not expected to impact the bank's financial condition or its results of operations but could change the classification of certain items in the statement of cash flows.

In June 2016, the FASB issued guidance entitled "Measurement of Credit Losses on Financial Instruments." The guidance replaces the current incurred loss impairment methodology with a methodology that reflects expected credit losses and requires consideration of a broader range of reasonable and supportable information to inform credit loss estimates. Credit losses relating to available-for-sale securities would also be recorded through an allowance for credit losses. For public business entities that are not U.S. Securities and Exchange Commission filers this guidance becomes effective for interim and annual periods beginning after December 15, 2020, with early application permitted. The bank will evaluate the impact of adoption on its financial condition and results of operations.

In February 2016, the FASB issued guidance entitled "Leases." The guidance requires the recognition by lessees of lease assets and lease liabilities on the balance sheet for the rights and obligations created by those leases. Leases with lease terms of more than 12 months are impacted by this guidance. This guidance becomes effective for interim and annual periods beginning after December 15, 2018, with early application permitted. The bank is currently evaluating the impact of adoption on its financial condition and results of operations.

In January 2016, the FASB issued guidance entitled “Recognition and Measurement of Financial Assets and Liabilities.” The guidance affects, among other things, the presentation and disclosure requirements for financial instruments. This guidance becomes effective for interim and annual periods beginning after December 15, 2017. The adoption of this guidance is not expected to impact the bank’s financial condition or its results of operations.

In August 2014, the FASB issued guidance entitled “Presentation of Financial Statements — Going Concern.” The guidance governs management’s responsibility to evaluate whether there is substantial doubt about an entity’s ability to continue as a going concern and to provide related footnote disclosures. This guidance requires management to perform interim and annual assessments of an entity’s ability to continue as a going concern within one year after the date the financial statements are issued or within one year after the financial statements are available to be issued, when applicable. Substantial doubt exists if it is probable that the entity will be unable to meet its obligations for the assessed period. This guidance becomes effective for interim and annual periods ending after December 15, 2016, and early application is permitted. Management will be required to make its initial assessment as of December 31, 2016.

In May 2014, the FASB issued guidance entitled, “Revenue from Contracts with Customers.” The guidance governs revenue recognition from contracts with customers and requires an entity to recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. Financial instruments and other contractual rights within the scope of other guidance issued by the FASB are excluded from the scope of this new revenue recognition guidance. In this regard, a majority of our contracts would be excluded from the scope of this new guidance. In August 2015, the FASB issued an update that defers this guidance by one year, which results in the new revenue standard becoming effective for interim and annual reporting periods beginning after December 15, 2017. The bank is in the process of reviewing contracts to determine the effect, if any, on their financial condition or results of operations.

## **NOTE 2 — INVESTMENTS**

### **Available for Sale**

The bank’s available-for-sale investments include a liquidity portfolio and a portfolio of other investments. The liquidity portfolio consists primarily of mortgage-backed securities (MBS), corporate debt, agency-guaranteed debt, U.S Treasury securities and asset-backed securities (ABS). The majority of the liquidity portfolio’s MBS were federal agency-guaranteed collateralized MBS, including Government National Mortgage Association (GNMA), Federal National Mortgage Association (FNMA) and Federal Home Loan Mortgage Corporation (FHLMC) securities. The bank’s other investments portfolio consists of Federal Agricultural Mortgage Corporation (Farmer Mac) guaranteed agricultural mortgage-backed securities (AMBS) purchased from district associations. A summary of the amortized cost and fair value of investment securities available for sale, at September 30, 2016, and December 31, 2015, is included in the following tables.

Investments in the available-for-sale liquidity portfolio at September 30, 2016:

|  | Amortized Cost      | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair Value          | Weighted<br>Average<br>Yield |
|--|---------------------|------------------------------|-------------------------------|---------------------|------------------------------|
| Agency-guaranteed debt   | \$ 233,543          | \$ 1,944                     | \$ (1,287)                    | \$ 234,200          | 1.77 %                       |
| Corporate debt   | 202,356             | 522                          | (215)                         | 202,663             | 1.31                         |
| Federal agency-guaranteed collateralized mortgage-backed securities: |                     |                              |                               |                     |                              |
| GNMA   | 1,811,037           | 8,354                        | (5,731)                       | 1,813,660           | 1.51                         |
| FNMA and FHLMC   | 2,224,816           | 9,307                        | (4,521)                       | 2,229,602           | 1.33                         |
| U.S. Treasury securities   | 199,508             | 515                          | -                             | 200,023             | 0.91                         |
| Asset-backed securities  | 162,579             | 61                           | (26)                          | 162,614             | 0.95                         |
| Total available-for-sale liquidity investments                       | <b>\$ 4,833,839</b> | <b>\$ 20,703</b>             | <b>\$ (11,780)</b>            | <b>\$ 4,842,762</b> | <b>1.39 %</b>                |

Investments in the available-for-sale other investments portfolio at September 30, 2016:

|   | Amortized Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair Value | Weighted<br>Average<br>Yield |
|---|----------------|------------------------------|-------------------------------|------------|------------------------------|
| Agricultural mortgage-backed securities | \$ 57,346      | \$ 71                        | \$ (1,783)                    | \$ 55,634  | 4.22 %                       |

Investments in the available-for-sale liquidity portfolio at December 31, 2015:

|  | Amortized Cost      | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair Value          | Weighted<br>Average<br>Yield |
|--|---------------------|------------------------------|-------------------------------|---------------------|------------------------------|
| Agency-guaranteed debt   | \$ 252,436          | \$ 112                       | \$ (4,193)                    | \$ 248,355          | 1.68 %                       |
| Corporate debt   | 201,332             | 54                           | (784)                         | 200,602             | 0.97                         |
| Federal agency-guaranteed collateralized mortgage-backed securities: |                     |                              |                               |                     |                              |
| GNMA   | 1,740,411           | 3,778                        | (12,433)                      | 1,731,756           | 1.51                         |
| FNMA and FHLMC   | 2,008,449           | 2,996                        | (12,776)                      | 1,998,669           | 1.31                         |
| Asset-backed securities  | 200,485             | 2                            | (414)                         | 200,073             | 0.85                         |
| Total available-for-sale liquidity investments                       | <b>\$ 4,403,113</b> | <b>\$ 6,942</b>              | <b>\$ (30,600)</b>            | <b>\$ 4,379,455</b> | <b>1.37 %</b>                |

Investments in the available-for-sale other investments portfolio at December 31, 2015:

|   | Amortized Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair Value | Weighted<br>Average<br>Yield |
|---|----------------|------------------------------|-------------------------------|------------|------------------------------|
| Agricultural mortgage-backed securities | \$ 67,268      | \$ -                         | \$ (1,618)                    | \$ 65,650  | 4.10 %                       |

The following tables summarize the contractual maturity, fair value, amortized cost and weighted average yield of available-for-sale investments at September 30, 2016:

Investments in the available-for-sale liquidity portfolio:

|   | <b>Due in<br/>one year<br/>or less</b> | <b>Due after one<br/>year through<br/>five years</b> | <b>Due after five<br/>years through<br/>10 years</b> | <b>Due<br/>after<br/>10 years</b> | <b>Total</b>        |
|---|--|--|--|-----------------------------------|---------------------|
| Agency-guaranteed debt  | \$ -                                   | \$ -   | \$ 234,200   | \$ -                              | \$ 234,200          |
| Corporate debt  | 67,521                                 | 135,142  | -  | -                                 | 202,663             |
| Federal agency-guaranteed collateralized<br>mortgage-backed securities: |  |  |  |                                   |                     |
| GNMA  | -                                      | 466  | 3,225  | 1,809,969                         | 1,813,660           |
| FNMA and FHLMC  | -                                      | 23,699   | 335,032  | 1,870,871                         | 2,229,602           |
| U.S. Treasury securities  | -                                      | 200,023  | -  | -                                 | 200,023             |
| Asset-backed securities   | 2,776                                  | 156,490  | -  | 3,348                             | 162,614             |
| <b>Total fair value</b>   | <b>\$ 70,297</b>                       | <b>\$ 515,820</b>                                    | <b>\$ 572,457</b>                                    | <b>\$ 3,684,188</b>               | <b>\$ 4,842,762</b> |
| <br>  |  |  |  |                                   |                     |
| Total amortized cost  | \$ 70,301                              | \$ 514,734   | \$ 570,893   | \$ 3,677,911                      | \$ 4,833,839        |
| Weighted average yield  | 1.15%                                  | 1.09%  | 1.57%  | 1.41%                             | 1.39%               |

Investments in the available-for-sale other investments portfolio:

|  | <b>Due after one<br/>year through<br/>five years</b> | <b>Due after five<br/>years through<br/>10 years</b> | <b>Total</b> |
|--|--|--|--------------|
| Fair value of agricultural<br>mortgage-backed securities | \$ 23,610  | \$ 32,024  | \$ 55,634    |
| <br>   |  |  |              |
| Total amortized cost                                     | \$ 24,136  | \$ 33,210  | \$ 57,346    |
| Weighted average yield                                   | 4.17%  | 4.26%  | 4.22%        |

### Other-Than-Temporarily Impaired Investments Evaluation

The following table shows available-for-sale liquidity portfolio investments by gross unrealized losses and fair value, aggregated by investment category and length of time, for securities that have been in a continuous unrealized loss position at September 30, 2016. The continuous loss position is based on the date the impairment was first identified:

|   | <b>Less Than<br/>12 Months</b> |                              | <b>Greater Than<br/>12 Months</b> |                              | <b>Total</b>          |                              |
|---|--------------------------------|------------------------------|-----------------------------------|------------------------------|-----------------------|------------------------------|
|   | <b>Fair<br/>Value</b>          | <b>Unrealized<br/>Losses</b> | <b>Fair<br/>Value</b>             | <b>Unrealized<br/>Losses</b> | <b>Fair<br/>Value</b> | <b>Unrealized<br/>Losses</b> |
| Agency-guaranteed debt  | \$ 35,756                      | \$ (102)                     | \$ 92,423                         | \$ (1,185)                   | \$ 128,179            | \$ (1,287)                   |
| Corporate debt  | 14,906                         | (95)                         | 22,404                            | (120)                        | 37,310                | (215)                        |
| Federal agency-guaranteed collateralized<br>mortgage-backed securities: |                                |                              |                                   |                              |                       |                              |
| GNMA  | 546,407                        | (1,465)                      | 308,031                           | (4,266)                      | 854,438               | (5,731)                      |
| FNMA and FHLMC  | 700,333                        | (1,915)                      | 401,147                           | (2,606)                      | 1,101,480             | (4,521)                      |
| Asset-backed securities   | 35,852                         | (11)                         | 37,395                            | (15)                         | 73,247                | (26)                         |
| <b>Total</b>  | <b>\$ 1,333,254</b>            | <b>\$ (3,588)</b>            | <b>\$ 861,400</b>                 | <b>\$ (8,192)</b>            | <b>\$ 2,194,654</b>   | <b>\$ (11,780)</b>           |

The bank evaluates investment securities for other-than-temporary impairment (OTTI) on a quarterly basis. Impairment is considered to be other than temporary if an entity (i) intends to sell the security, (ii) is more likely than not to be required to sell the security before recovering its cost or (iii) does not expect to recover the security's entire amortized cost basis (even if the entity does not intend to sell).

