

2016 ANNUAL REPORT

LONE  STAR  
AG CREDIT



FINANCING YOUR PIECE OF TEXAS SINCE 1917

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## REPORT OF MANAGEMENT

The consolidated financial statements of Lone Star, ACA (association) are prepared by management, who is responsible for the statements' integrity and objectivity, including amounts that must necessarily be based on judgments and estimates. The consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America. Other financial information included in the annual report is consistent with that in the consolidated financial statements.

To meet its responsibility for reliable financial information, management depends on the Farm Credit Bank of Texas' and the association's accounting and internal control systems, which have been designed to provide reasonable, but not absolute, assurance that assets are safeguarded and transactions are properly authorized and recorded. The systems have been designed to recognize that the cost of controls must be related to the benefits derived. The consolidated financial statements are audited by PricewaterhouseCoopers LLP, independent accountants, who also conduct a review of internal controls to the extent necessary to comply with auditing standards generally accepted in the United States of America. The association is also examined by the Farm Credit Administration.

The board of directors has overall responsibility for the association's systems of internal control and financial reporting. The board consults regularly with management and reviews the results of the audits and examinations referred to previously.

The undersigned certify that we have reviewed this annual report, that it has been prepared in accordance with all applicable statutory and regulatory requirements, and that the information contained herein is true, accurate and complete to the best of our knowledge or belief.



Troy Bussmeir, Chief Executive Officer

*March 14, 2017*



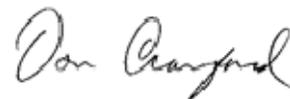
Tom Johnson, Chairman, Board of Directors

*March 14, 2017*



M'Lissa Kiel, Chief Financial Officer

*March 14, 2017*



Don Crawford, Chairman, Audit Committee

*March 14, 2017*

## REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

The association's chief executive officer and chief financial officer, or persons performing similar functions, are responsible for establishing and maintaining adequate internal control over financial reporting for the association's consolidated financial statements. For purposes of this report, "internal control over financial reporting" is defined as a process designed by, or under the supervision of, the association's principal executives and principal financial officers, or persons performing similar functions, and effected by its boards of directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting information and the preparation of the consolidated financial statements for external purposes in accordance with accounting principles generally accepted in the United States of America and includes those policies and procedures that: (1) pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the association, (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial information in accordance with accounting principles generally accepted in the United States of America, and that receipts and expenditures are being made only in accordance with authorizations of management and directors of the association, and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the association's assets that could have a material effect on its consolidated financial statements.

The association's management has completed an assessment of the effectiveness of internal control over financial reporting as of December 31, 2016. In making the assessment, management used the framework in Internal Control—Integrated Framework, promulgated by the Committee of Sponsoring Organizations of the Treadway Commission, commonly referred to as the "COSO" criteria.

Based on the assessment performed, the association concluded that as of December 31, 2016, the internal control over financial reporting was effective based upon the COSO criteria. Additionally, based on this assessment, the association determined that there were no material weaknesses in the internal control over financial reporting as of December 31, 2016. A review of the assessment performed was reported to the association's audit committee.



Troy Bussmeir, Chief Executive Officer

*March 14, 2017*



M'Lissa Kiel, Chief Financial Officer

*March 14, 2017*

## REPORT OF AUDIT COMMITTEE

The Audit Committee (committee) is composed of five members from the board of directors of Lone Star, ACA. Don Crawford, CPA, serves as the chairman of the committee, and David W. Conrad, CPA, serves as vice chairman. David Harris, Brent Neuhaus and Bert Pruett are also members of the audit committee. In 2016, 12 committee meetings were held. The committee oversees the scope of Lone Star, ACA's system of internal controls and procedures, and the adequacy of management's action with respect to recommendations arising from those auditing activities. The committee's approved responsibilities are described more fully in the Audit Committee Charter, which is available on request or on Lone Star, ACA's website. The committee approved the appointment of PricewaterhouseCoopers LLP, independent auditors, to perform the outside audit for 2016.

Management is responsible for Lone Star, ACA's internal controls and the preparation of the consolidated financial statements in accordance with accounting principles generally accepted in the United States of America. The consolidated financial statements are prepared under the oversight of the committee. PricewaterhouseCoopers LLP, is responsible for performing an independent audit of Lone Star, ACA's consolidated financial statements in accordance with auditing standards generally accepted in the United States of America and for issuing a report thereon. The committee's responsibilities include monitoring and overseeing the processes.

In this context, the committee reviewed and discussed Lone Star, ACA's audited consolidated financial statements for the year ended December 31, 2016 (audited consolidated financial statements) with management and PricewaterhouseCoopers LLP. The committee also reviews with PricewaterhouseCoopers LLP the matters required to be discussed by authoritative guidance "The Auditor's Communication With Those Charged With Governance," and both PricewaterhouseCoopers LLP's and Lone Star, ACA's internal auditors directly provide reports on significant matters to the committee.