In the event of an investment being designated OTTI, to measure the amount related to credit loss in the determination of OTTI, the bank utilizes a third-party vendor's services for cash flow modeling and projection of credit losses for specific non-agency residential mortgage-backed securities and subprime asset-backed securities. Significant inputs utilized in the methodology of the modeling include assumptions surrounding market data (interest rates and home prices) and the applicable securities' loan-level data. Loan-level data evaluated includes loan status, coupon and resets, FICO scores, loan-to-value, geography, property type, etc. Loan-level data is then combined with assumptions surrounding future behavior of home prices, prepayment rates, default rates and loss severity to arrive at cash flow projections for the underlying collateral. Default rate assumptions are generally estimated using historical loss and performance information to estimate future defaults. The present value of these cash flow projections is then evaluated against the specific security's structure and credit enhancement to determine if the bond will absorb losses. In the nine months ended September 30, 2016 and 2015, the bank did not recognize any other-than-temporary impairment credit losses and no securities were identified as OTTI at September 30, 2016, December 31, 2015 and September 30, 2015.

### NOTE 3 — LOANS AND RESERVES FOR CREDIT LOSSES

Loans, including direct notes to district associations and other financing institutions (OFIs), participations purchased and other bank-owned loans, comprised the following categories at:

|   | <u>September 30, 2016</u> | <u>December 31, 2015</u> |
|---|---------------------------|--------------------------|
| Direct notes receivable from district associations and OFIs | \$ 10,504,253             | \$ 9,621,039             |
| Participations purchased                                    | 5,177,194                 | 5,149,552                |
| Other bank-owned loans                                      | 383                       | 415                      |
| Total   | <u>\$ 15,681,830</u>      | <u>\$ 14,771,006</u>     |

A summary of the bank's loans by type follows:

|  | <u>September 30, 2016</u> | <u>December 31, 2015</u> |
|--|---------------------------|--------------------------|
| Direct notes receivable from district associations | \$ 10,462,165             | \$ 9,578,441             |
| Real estate mortgage                               | 406,194                   | 314,098                  |
| Production and intermediate term                   | 450,044                   | 604,007                  |
| Loans to cooperatives                              | 257,667                   | 184,918                  |
| Processing and marketing                           | 2,171,135                 | 2,193,850                |
| Farm-related business                              | 152,267                   | 164,074                  |
| Communication                                      | 321,256                   | 345,555                  |
| Energy (rural utilities)                           | 1,250,234                 | 1,120,981                |
| Water and waste disposal                           | 150,428                   | 144,187                  |
| Rural residential real estate                      | 12                        | 11                       |
| Agricultural export finance                        | -                         | 9,713                    |
| Loans to other financing institutions              | 42,089                    | 42,598                   |
| Mission-related                                    | 18,339                    | 68,573                   |
| Total  | <u>\$ 15,681,830</u>      | <u>\$ 14,771,006</u>     |

The bank's capital markets loan portfolio predominantly includes participations, syndications and purchased whole loans, along with other financing structures within our lending authorities. The bank also refers to the capital markets portfolio as participations purchased. In addition to purchasing loans from our district associations, which may exceed their hold limits, the bank actively pursues the purchase of participations and syndications originated outside of the district's territory by other System institutions, commercial banks and other lenders. These loans may be held as earning assets of the bank or sub-participated to the associations or to other System entities.

The bank purchases or sells participation interests with other parties in order to diversify risk, manage loan volume and comply with Farm Credit Administration regulations.

The following table presents information regarding the balances of participations purchased and sold, excluding syndications, at September 30, 2016.

|   | Other Farm Credit Institutions |                     | Non-Farm Credit Institutions |                     | Total                    |                     |
|---|--------------------------------|---------------------|------------------------------|---------------------|--------------------------|---------------------|
|   | Participations Purchased       | Participations Sold | Participations Purchased     | Participations Sold | Participations Purchased | Participations Sold |
| Real estate mortgage                              | \$ 720,066                     | \$ 347,997          | \$ -                         | \$ 1,812            | \$ 720,066               | \$ 349,809          |
| Production and intermediate term                  | 1,098,609                      | 622,620             | 8,067                        | 70,095              | 1,106,676                | 692,715             |
| Agribusiness                                      | 2,012,177                      | 893,668             | 19,127                       | -                   | 2,031,304                | 893,668             |
| Communication                                     | 437,295                        | 115,609             | -                            | -                   | 437,295                  | 115,609             |
| Energy (rural utilities)                          | 1,444,946                      | 194,426             | -                            | -                   | 1,444,946                | 194,426             |
| Water and waste disposal                          | 149,787                        | 17,879              | -                            | -                   | 149,787                  | 17,879              |
| Mission-related                                   | 4,535                          | -                   | -                            | -                   | 4,535                    | -                   |
| Loans to other financing institutions             | -                              | 13,566              | -                            | -                   | -                        | 13,566              |
| Direct note receivable from district associations | -                              | 3,850,000           | -                            | -                   | -                        | 3,850,000           |
| <b>Total</b>                                      | <b>\$ 5,867,415</b>            | <b>\$ 6,055,765</b> | <b>\$ 27,194</b>             | <b>\$ 71,907</b>    | <b>\$ 5,894,609</b>      | <b>\$ 6,127,672</b> |

The bank is authorized under the Farm Credit Act to accept "advance conditional payments" (ACPs) from borrowers. To the extent the borrower's access to such ACPs is restricted and the legal right of setoff exists, the ACPs are netted against the borrower's related loan balance. Unrestricted advance conditional payments are included in other liabilities. ACPs are not insured, and interest is generally paid by the bank on such balances. There were no significant balances of ACPs at September 30, 2016, or December 31, 2015.

During 2012, the bank elected the fair value option for certain callable loans purchased on the secondary market at a significant premium. The fair value option provides an irrevocable option to elect fair value as an alternative measurement for selected financial assets. The fair value of loans held under the fair value option totaled \$26,884 at September 30, 2016. Fair value is used for both the initial and subsequent measurement of the designated instrument, with the changes in fair value recognized in net income. On these instruments, the related contractual interest income and premium amortization are recorded as Interest Income in the Statements of Comprehensive Income. The remaining changes in fair value on these instruments are recorded as net gains (losses) in Noninterest Income on the Statements of Comprehensive Income. The fair value of these instruments is included in Level 2 in the fair value hierarchy for assets recorded at fair value on a recurring basis.

The following is a summary of the transactions on loans for which the fair value option has been elected for the nine months ended September 30, 2016:

|                                   |    |               |
|-----------------------------------|----|---------------|
| Balance at January 1, 2016        | \$ | 27,506        |
| Net gain on financial instruments |    |               |
| under fair value option           |    | (14)          |
| Net principal reductions          |    | -             |
| Premium amortization              |    | (608)         |
| Balance at September 30, 2016     | \$ | <u>26,884</u> |

Nonperforming assets (including related accrued interest) and related credit quality statistics are as follows:

|                                     | <b>September 30,</b> |    | <b>December 31,</b> |
|-------------------------------------|----------------------|----|---------------------|
|                                     | <b>2016</b>          |    | <b>2015</b>         |
| <b>Nonaccrual loans:</b>            |                      |    |                     |
| Real estate mortgage                | \$ 2,281             | \$ | 2,588               |
| Mission-related                     | 1,918                |    | 2,084               |
| Total nonaccrual loans              | <u>4,199</u>         |    | <u>4,672</u>        |
| <b>Accruing restructured loans:</b> |                      |    |                     |
| Real estate mortgage                | 4,677                |    | 19                  |
| Production and intermediate term    | 8,172                |    | 13,341              |
| Mission-related                     | 2,720                |    | 2,742               |
| Total accruing restructured loans   | <u>15,569</u>        |    | <u>16,102</u>       |
| Total nonperforming loans           | 19,768               |    | 20,774              |
| Other property owned                | -                    |    | 438                 |
| Total nonperforming assets          | <u>\$ 19,768</u>     | \$ | <u>21,212</u>       |

One credit quality indicator utilized by the bank and associations is the Farm Credit Administration Uniform Loan Classification System that categorizes loans into five categories. The categories are defined as follows:

- Acceptable – assets are expected to be fully collectible and represent the highest quality;
- Other assets especially mentioned (OAEM) – assets are currently collectible but exhibit some potential weakness;
- Substandard – assets exhibit some serious weakness in repayment capacity, equity and/or collateral pledged on the loan;
- Doubtful – assets exhibit similar weaknesses to substandard assets; however, doubtful assets have additional weaknesses in existing factors, conditions and values that make collection in full highly questionable; and
- Loss – assets are considered uncollectible.

The following table shows loans and related accrued interest as a percentage of total loans and related accrued interest receivable by loan type as of:

|   | September 30,<br>2016 | December 31,<br>2015 |
|---|-----------------------|----------------------|
| <b>Real estate mortgage:</b>                  |                       |                      |
| Acceptable                                    | 98.5 %                | 92.5 %               |
| OAEM  | -                     | 6.7                  |
| Substandard/Doubtful                          | 1.5                   | 0.8                  |
|   | <b>100.0 %</b>        | <b>100.0 %</b>       |
| <b>Production and intermediate term:</b>      |                       |                      |
| Acceptable                                    | 98.5 %                | 98.6 %               |
| OAEM  | 0.5                   | 1.4                  |
| Substandard/Doubtful                          | 1.0                   | -                    |
|   | <b>100.0 %</b>        | <b>100.0 %</b>       |
| <b>Agribusiness:</b>                          |                       |                      |
| Acceptable                                    | 98.5 %                | 98.4 %               |
| OAEM  | 1.1                   | 1.3                  |
| Substandard/Doubtful                          | 0.4                   | 0.3                  |
|   | <b>100.0 %</b>        | <b>100.0 %</b>       |
| <b>Energy and water/waste disposal:</b>       |                       |                      |
| Acceptable                                    | 94.9 %                | 98.0 %               |
| OAEM  | 5.1                   | 2.0                  |
| Substandard/Doubtful                          | -                     | -                    |
|   | <b>100.0 %</b>        | <b>100.0 %</b>       |
| <b>Communication:</b>                         |                       |                      |
| Acceptable                                    | 100.0 %               | 100.0 %              |
| OAEM  | -                     | -                    |
| Substandard/Doubtful                          | -                     | -                    |
|   | <b>100.0 %</b>        | <b>100.0 %</b>       |
| <b>Rural residential real estate:</b>         |                       |                      |
| Acceptable                                    | 100.0 %               | 100.0 %              |
| OAEM  | -                     | -                    |
| Substandard/Doubtful                          | -                     | -                    |
|   | <b>100.0 %</b>        | <b>100.0 %</b>       |
| <b>Agricultural export finance:</b>           |                       |                      |
| Acceptable                                    | -                     | 100.0 %              |
| OAEM  | -                     | -                    |
| Substandard/Doubtful                          | -                     | -                    |
|   | <b>- %</b>            | <b>100.0 %</b>       |
| <b>Direct notes to associations:</b>          |                       |                      |
| Acceptable                                    | 98.2 %                | 98.3 %               |
| OAEM  | 1.8                   | 1.7                  |
| Substandard/Doubtful                          | -                     | -                    |
|   | <b>100.0 %</b>        | <b>100.0 %</b>       |
| <b>Loans to other financing institutions:</b> |                       |                      |
| Acceptable                                    | 100.0 %               | 100.0 %              |
| OAEM  | -                     | -                    |
| Substandard/Doubtful                          | -                     | -                    |
|   | <b>100.0 %</b>        | <b>100.0 %</b>       |
| <b>Mission-related:</b>                       |                       |                      |
| Acceptable                                    | 89.6 %                | 97.0 %               |
| OAEM  | -                     | -                    |
| Substandard/Doubtful                          | 10.4                  | 3.0                  |
|   | <b>100.0 %</b>        | <b>100.0 %</b>       |
| <b>Total loans:</b>                           |                       |                      |
| Acceptable                                    | 98.1 %                | 98.2 %               |
| OAEM  | 1.8                   | 1.7                  |
| Substandard/Doubtful                          | 0.1                   | 0.1                  |
|   | <b>100.0 %</b>        | <b>100.0 %</b>       |



The following tables provide an age analysis of past due loans (including accrued interest) for the entire loan portfolio (including nonaccrual loans) as of:

September 30, 2016

|                                       | 30-89 Days<br>Past Due | 90 Days<br>or More<br>Past Due | Total<br>Past Due | Not Past Due<br>or Less Than<br>30 Days<br>Past Due | Total<br>Loans       | Recorded<br>Investment<br>> 90 Days<br>and Accruing |
|---------------------------------------|------------------------|--------------------------------|-------------------|---|----------------------|---|
| Real estate mortgage                  | \$ -                   | \$ -                           | \$ -              | \$ 409,411  | \$ 409,411           | \$ -  |
| Production and intermediate term      | -                      | -                              | -                 | 452,288   | 452,288              | -   |
| Agribusiness                          | -                      | -                              | -                 | 2,593,863   | 2,593,863            | -   |
| Communication                         | -                      | -                              | -                 | 321,432   | 321,432              | -   |
| Energy and water/waste disposal       | -                      | -                              | -                 | 1,407,107   | 1,407,107            | -   |
| Rural residential real estate         | -                      | -                              | -                 | 12  | 12                   | -   |
| Direct notes to associations          | -                      | -                              | -                 | 10,482,101  | 10,482,101           | -   |
| Loans to other financing institutions | -                      | -                              | -                 | 42,146  | 42,146               | -   |
| Mission-related                       | -                      | -                              | -                 | 18,481  | 18,481               | -   |
| <b>Total</b>                          | <b>\$ -</b>            | <b>\$ -</b>                    | <b>\$ -</b>       | <b>\$ 15,726,841</b>                                | <b>\$ 15,726,841</b> | <b>\$ -</b>   |

December 31, 2015

|                                       | 30-89 Days<br>Past Due | 90 Days<br>or More<br>Past Due | Total<br>Past Due | Not Past Due<br>or Less Than<br>30 Days<br>Past Due | Total<br>Loans       | Recorded<br>Investment<br>> 90 Days<br>and Accruing |
|---------------------------------------|------------------------|--------------------------------|-------------------|---|----------------------|---|
| Real estate mortgage                  | \$ -                   | \$ -                           | \$ -              | \$ 316,657  | \$ 316,657           | \$ -  |
| Production and intermediate term      | -                      | -                              | -                 | 605,952   | 605,952              | -   |
| Agribusiness                          | -                      | -                              | -                 | 2,554,906   | 2,554,906            | -   |
| Communication                         | -                      | -                              | -                 | 345,799   | 345,799              | -   |
| Energy and water/waste disposal       | -                      | -                              | -                 | 1,270,310   | 1,270,310            | -   |
| Rural residential real estate         | -                      | -                              | -                 | 11  | 11                   | -   |
| Agricultural export finance           | -                      | -                              | -                 | 9,734   | 9,734                | -   |
| Direct notes to associations          | -                      | -                              | -                 | 9,597,745   | 9,597,745            | -   |
| Loans to other financing institutions | -                      | -                              | -                 | 42,647  | 42,647               | -   |
| Mission-related                       | -                      | 2,084                          | 2,084             | 66,981  | 69,065               | -   |
| <b>Total</b>                          | <b>\$ -</b>            | <b>\$ 2,084</b>                | <b>\$ 2,084</b>   | <b>\$ 14,810,742</b>                                | <b>\$ 14,812,826</b> | <b>\$ -</b>   |

Additional impaired loan information is as follows:

|  | At September 30, 2016 |                          |                   | At December 31, 2015 |                          |                   |
|--|-----------------------|--------------------------|-------------------|----------------------|--------------------------|-------------------|
|  | Recorded Investment   | Unpaid Principal Balance | Related Allowance | Recorded Investment  | Unpaid Principal Balance | Related Allowance |
| <b>Impaired loans with a related allowance for credit losses:</b>  |                       |                          |                   |                      |                          |                   |
| Mission-related  | \$ 212                | \$ 212                   | \$ 75             | \$ 219               | \$ 219                   | \$ 75             |
| Total  | \$ 212                | \$ 212                   | \$ 75             | \$ 219               | \$ 219                   | \$ 75             |
| <b>Impaired loans with no related allowance for credit losses:</b> |                       |                          |                   |                      |                          |                   |
| Real estate mortgage   | \$ 6,958              | \$ 6,959                 | \$ -              | \$ 2,607             | \$ 7,081                 | \$ -              |
| Production and intermediate term                                   | 8,172                 | 11,125                   | -                 | 13,341               | 16,129                   | -                 |
| Processing and marketing   | -                     | 1,192                    | -                 | -                    | 1,371                    | -                 |
| Energy and water/waste disposal                                    | -                     | 9,042                    | -                 | -                    | 17,578                   | -                 |
| Mission-related  | 4,426                 | 4,426                    | -                 | 4,607                | 7,797                    | -                 |
| Total  | \$ 19,556             | \$ 32,744                | \$ -              | \$ 20,555            | \$ 49,956                | \$ -              |
| <b>Total impaired loans:</b>                                       |                       |                          |                   |                      |                          |                   |
| Real estate mortgage   | \$ 6,958              | \$ 6,959                 | \$ -              | \$ 2,607             | \$ 7,081                 | \$ -              |
| Production and intermediate term                                   | 8,172                 | 11,125                   | -                 | 13,341               | 16,129                   | -                 |
| Processing and marketing   | -                     | 1,192                    | -                 | -                    | 1,371                    | -                 |
| Energy and water/waste disposal                                    | -                     | 9,042                    | -                 | -                    | 17,578                   | -                 |
| Mission-related  | 4,638                 | 4,638                    | 75                | 4,826                | 8,016                    | 75                |
| Total  | \$ 19,768             | \$ 32,956                | \$ 75             | \$ 20,774            | \$ 50,175                | \$ 75             |

|  | For the Three Months Ended |                            |                        |                            | For the Nine Months Ended |                            |                        |                            |
|--|----------------------------|----------------------------|------------------------|----------------------------|---------------------------|----------------------------|------------------------|----------------------------|
|  | September 30, 2016         |                            | September 30, 2015     |                            | September 30, 2016        |                            | September 30, 2015     |                            |
|  | Average Impaired Loans     | Interest Income Recognized | Average Impaired Loans | Interest Income Recognized | Average Impaired Loans    | Interest Income Recognized | Average Impaired Loans | Interest Income Recognized |
| <b>Impaired loans with a related allowance for credit losses:</b>  |                            |                            |                        |                            |                           |                            |                        |                            |
| Energy and water/waste disposal                                    | \$ -                       | \$ -                       | \$ -                   | \$ -                       | \$ -                      | \$ -                       | \$ 2,292               | \$ -                       |
| Mission-related  | 212                        | 4                          | 2,716                  | 42                         | 215                       | 12                         | 1,064                  | 50                         |
| Total  | \$ 212                     | \$ 4                       | \$ 2,716               | \$ 42                      | \$ 215                    | \$ 12                      | \$ 3,356               | \$ 50                      |
| <b>Impaired loans with no related allowance for credit losses:</b> |                            |                            |                        |                            |                           |                            |                        |                            |
| Real estate mortgage   | \$ 6,936                   | \$ 54                      | \$ 3,021               | \$ -                       | \$ 6,993                  | \$ 125                     | \$ 3,814               | \$ 51                      |
| Production and intermediate term                                   | 8,090                      | 125                        | 13,209                 | 173                        | 8,127                     | 375                        | 12,780                 | 1,003                      |
| Energy and water/waste disposal                                    | -                          | -                          | -                      | -                          | -                         | -                          | 2,255                  | -                          |
| Mission-related  | 4,368                      | 37                         | -                      | -                          | 4,457                     | 113                        | 1,679                  | 77                         |
| Total  | \$ 19,394                  | \$ 216                     | \$ 16,230              | \$ 173                     | \$ 19,577                 | \$ 613                     | \$ 20,528              | \$ 1,131                   |
| <b>Total impaired loans:</b>                                       |                            |                            |                        |                            |                           |                            |                        |                            |
| Real estate mortgage   | \$ 6,936                   | \$ 54                      | \$ 3,021               | \$ -                       | \$ 6,993                  | \$ 125                     | \$ 3,814               | \$ 51                      |
| Production and intermediate term                                   | 8,090                      | 125                        | 13,209                 | 173                        | 8,127                     | 375                        | 12,780                 | 1,003                      |
| Energy and water/waste disposal                                    | -                          | -                          | -                      | -                          | -                         | -                          | 4,547                  | -                          |
| Mission-related  | 4,580                      | 41                         | 2,716                  | 42                         | 4,672                     | 125                        | 2,743                  | 127                        |
| Total  | \$ 19,606                  | \$ 220                     | \$ 18,946              | \$ 215                     | \$ 19,792                 | \$ 625                     | \$ 23,884              | \$ 1,181                   |

At September 30, 2016, impaired loans of \$212 had a related specific allowance of \$75, while the remaining \$19.6 million of impaired loans had no related specific allowance as a result of adequate collateralization.

The average recorded investment in impaired loans for the three months ended September 30, 2016, was \$19.6 million. The bank recognized interest income of \$220 on impaired loans during the three months ended September 30, 2016.

The average recorded investment in impaired loans for the nine months ended September 30, 2016, was \$19.8 million. The bank recognized interest income of \$625 on impaired loans during the nine months ended September 30, 2016.

A summary of changes in the allowance for loan losses and period-end recorded investment in loans is as follows:

|   | Real Estate<br>Mortgage | Production and<br>Intermediate Term | Agribusiness | Communi-<br>cations | Energy and<br>Water/Waste<br>Disposal | Rural<br>Residential<br>Real Estate | Agricultural<br>Export<br>Finance | Direct Notes to<br>Associations | Loans to<br>OFIs | Mission-<br>Related | Total         |
|---|-------------------------|-------------------------------------|--------------|---------------------|---------------------------------------|-------------------------------------|-----------------------------------|---------------------------------|------------------|---------------------|---------------|
| <b>Allowance for Credit Losses</b>                |                         |                                     |              |                     |                                       |                                     |                                   |                                 |                  |                     |               |
| Balance at June 30, 2016                          | \$ 816                  | \$ 494                              | \$ 1,485     | \$ 311              | \$ 4,273                              | \$ -                                | \$ -                              | \$ -                            | \$ -             | \$ 103              | \$ 7,482      |
| Charge-offs                                       | -                       | -                                   | -            | -                   | -                                     | -                                   | -                                 | -                               | -                | -                   | -             |
| Recoveries  | 5                       | -                                   | 1            | 1,316               | -                                     | -                                   | -                                 | -                               | -                | -                   | 1,322         |
| Provision for credit losses (loan loss reversal)  | (749)                   | 262                                 | 902          | (1,156)             | (339)                                 | -                                   | -                                 | -                               | -                | (24)                | (1,104)       |
| Other *   | (1)                     | (26)                                | -            | 2                   | 8                                     | -                                   | -                                 | -                               | -                | -                   | (17)          |
| Balance at September 30, 2016                     | \$ 71                   | \$ 730                              | \$ 2,388     | \$ 473              | \$ 3,942                              | \$ -                                | \$ -                              | \$ -                            | \$ -             | \$ 79               | \$ 7,683      |
| Balance at December 31, 2015                      | \$ 789                  | \$ 428                              | \$ 1,586     | \$ 343              | \$ 2,575                              | \$ -                                | \$ 3                              | \$ -                            | \$ -             | \$ 109              | \$ 5,833      |
| Charge-offs                                       | -                       | -                                   | -            | -                   | -                                     | -                                   | -                                 | -                               | -                | -                   | -             |
| Recoveries  | 12                      | -                                   | 179          | 1,367               | -                                     | -                                   | -                                 | -                               | -                | -                   | 1,558         |
| Provision for credit losses (loan loss reversal)  | (731)                   | 377                                 | 694          | (1,236)             | 1,317                                 | -                                   | (3)                               | -                               | -                | (30)                | 388           |
| Other *   | 1                       | (75)                                | (71)         | (1)                 | 50                                    | -                                   | -                                 | -                               | -                | -                   | (96)          |
| Balance at September 30, 2016                     | \$ 71                   | \$ 730                              | \$ 2,388     | \$ 473              | \$ 3,942                              | \$ -                                | \$ -                              | \$ -                            | \$ -             | \$ 79               | \$ 7,683      |
| Individually evaluated for impairment             | -                       | -                                   | -            | -                   | -                                     | -                                   | -                                 | -                               | -                | 75                  | 75            |
| Collectively evaluated for impairment             | 71                      | 730                                 | 2,388        | 473                 | 3,942                                 | -                                   | -                                 | -                               | -                | 4                   | 7,608         |
| Loans acquired with deteriorated credit quality   | -                       | -                                   | -            | -                   | -                                     | -                                   | -                                 | -                               | -                | -                   | -             |
| Balance at September 30, 2016                     | \$ 71                   | \$ 730                              | \$ 2,388     | \$ 473              | \$ 3,942                              | \$ -                                | \$ -                              | \$ -                            | \$ -             | \$ 79               | \$ 7,683      |
| Balance at June 30, 2015                          | \$ 789                  | \$ 364                              | \$ 2,182     | \$ 188              | \$ 2,096                              | \$ -                                | \$ 23                             | \$ -                            | \$ -             | \$ 103              | \$ 5,745      |
| Charge-offs                                       | -                       | -                                   | -            | -                   | -                                     | -                                   | -                                 | -                               | -                | -                   | -             |
| Recoveries  | 134                     | -                                   | -            | -                   | -                                     | -                                   | -                                 | -                               | -                | -                   | 134           |
| Provision for credit losses (loan loss reversal)  | (132)                   | (56)                                | 107          | 114                 | 84                                    | -                                   | (23)                              | -                               | -                | (1)                 | 93            |
| Other *   | (2)                     | 27                                  | (38)         | (15)                | (2)                                   | -                                   | -                                 | -                               | -                | -                   | (30)          |
| Balance at September 30, 2015                     | \$ 789                  | \$ 335                              | \$ 2,251     | \$ 287              | \$ 2,178                              | \$ -                                | \$ -                              | \$ -                            | \$ -             | \$ 102              | \$ 5,942      |
| Balance at December 31, 2014                      | \$ 794                  | \$ 304                              | \$ 1,120     | \$ 200              | \$ 7,590                              | \$ -                                | \$ -                              | \$ -                            | \$ -             | \$ 104              | \$ 10,112     |
| Charge-offs                                       | -                       | -                                   | -            | -                   | (2,065)                               | -                                   | -                                 | -                               | -                | -                   | (2,065)       |
| Recoveries  | 140                     | -                                   | 11           | 142                 | -                                     | -                                   | -                                 | -                               | -                | -                   | 293           |
| Provision for credit losses (loan loss reversal)  | (173)                   | (60)                                | 2,089        | (38)                | (3,391)                               | -                                   | -                                 | -                               | -                | (1)                 | (1,574)       |
| Other *   | 28                      | 91                                  | (969)        | (17)                | 44                                    | -                                   | -                                 | -                               | -                | (1)                 | (824)         |
| Balance at September 30, 2015                     | \$ 789                  | \$ 335                              | \$ 2,251     | \$ 287              | \$ 2,178                              | \$ -                                | \$ -                              | \$ -                            | \$ -             | \$ 102              | \$ 5,942      |
| Individually evaluated for impairment             | -                       | -                                   | -            | -                   | -                                     | -                                   | -                                 | -                               | -                | 74                  | 74            |
| Collectively evaluated for impairment             | 789                     | 335                                 | 2,251        | 287                 | 2,178                                 | -                                   | -                                 | -                               | -                | 28                  | 5,868         |
| Loans acquired with deteriorated credit quality   | -                       | -                                   | -            | -                   | -                                     | -                                   | -                                 | -                               | -                | -                   | -             |
| Balance at September 30, 2015                     | \$ 789                  | \$ 335                              | \$ 2,251     | \$ 287              | \$ 2,178                              | \$ -                                | \$ -                              | \$ -                            | \$ -             | \$ 102              | \$ 5,942      |
| <b>Recorded Investments in Loans Outstanding:</b> |                         |                                     |              |                     |                                       |                                     |                                   |                                 |                  |                     |               |
| Ending balance at September 30, 2016              | \$ 409,411              | \$ 452,288                          | \$ 2,593,863 | \$ 321,432          | \$ 1,407,107                          | \$ 12                               | \$ -                              | \$ 10,482,101                   | \$ 42,146        | \$ 18,481           | \$ 15,726,841 |
| Individually evaluated for impairment             | \$ 6,959                | \$ 8,172                            | \$ -         | \$ -                | \$ -                                  | \$ -                                | \$ -                              | \$ 10,482,101                   | \$ -             | \$ 4,637            | \$ 10,501,869 |
| Collectively evaluated for impairment             | \$ 402,452              | \$ 444,116                          | \$ 2,593,863 | \$ 321,432          | \$ 1,407,107                          | \$ 12                               | \$ -                              | \$ -                            | \$ 42,146        | \$ 13,844           | \$ 5,224,972  |
| Loans acquired with deteriorated credit quality   | \$ -                    | \$ -                                | \$ -         | \$ -                | \$ -                                  | \$ -                                | \$ -                              | \$ -                            | \$ -             | \$ -                | \$ -          |
| Ending balance at September 30, 2015              | \$ 332,290              | \$ 534,540                          | \$ 2,478,610 | \$ 316,492          | \$ 1,231,739                          | \$ 17                               | \$ 9,714                          | \$ 9,442,330                    | \$ 29,785        | \$ 69,716           | \$ 14,445,233 |
| Individually evaluated for impairment             | \$ 2,631                | \$ 13,297                           | \$ -         | \$ -                | \$ -                                  | \$ -                                | \$ -                              | \$ -                            | \$ -             | \$ 2,785            | \$ 18,713     |
| Collectively evaluated for impairment             | \$ 329,659              | \$ 521,243                          | \$ 2,478,610 | \$ 316,492          | \$ 1,231,739                          | \$ 17                               | \$ 9,714                          | \$ 9,442,330                    | \$ 29,785        | \$ 66,931           | \$ 14,426,520 |
| Loans acquired with deteriorated credit quality   | \$ -                    | \$ -                                | \$ -         | \$ -                | \$ -                                  | \$ -                                | \$ -                              | \$ -                            | \$ -             | \$ -                | \$ -          |

\* Reserve for losses on standby letters of credit recorded in other liabilities

A restructuring of a debt constitutes a troubled debt restructuring (TDR) if the creditor for economic or legal reasons related to the debtor's financial difficulties grants a concession to the debtor that it would not otherwise consider. Troubled debt restructurings are undertaken in order to improve the likelihood of recovery on the loan and may include, but are not limited to, forgiveness of principal or interest, interest rate reductions that are lower than the current market rate for new debt with similar risk, or significant term or payment extensions.

As of September 30, 2016, the total recorded investment of TDR loans was \$17,487, including \$1,918 classified as nonaccrual and \$15,569 classified as accrual, with specific allowance for loan losses of \$75. At September 30, 2016, there were no additional commitments to lend to borrowers whose loan terms have been modified in TDRs.

The following table summarizes TDR loan balances by loan type:

|                                  | Loans Modified as TDRs |                      | TDRs in Nonaccrual Status |                      |
|----------------------------------|------------------------|----------------------|---------------------------|----------------------|
|                                  | September 30,<br>2016  | December 31,<br>2015 | September 30,<br>2016     | December 31,<br>2015 |
| Real estate mortgage             | \$ 4,677               | \$ 19                | \$ -                      | \$ -                 |
| Production and intermediate term | 8,172                  | 13,341               | -                         | -                    |
| Mission-related                  | 4,638                  | 2,742                | 1,918                     | -                    |
| Total                            | <u>\$ 17,487</u>       | <u>\$ 16,102</u>     | <u>\$ 1,918</u>           | <u>\$ -</u>          |

In the first quarter of 2016, TDR loans totaling \$4,533 which were previously classified as “production and intermediate term” were reclassified to the “real estate mortgage” loan type.

The following tables present additional information regarding troubled debt restructurings, which includes both accrual and nonaccrual loans with troubled debt restructuring designation, that occurred during the nine months ended September 30, 2016. The premodification outstanding recorded investment represents the recorded investment of the loans as of the quarter end prior to the restructuring. The postmodification outstanding recorded investment represents the recorded investment of the loans as of the quarter end after the restructuring. In June 2016, one nonaccrual mission-related loan was restructured, the concession being a deferral on principal payment. There were no loans designated as TDR during the three months ended September 30, 2016.

For the nine months ended September 30, 2016:

|                               | Premodification<br>Outstanding<br>Recorded<br>Investment | Postmodification<br>Outstanding<br>Recorded<br>Investment |
|-------------------------------|--|---|
| Troubled debt restructurings: |  |   |
| Mission-related               | \$ 2,066   | \$ 1,947  |
| Total                         | <u>\$ 2,066</u>  | <u>\$ 1,947</u>   |

During the period there were no payment defaults on loans that were restructured during the previous 12 months. A payment default is defined as a payment that is 30 days past due after the date the loan was restructured.

#### **NOTE 4 — COMMITMENTS AND CONTINGENT LIABILITIES**

The bank is primarily liable for its portion of Systemwide debt obligations. Additionally, the bank is jointly and severally liable for the consolidated Systemwide bonds and notes of the other System banks. Total consolidated bank and Systemwide obligations of the System at September 30, 2016, were approximately \$251.99 billion.

In the normal course of business, the bank has various outstanding commitments and contingent liabilities, including the possibility of actions against the bank in which claims for monetary damages may be asserted. Management and legal counsel are not aware of any other pending lawsuits or actions. Upon the basis of current information, management and legal counsel are of the opinion that the ultimate liability, if any, resulting from lawsuits or other pending actions will not be material in relation to the financial position, results of operations or cash flows of the bank.

**NOTE 5 — FAIR VALUE MEASUREMENTS**

Accounting guidance defines fair value as the exchange price that would be received for an asset or paid to transfer a liability in the principal or most advantageous market for the asset or liability. See Note 2, “Summary of Significant Accounting Policies,” of the 2015 Annual Report for a more complete description.

Assets and liabilities recorded at fair value on a recurring basis at September 30, 2016, for each of the fair value hierarchy levels are summarized below:

|   | <b>Fair Value Measurements at September 30, 2016</b> |   |  |  |
|---|--|---|--|--|
|   | <b>Total</b>   | <b>Quoted Prices<br/>in Active<br/>Markets for<br/>Identical Assets<br/>(Level 1)</b> | <b>Significant<br/>Other<br/>Observable<br/>Inputs<br/>(Level 2)</b> | <b>Significant<br/>Unobservable<br/>Inputs<br/>(Level 3)</b> |
| <b>Assets:</b>  |  |   |  |  |
| Federal funds   | \$ 22,031  | \$ -  | \$ 22,031  | \$ -   |
| Investments available for sale:                             |  |   |  |  |
| Agency-guaranteed debt                                      | 234,200  | -   | 234,200  | -  |
| Corporate debt  | 202,663  | -   | 202,663  | -  |
| Mortgage-backed securities                                  | 4,043,262  | -   | 4,043,262  | -  |
| U.S. Treasury securities                                    | 200,023  | -   | 200,023  | -  |
| Asset-backed securities                                     | 162,614  | -   | 162,614  | -  |
| Mission-related and other<br>available-for-sale investments | 55,634   | -   | -  | 55,634   |
| Loans valued under the<br>fair value option                 | 26,884   | -   | 26,884   | -  |
| Derivative assets   | 161  | -   | 161  | -  |
| Assets held in nonqualified<br>benefit trusts               | 405  | 405   | -  | -  |
| <b>Total assets</b>   | <b>\$ 4,947,877</b>                                  | <b>\$ 405</b>   | <b>\$ 4,891,838</b>  | <b>\$ 55,634</b>   |
| <b>Liabilities:</b>   |  |   |  |  |
| Derivative liabilities                                      | \$ 2,809   | \$ -  | \$ 2,809   | \$ -   |
| Standby letters of credit                                   | 776  | -   | -  | 776  |
| <b>Total liabilities</b>                                    | <b>\$ 3,585</b>                                      | <b>\$ -</b>   | <b>\$ 2,809</b>  | <b>\$ 776</b>  |

*Loans With Fair Value Option*

The bank has elected the fair value option for certain callable loans purchased on the secondary market at a significant premium. The fair value option provides an irrevocable option to elect fair value as an alternative measurement for selected financial assets. Fair value is used for both the initial and subsequent measurement of the designated instrument, with the changes in fair value recognized in net income. On these instruments, the related contractual interest income and premium amortization are recorded as Interest Income in the Statements of Comprehensive Income. The remaining changes in fair value on these instruments are recorded as net gains (losses) in Noninterest Income on the Statements of Comprehensive Income. The fair value of these instruments is included in Level 2 in the fair value

hierarchy for assets recorded at fair value on a recurring basis. The fair value of loans held under the fair value option totaled \$26,884 at September 30, 2016.

The following table represents a reconciliation of all assets and liabilities measured at fair value on a recurring basis using significant unobservable inputs (Level 3) for the period from June 30, 2016, to September 30, 2016:

|   | <u>Assets</u>                                     | <u>Liabilities</u>              |                  |
|---|---|---------------------------------|------------------|
|   | Agricultural<br>Mortgage-<br>Backed<br>Securities | Standby<br>Letters of<br>Credit | <u>Net</u>       |
| Available-for-sale investment securities:         |   |                                 |                  |
| Balance at June 30, 2016                          | \$ 59,674   | \$ 1,016                        | \$ 58,658        |
| Net losses included in other comprehensive income | (160)   | -                               | (160)            |
| Purchases, issuances and settlements              | <u>(3,880)</u>                                    | <u>(240)</u>                    | <u>(3,640)</u>   |
| Balance at September 30, 2016                     | <u>\$ 55,634</u>                                  | <u>\$ 776</u>                   | <u>\$ 54,858</u> |

The following table represents a reconciliation of all assets and liabilities measured at fair value on a recurring basis using significant unobservable inputs (Level 3) for the period from January 1, 2016, to September 30, 2016:

|   | <u>Assets</u>                     |   |                          | <u>Liabilities</u>              |                  |
|---|-----------------------------------|---|--------------------------|---------------------------------|------------------|
|   | Mortgage-<br>Backed<br>Securities | Agricultural<br>Mortgage-<br>Backed<br>Securities | Loan<br>Held For<br>Sale | Standby<br>Letters of<br>Credit | <u>Net</u>       |
| Balance at January 1, 2016                        | \$ 50,250                         | \$ 65,650   | \$ 4,850                 | \$ 807                          | \$ 119,943       |
| Net losses included in other comprehensive income | -                                 | (94)  | -                        | -                               | (94)             |
| Purchases, issuances and settlements              | -                                 | (9,922)   | (4,850)                  | (31)                            | (14,741)         |
| Transfers out of Level 3                          | <u>(50,250)</u>                   | <u>-</u>  | <u>-</u>                 | <u>-</u>                        | <u>(50,250)</u>  |
| Balance at September 30, 2016                     | <u>\$ -</u>                       | <u>\$ 55,634</u>                                  | <u>\$ -</u>              | <u>\$ 776</u>                   | <u>\$ 54,858</u> |

There were no transfers of assets or liabilities into or out of Level 1 from other levels during the nine months ended September 30, 2016. At December 31, 2015, Level 3 investments included one agency MBS and one loan held for sale due to the fact that their valuations were based on Level 3 criteria (broker quotes). In the nine months ended September 30, 2016, the loan held for sale was disposed of and the agency MBS was transferred to Level 2 when it had a valuation based on Level 2 criteria (independent third party valuation services). AMBS are included in Level 3 due to limited activity or less transparency around inputs to their valuation. The liability for standby letters of credit is included in Level 3 due to a determination that their valuation, based on fees currently charged for similar agreements, may not closely correlate to a fair value for instruments that are not regularly traded in the secondary market.

Assets and liabilities measured at fair value on a nonrecurring basis at September 30, 2016, for each of the fair value hierarchy levels are summarized below:

|                      | Fair Value Measurements at September 30, 2016 |  |   |   | Total Losses |
|----------------------|---|--|---|---|--------------|
|                      | Total   | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |              |
| <b>Assets:</b>       |   |  |   |   |              |
| Loans                | \$ 4,124                                      | \$ -   | \$ -  | \$ 4,124                                  | \$ -         |
| Other property owned | -   | -  | -   | -   | (439)        |
| Total assets         | \$ 4,124                                      | \$ -   | \$ -  | \$ 4,124                                  | \$ (439)     |

Assets and liabilities measured at fair value on a recurring basis at December 31, 2015, for each of the fair value hierarchy levels are summarized below:

|  | Fair Value Measurements at December 31, 2015 |  |   |   |
|--|--|--|---|---|
|  | Total  | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| <b>Assets:</b>   |  |  |   |   |
| Federal funds  | \$ 22,413                                    | \$ -   | \$ 22,413                                     | \$ -                                      |
| Investments available for sale:                          |  |  |   |   |
| Agency-guaranteed debt                                   | 248,355                                      | -  | 248,355                                       | -   |
| Corporate debt   | 200,602                                      | -  | 200,602                                       | -   |
| Mortgage-backed securities                               | 3,730,425                                    | -  | 3,680,175                                     | 50,250                                    |
| Asset-backed securities                                  | 200,073                                      | -  | 200,073                                       | -   |
| Mission-related and other available-for-sale investments | 65,650                                       | -  | -   | 65,650                                    |
| Loans valued under the fair value option                 | 27,506                                       | -  | 27,506  | -   |
| Loans held for sale in other assets                      | 4,850  | -  | -   | 4,850                                     |
| Derivative assets  | 504  | -  | 504   | -   |
| Assets held in nonqualified benefit trusts               | 347  | 347  | -   | -   |
| Total assets   | \$ 4,500,725                                 | \$ 347   | \$ 4,379,628                                  | \$ 120,750                                |
| <b>Liabilities:</b>                                      |  |  |   |   |
| Standby letters of credit                                | \$ 807                                       | \$ -   | \$ -  | \$ 807                                    |
| Total liabilities  | \$ 807                                       | \$ -   | \$ -  | \$ 807                                    |

The following table represents a reconciliation of all assets and liabilities measured at fair value on a recurring basis using significant unobservable inputs (Level 3) for the period from June 30, 2015, to September 30, 2015:

|  | Assets  | Liabilities                     |                  |
|--|---|---------------------------------|------------------|
|  | Agricultural<br>Mortgage-<br>Backed<br>Securities | Standby<br>Letters of<br>Credit | Net              |
| Available-for-sale investment securities:      |   |                                 |                  |
| Balance at June 30, 2015                       | \$ 71,631   | \$ 1,443                        | \$ 70,188        |
| Net gains included in other comprehensive loss | 220   | -                               | 220              |
| Purchases, issuances and settlements           | (2,871)   | (227)                           | (2,644)          |
| Balance at September 30, 2015                  | <u>\$ 68,980</u>                                  | <u>\$ 1,216</u>                 | <u>\$ 67,764</u> |

The following table represents a reconciliation of all assets and liabilities measured at fair value on a recurring basis using significant unobservable inputs (Level 3) for the period from January 1, 2015, to September 30, 2015:

|  | Assets                            |   | Liabilities                     |                  |
|--|-----------------------------------|---|---------------------------------|------------------|
|  | Mortgage-<br>Backed<br>Securities | Agricultural<br>Mortgage-<br>Backed<br>Securities | Standby<br>Letters of<br>Credit | Net              |
| Balance at January 1, 2015                     | \$ 7                              | \$ 80,583   | \$ 797                          | \$ 79,793        |
| Net gains included in other comprehensive loss | -                                 | 505   | -                               | 505              |
| Purchases, issuances and settlements           | (7)                               | (12,108)  | 419                             | (12,534)         |
| Balance at September 30, 2015                  | <u>\$ -</u>                       | <u>\$ 68,980</u>                                  | <u>\$ 1,216</u>                 | <u>\$ 67,764</u> |

There were no transfers of assets or liabilities into or out of Level 1, Level 2 or Level 3 from other levels during the nine months ended September 30, 2015. AMBS are included in Level 3 due to limited activity or less transparency around inputs to their valuation. The liability for standby letters of credit is included in Level 3 due to a determination that their valuation, based on fees currently charged for similar agreements, may not closely correlate to a fair value for instruments that are not regularly traded in the secondary market.

Assets and liabilities measured at fair value on a nonrecurring basis at December 31, 2015, for each of the fair value hierarchy levels are summarized below:

|                      | Total           | Quoted Prices<br>in Active<br>Markets for<br>Identical Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) | Total Gains<br>(Losses) |
|----------------------|-----------------|--|---|--|-------------------------|
| <b>Assets:</b>       |                 |  |   |  |                         |
| Loans                | \$ 4,597        | \$ -   | \$ -  | \$ 4,597   | \$ (2,065)              |
| Other property owned | 487             | -  | -   | 487  | 3,090                   |
| Total assets         | <u>\$ 5,084</u> | <u>\$ -</u>  | <u>\$ -</u>   | <u>\$ 5,084</u>                                    | <u>\$ 1,025</u>         |



Financial assets and financial liabilities measured at carrying amounts and not measured at fair value on the Balance Sheet for each of the fair value hierarchy values are summarized as follows:

|                            | September 30, 2016            |  |   |  |                        |
|----------------------------|-------------------------------|--|---|--|------------------------|
|                            | Fair Value Measurements Using |  |   |  |                        |
|                            | Total<br>Carrying<br>Amount   | Quoted Prices<br>in Active<br>Markets for<br>Identical Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) | Total<br>Fair<br>Value |
| <b>Assets:</b>             |                               |  |   |  |                        |
| Cash                       | \$ 504,708                    | \$ 504,708   | \$ -  | \$ -   | \$ 504,708             |
| Net loans                  | 15,643,139                    | -  | -   | 15,935,644   | 15,935,644             |
| Total assets               | <b>\$ 16,147,847</b>          | \$ 504,708   | \$ -  | \$ 15,935,644                                      | \$ 16,440,352          |
| <b>Liabilities:</b>        |                               |  |   |  |                        |
| Systemwide debt securities | \$ 19,506,829                 | \$ -   | \$ -  | \$ 19,686,260                                      | \$ 19,686,260          |
| Total Liabilities          | <b>\$ 19,506,829</b>          | \$ -   | \$ -  | \$ 19,686,260                                      | \$ 19,686,260          |

|                            | December 31, 2015             |  |   |  |                        |
|----------------------------|-------------------------------|--|---|--|------------------------|
|                            | Fair Value Measurements Using |  |   |  |                        |
|                            | Total<br>Carrying<br>Amount   | Quoted Prices<br>in Active<br>Markets for<br>Identical Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) | Total<br>Fair<br>Value |
| <b>Assets:</b>             |                               |  |   |  |                        |
| Cash                       | \$ 545,090                    | \$ 545,090   | \$ -  | \$ -   | \$ 545,090             |
| Net loans                  | 14,733,070                    | -  | -   | 14,676,805   | 14,676,805             |
| Total assets               | <b>\$ 15,278,160</b>          | \$ 545,090   | \$ -  | \$ 14,676,805                                      | \$ 15,221,895          |
| <b>Liabilities:</b>        |                               |  |   |  |                        |
| Systemwide debt securities | \$ 18,206,726                 | \$ -   | \$ -  | \$ 18,265,040                                      | \$ 18,265,040          |
| Subordinated debt          | 49,801                        | -  | -   | 52,972   | 52,972                 |
| Total Liabilities          | <b>\$ 18,256,527</b>          | \$ -   | \$ -  | \$ 18,318,012                                      | \$ 18,318,012          |

## Valuation Techniques

As more fully discussed in Note 2, "Summary of Significant Accounting Policies," of the 2015 Annual Report, accounting guidance establishes a fair value hierarchy, which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The following represent a brief summary of the valuation techniques used for the bank's assets and liabilities:

### *Investments Available for Sale*

Where quoted prices are available in an active market, available-for-sale securities would be classified as Level 1. If quoted prices are not available in an active market, the fair value of securities is estimated using pricing models, quoted prices for similar securities received from pricing services or discounted cash flows. Generally, these securities would be classified as Level 2. To estimate the fair value of investments, the bank obtains prices from third-party pricing services. This would include certain mortgage-backed and asset-backed securities. Where there is limited activity or less transparency around

inputs to the valuation, the securities are classified as Level 3. Investments classified as Level 3 are Farmer Mac AMBS.

#### *Derivative Assets and Liabilities*

The bank's derivative positions are valued using internally developed models that use as their basis readily observable market parameters and are classified within Level 2 of the valuation hierarchy. Such derivatives may include fair value interest rate swaps, interest rate caps and cash flow interest rate swaps. The models used to determine the fair value of derivative assets and liabilities use an income approach based on observable inputs, primarily the LIBOR swap curve and volatility assumptions about future interest rate movements.

#### *Assets Held in Nonqualified Benefit Trusts*

Assets held in trust funds related to deferred compensation and supplemental retirement plans are classified within Level 1. The trust funds include investments that are actively traded and have quoted net asset values that are observable in the marketplace.

#### *Standby Letters of Credit*

The fair value of letters of credit approximates the fees currently charged for similar agreements or the estimated cost to terminate or otherwise settle similar obligations.

#### *Loans*

Fair value is estimated by discounting the expected future cash flows using the bank's current interest rates at which similar loans would be made to borrowers with similar credit risk. As the discount rates are based on the bank's loan rates as well as on management estimates, management has no basis to determine whether the fair values presented would be indicative of the value negotiated in an actual sale.

For purposes of determining fair value of accruing loans, the loan portfolio is segregated into pools of loans with homogeneous characteristics. Expected future cash flows and discount rates reflecting appropriate credit risk are determined separately for each individual pool.

For loans which are valued at fair value under the fair value pricing option, if quoted prices are not available in an active market, the fair value is estimated using pricing models, quoted prices for similar instruments received from pricing services or discounted cash flows. Generally, these loans would be classified as Level 2. To estimate the fair value of these instruments, the bank obtains prices from third-party pricing services.

For certain loans evaluated for impairment, the fair value is based upon the underlying collateral since the loans were collateral-dependent loans for which real estate is the collateral. These loans are generally classified as Level 3. The fair value measurement process uses independent appraisals and other market-based information, but in many cases it also requires significant input based on management's knowledge of and judgment about current market conditions, specific issues relating to the collateral and other matters. As a result, these fair value measurements fall within Level 3 of the hierarchy. When the value of the real estate, less estimated costs to sell, is less than the principal balance of the loan, a specific reserve is established.

#### *Systemwide Debt Securities and Other Notes*

Systemwide debt securities are not all traded in the secondary market and those that are traded may not have readily available quoted market prices. Therefore, the fair value of the instruments is estimated by calculating the discounted value of the expected future cash flows. The discount rates used are based on the sum of quoted market yields for the Treasury yield curve and an estimated yield-spread relationship between System debt instruments and Treasury securities. We estimate an appropriate yield-spread taking

into consideration selling group member (banks and securities dealers) yield indications, observed new government-sponsored enterprise debt security pricing, and pricing levels in the related U.S. dollar interest rate swap market.

*Other Property Owned*

Other property owned (OPO) is generally classified as Level 3 of the fair value hierarchy. The process for measuring the fair value of other property owned involves the use of independent appraisals or other market-based information. Costs to sell represent transaction costs and are not included as a component of the asset's fair value.

*Sensitivity to Changes in Significant Unobservable Inputs*

For recurring fair value measurements categorized within Level 3 of the fair value hierarchy, the significant unobservable inputs used in the fair value measurement of the mortgage-backed securities are prepayment rates, probability of default and loss severity in the event of default. Significant increases (decreases) in any of those inputs in isolation would result in a significantly lower (higher) fair value measurement.

Generally, a change in the assumption used for the probability of default is accompanied by a directionally similar change in the assumption used for the loss severity and a directionally opposite change in the assumption used for prepayment rates.

Quoted market prices may not be available for the instruments presented below. Accordingly, fair values are based on internal models that consider judgments regarding anticipated cash flows, future expected loss experience, current economic conditions, risk characteristics of various financial instruments and other factors. These estimates involve uncertainties and matters of judgment, and therefore cannot be determined with precision. Changes in assumptions could significantly affect the estimates.

*Quantitative Information About Recurring and Nonrecurring Level 3 Fair Value Measurements*

|                             | <b>Valuation Technique(s)</b> | <b>Unobservable Input</b>                                  |
|-----------------------------|-------------------------------|--|
| Mortgage-backed securities  | Discounted cash flow          | Prepayment rate<br>Probability of default<br>Loss severity |
| Asset-backed securities     | Discounted cash flow          | Prepayment rate<br>Probability of default<br>Loss severity |
| Mission-related investments | Discounted cash flow          | Prepayment rates   |

***Information About Recurring and Nonrecurring Level 2 Fair Value Measurements***

|  | <b>Valuation Technique(s)</b> | <b>Input</b>  |
|--|-------------------------------|---|
| Federal funds sold                       | Carrying value                | Par/principal   |
| Investment securities available for sale | Quoted prices                 | Price for similar asset   |
|  | Discounted cash flow          | Constant prepayment rate<br>Appropriate interest rate yield curve |
| Loans held under the fair value option   | Quoted prices                 | Price for similar instruments                                     |
|  | Discounted cash flow          | Constant prepayment rate<br>Appropriate interest rate yield curve |
| Interest rate caps                       | Discounted cash flow          | Benchmark yield curve<br>Counterparty credit risk<br>Volatility   |
| Interest rate swaps                      | Discounted cash flow          | Benchmark yield curve<br>Counterparty credit risk<br>Volatility   |

***Information About Other Financial Instrument Fair Value Measurements***

|                            | <b>Valuation Technique(s)</b> | <b>Input</b>                                  |
|----------------------------|-------------------------------|---|
| Cash                       | Carrying value                | Actual balances                               |
| Loans                      | Discounted cash flow          | Prepayment forecasts                          |
|                            |                               | Appropriate interest rate yield curve         |
|                            |                               | Probability of default                        |
|                            |                               | Loss severity                                 |
| Systemwide debt securities | Discounted cash flow          | Benchmark yield curve<br>Derived yield spread |

**NOTE 6 — DERIVATIVE FINANCIAL INSTRUMENTS AND HEDGING ACTIVITIES**

The bank maintains an overall interest rate risk management strategy that incorporates the use of derivative products to minimize significant unplanned fluctuations in earnings that are caused by interest rate volatility. The bank's goal is to manage interest rate sensitivity by modifying the repricing or maturity characteristics of certain balance sheet assets and liabilities so that movements in interest rates do not adversely affect the net interest margin. The bank considers the strategic use of derivatives to be a prudent method of managing interest rate sensitivity, as it prevents earnings from being exposed to undue risk posed by changes in interest rates.

The bank may enter into derivative transactions to lower funding costs, diversify sources of funding, alter interest rate exposures arising from mismatches between assets and liabilities or better manage liquidity. Interest rate swaps allow the bank to raise long-term borrowings at fixed rates and swap them into floating rates to better match the repricing characteristics of earning assets. Under interest rate swap arrangements, the bank agrees with other parties to exchange, at specified intervals, payment streams calculated on a specified notional principal amount, with at least one stream based on a specified floating-

rate index. The bank may purchase interest rate options, such as caps, in order to reduce the impact of rising interest rates on its floating-rate debt.

The notional amounts of the bank's interest rate swaps and interest rate caps held and the amount of activity during the period are summarized in the following table:

|                               | <b>Pay-Fixed<br/>Swaps</b> | <b>Interest Rate<br/>Caps</b> | <b>Total</b>      |
|-------------------------------|----------------------------|-------------------------------|-------------------|
| Balance at January 1, 2016    | \$ -                       | \$ 310,000                    | \$ 310,000        |
| Additions                     | 200,000                    | -                             | 200,000           |
| Maturities/Amortizations      | -                          | (115,000)                     | (115,000)         |
| Balance at September 30, 2016 | <b>\$ 200,000</b>          | <b>\$ 195,000</b>             | <b>\$ 395,000</b> |

To minimize the risk of credit losses, the bank deals with counterparties that have an investment grade or better credit rating from a major rating agency, and also monitors the credit standing and levels of exposure to individual counterparties. In addition, substantially all derivative contracts are supported by bilateral collateral agreements with counterparties requiring the posting of collateral in the event certain dollar thresholds of exposure of one party to another are reached, which thresholds may vary, depending on the counterparty's credit rating. The bank does not anticipate nonperformance by any of these counterparties. However, derivative contracts are reflected in the financial statements on a gross basis regardless of the netting agreement. At September 30, 2016, and December 31, 2015, the bank's exposure to counterparties was \$161 and \$504, respectively. At September 30, 2016, and December 31, 2015, the bank had posted no securities as collateral, nor had any counterparty been required to post collateral.

#### Cash Flow Hedges

The bank's derivative instruments at September 30, 2016, and December 31, 2015, which are designated and qualify as a cash flow hedge, all meet the standards for accounting treatment that presume full effectiveness. Thus, the effective portion of the gain or loss on the derivative is reported as a component of other comprehensive income.

| Derivatives designated as hedging instruments | Balance Sheet Location | Fair Value         | Fair Value        | Balance Sheet Location | Fair Value         | Fair Value        |
|---|------------------------|--------------------|-------------------|------------------------|--------------------|-------------------|
|   |                        | September 30, 2016 | December 31, 2015 |                        | September 30, 2016 | December 31, 2015 |
| Interest rate caps                            | Other assets           | \$ 161             | \$ 504            | Other liabilities      | \$ -               | \$ -              |
| Pay fixed swaps                               | Other assets           | -                  | -                 | Other liabilities      | 2,809              | -                 |

| Derivatives designated as hedging instruments | Amount of (Loss) Gain Recognized in OCL on Derivatives (Effective Portion) |          | Location of Gain Reclassification from AOCI into Income | Amount of Gain (Loss) Reclassified from AOCL into Income (Effective Portion) |          |
|---|--|----------|---|--|----------|
|   | September 30,  |          |   | September 30,  |          |
|   | 2016   | 2015     |   | 2016   | 2015     |
| Interest rate caps                            | \$ (343)   | \$ (419) | Interest expense  | \$ 665   | \$ 1,120 |
| Pay fixed swaps                               | 3,484  | -        | Interest expense  | 714  | -        |

**NOTE 7 — EMPLOYEE BENEFIT PLANS**

In addition to pension benefits, the bank provides certain health care benefits to qualifying retired employees (other postretirement benefits). These benefits are not characterized as multiemployer and, consequently, the liability for these benefits is included in other liabilities. Bank employees hired after January 1, 2004, will be eligible for retiree medical benefits for themselves and their spouses at their expense but will be responsible for 100 percent of the related premiums. The following table summarizes the components of net periodic benefit costs for the bank's other postretirement benefit costs for the nine months ended September 30:

|                                     | Other Postretirement<br>Benefits |        |
|-------------------------------------|----------------------------------|--------|
|                                     | 2016                             | 2015   |
| Service cost                        | \$ 177                           | \$ 210 |
| Interest cost                       | 363                              | 373    |
| Amortization of prior service costs | (139)                            | (139)  |
| Amortization of net loss            | -                                | 52     |
| Net periodic benefit cost           | \$ 401                           | \$ 496 |

The structure of the district's defined benefit pension plan is characterized as multiemployer, since the assets, liabilities and cost of the plan are not segregated or separately accounted for by participating employers (bank and associations).

**NOTE 8 — ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS)**

Accumulated other comprehensive income (AOCI) includes the accumulated balance of certain gains, losses or costs for which values are included in assets or liabilities on the balance sheets, but which have not yet been recognized in earnings. For the bank, these elements include unrealized gains or losses on the bank's available-for-sale investment portfolio, amortization of retirement benefit elements and changes in the value of cash flow derivative instruments.

The following table summarizes the changes in the balance of the components of AOCI for the nine months ended September 30, 2016:

|   | Total           | Unrealized<br>Gain (Loss)<br>on Securities | Retirement<br>Benefit<br>Plans | Cash Flow<br>Derivative<br>Instruments |
|---|-----------------|--|--------------------------------|--|
| Balance, January 1, 2016                                    | \$ (27,331)     | \$ (25,276)                                | \$ (148)                       | \$ (1,907)                             |
| Change in unrealized gains on available-for-sale securities |                 |  |                                |  |
| Net increase in unrealized gains on investment securities   | 32,487          | 32,487                                     |                                |  |
| Net change in unrealized gains on securities                | 32,487          | 32,487                                     |                                |  |
| Change in postretirement benefit plans                      |                 |  |                                |  |
| Amounts amortized into net periodic expense:                |                 |  |                                |  |
| Amortization of prior service credits                       | (139)           |  | (139)                          |  |
| Net change in postretirement benefit plans                  | (139)           |  | (139)                          |  |
| Change in cash flow derivative instruments                  |                 |  |                                |  |
| Unrealized losses on cash flow derivative instruments       | (3,827)         |  |                                | (3,827)                                |
| Reclassification of amount recognized in interest expense   | 1,379           |  |                                | 1,379                                  |
| Net change in cash flow derivative instruments              | (2,448)         |  |                                | (2,448)                                |
| <b>Total other comprehensive income (loss)</b>              | <b>29,900</b>   | <b>32,487</b>                              | <b>(139)</b>                   | <b>(2,448)</b>                         |
| <b>Balance, September 30, 2016</b>                          | <b>\$ 2,569</b> | <b>\$ 7,211</b>                            | <b>\$ (287)</b>                | <b>\$ (4,355)</b>                      |

The following table summarizes the changes in the balance of the components of AOCL for the nine months ended September 30, 2015:

|  | <b>Total</b>  | <b>Unrealized Gain (Loss) on Securities</b> | <b>Retirement Benefit Plans</b> | <b>Cash Flow Derivative Instruments</b> |
|--|---------------|---|---------------------------------|---|
| Balance, January 1, 2015                                     | \$ (19,822)   | \$ (16,100)                                 | \$ (1,027)                      | \$ (2,695)                              |
| Change in unrealized losses on available-for-sale securities |               |   |                                 |   |
| Net decrease in unrealized losses on investment securities   | 19,338        | 19,338                                      |                                 |   |
| Net change in unrealized losses on securities                | 19,338        | 19,338                                      |                                 |   |
| Change in postretirement benefit plans                       |               |   |                                 |   |
| Amounts amortized into net periodic expense:                 |               |   |                                 |   |
| Amortization of prior service credits                        | (139)         |   | (139)                           |   |
| Amortization of net losses                                   | 52            |   | 52                              |   |
| Net change in postretirement benefit plans                   | (87)          |   | (87)                            |   |
| Change in cash flow derivative instruments                   |               |   |                                 |   |
| Unrealized losses on interest rate caps                      | (419)         |   |                                 | (419)                                   |
| Reclassification of amount recognized in interest expense    | 1,120         |   |                                 | 1,120                                   |
| Net change in cash flow derivative instruments               | 701           |   |                                 | 701                                     |
| <b>Total other comprehensive income (loss)</b>               | <b>19,952</b> | <b>19,338</b>                               | <b>(87)</b>                     | <b>701</b>                              |
| <b>Balance, September 30, 2015</b>                           | <b>\$ 130</b> | <b>\$ 3,238</b>                             | <b>\$ (1,114)</b>               | <b>\$ (1,994)</b>                       |

The following table summarizes reclassifications from AOCI to the Statements of Comprehensive Income for the nine months ended September 30:

| <b>Component of AOCI</b>                                    | <b>Amount Reclassified from AOCI</b> |             | <b>Affected Line in the Statement of Comprehensive Income</b> |
|---|--------------------------------------|-------------|---|
|   | <b>2016</b>                          | <b>2015</b> |   |
| Amortization of net credits on post-retirement benefit plan | \$ (139)                             | \$ (87)     | Salaries and employee benefits                                |
| Amortization on cash flow derivative instruments            | 1,379                                | 1,120       | Interest expense  |
| Total reclassifications                                     | \$ 1,240                             | \$ 1,033    |   |

#### NOTE 9 — SUBSEQUENT EVENTS

The bank has evaluated subsequent events through November 9, 2016, which is the date the financial statements were issued. There are no other significant subsequent events requiring disclosure as of November 9, 2016.

**NOTE 10 — COMBINED ASSOCIATION FINANCIAL DATA**

Condensed financial information for the associations follows. All significant transactions and balances between the associations are eliminated in combination. The multiemployer structure of certain of the district's retirement and benefit plans results in the recording of these plans only in the district's combined financial statements.

| <b>Balance sheet data</b>                    | <b>September 30, 2016</b> | <b>December 31, 2015</b> |
|--|---------------------------|--------------------------|
| Cash   | \$ 4,234                  | 5,762                    |
| Investment securities                        | 27,019                    | 30,213                   |
| Loans  | 16,898,112                | 15,985,054               |
| Less allowance for loan losses               | 72,848                    | 64,517                   |
| Net loans                                    | <u>16,825,264</u>         | <u>15,920,537</u>        |
| Accrued interest receivable                  | 174,139                   | 137,950                  |
| Other property owned                         | 22,369                    | 18,306                   |
| Other assets                                 | 430,557                   | 400,359                  |
| Total assets                                 | <u>\$ 17,483,582</u>      | <u>\$ 16,513,127</u>     |
|  |                           |                          |
| Notes payable                                | \$ 14,307,978             | \$ 13,420,186            |
| Other liabilities                            | 229,571                   | 336,638                  |
| Total liabilities                            | <u>14,537,549</u>         | <u>13,756,824</u>        |
| Capital stock and participation certificates | 62,802                    | 61,356                   |
| Retained earnings                            | 2,662,669                 | 2,473,964                |
| Additional paid-in-capital                   | 224,625                   | 224,625                  |
| Accumulated other comprehensive loss         | (4,063)                   | (3,642)                  |
| Total shareholder's equity                   | <u>2,946,033</u>          | <u>2,756,303</u>         |
| Total liabilities and shareholder's equity   | <u>\$ 17,483,582</u>      | <u>\$ 16,513,127</u>     |

| <b>Statement of income data</b>        | <b>Nine Months Ended September 30,</b> |                   |
|--|--|-------------------|
|  | <b>2016</b>                            | <b>2015</b>       |
| Interest income                        | \$ 575,517                             | \$ 521,917        |
| Interest expense                       | 209,201                                | 177,144           |
| Net interest income                    | <u>366,316</u>                         | <u>344,773</u>    |
| Provision for loan losses              | 9,776                                  | 8,493             |
| Net interest income after provision    |  |                   |
| for loan losses                        | 356,540                                | 336,280           |
| Noninterest income                     | 60,980                                 | 58,812            |
| Noninterest expense                    | 180,198                                | 171,527           |
| Provision for income taxes             | 231                                    | 232               |
| Net income                             | <u>237,091</u>                         | <u>223,333</u>    |
|  |  |                   |
| Other comprehensive (loss) gain:       |  |                   |
| Change in postretirement benefit plans | (421)                                  | 269               |
| Total other comprehensive (loss) gain  | <u>(421)</u>                           | <u>269</u>        |
| Comprehensive income                   | <u>\$ 236,670</u>                      | <u>\$ 223,602</u> |