The committee discussed with PricewaterhouseCoopers LLP its independence from Lone Star, ACA. The committee also reviewed the nonaudit services provided by PricewaterhouseCoopers LLP and concluded that these services were not incompatible with maintaining the independent accountant's independence. The committee has discussed with management and PricewaterhouseCoopers LLP such other matters and received such assurances from them as the committee deemed appropriate.

Based on the foregoing review and discussions and relying thereon, the committee recommended that the board of directors include the audited consolidated financial statements in Lone Star, ACA's Annual Report to Stockholders for the year ended December 31, 2016.

### Audit Committee Members

Don Crawford, CPA  
David W. Conrad, CPA  
David Harris  
Brent Neuhaus  
Bert Pruett

*March 14, 2017*

**LONE STAR, ACA**

**FIVE-YEAR SUMMARY OF SELECTED CONSOLIDATED FINANCIAL DATA**  
(unaudited)  
(dollars in thousands)

|  | <u>2016</u>         | <u>2015</u>  | <u>2014</u>  | <u>2013</u> | <u>2012</u> |
|--|---------------------|--------------|--------------|-------------|-------------|
| <b><u>Balance Sheet Data</u></b>                                   |                     |              |              |             |             |
| <u>Assets</u>  |                     |              |              |             |             |
| Cash   | \$ 61               | \$ 56        | \$ 72        | \$ 28       | \$ 77       |
| Loans  | <b>1,653,166</b>    | 1,553,142    | 1,400,308    | 841,975     | 831,335     |
| Less: allowance for loan losses                                    | <b>(7,046)</b>      | (6,818)      | (5,683)      | (6,880)     | (10,234)    |
| Net loans  | <b>1,646,120</b>    | 1,546,324    | 1,394,625    | 835,095     | 821,101     |
| Investment in and receivable from<br>the Farm Credit Bank of Texas | <b>27,559</b>       | 24,328       | 23,306       | 14,835      | 15,391      |
| Other property owned, net  | -                   | 79           | 201          | 858         | 1,061       |
| Other assets   | <b>13,310</b>       | 12,329       | 11,382       | 6,684       | 7,064       |
| Total assets   | <b>\$ 1,687,050</b> | \$ 1,583,116 | \$ 1,429,586 | \$ 857,500  | \$ 844,694  |
| <u>Liabilities</u>   |                     |              |              |             |             |
| Obligations with maturities<br>of one year or less                 | <b>\$ 26,652</b>    | \$ 24,031    | \$ 24,158    | \$ 12,686   | \$ 11,460   |
| Obligations with maturities<br>greater than one year               | <b>1,322,671</b>    | 1,231,371    | 1,088,806    | 643,308     | 644,820     |
| Total liabilities  | <b>1,349,323</b>    | 1,255,402    | 1,112,964    | 655,994     | 656,280     |
| <u>Members' Equity</u>   |                     |              |              |             |             |
| Capital stock and participation<br>certificates                    | <b>6,432</b>        | 6,339        | 6,367        | 3,716       | 3,772       |
| Additional paid-in capital   | <b>91,343</b>       | 91,343       | 91,343       | -           | -           |
| Allocated retained earnings  | -                   | 3,000        | 7,115        | -           | -           |
| Unallocated retained earnings                                      | <b>240,785</b>      | 227,852      | 213,133      | 198,155     | 185,513     |
| Accumulated other comprehensive income (loss)                      | <b>(833)</b>        | (820)        | (1,336)      | (365)       | (871)       |
| Total members' equity  | <b>337,727</b>      | 327,714      | 316,622      | 201,506     | 188,414     |
| Total liabilities and members' equity                              | <b>\$ 1,687,050</b> | \$ 1,583,116 | \$ 1,429,586 | \$ 857,500  | \$ 844,694  |
| <b><u>Statement of Income Data</u></b>                             |                     |              |              |             |             |
| Net interest income  | <b>\$ 44,409</b>    | \$ 43,654    | \$ 40,943    | \$ 26,998   | \$ 26,439   |
| (Provision for loan losses) or<br>loan loss reversal               | <b>205</b>          | (722)        | 1,080        | 2,593       | (666)       |
| Income from the Farm Credit Bank of Texas                          | <b>6,152</b>        | 5,724        | 5,657        | 3,860       | 4,059       |
| Other noninterest income   | <b>821</b>          | 840          | 1,045        | 835         | 3,975       |
| Noninterest expense  | <b>(24,754)</b>     | (21,884)     | (21,695)     | (14,223)    | (13,995)    |
| (Benefit from) provision for income taxes                          | -                   | (45)         | 53           | (21)        | (48)        |
| Net income (loss)  | <b>\$ 26,833</b>    | \$ 27,567    | \$ 27,083    | \$ 20,042   | \$ 19,764   |
| <b><u>Key Financial Ratios for the Year</u></b>                    |                     |              |              |             |             |
| Return on average assets   | <b>1.6%</b>         | 1.8%         | 1.9%         | 2.3%        | 2.3%        |
| Return on average members' equity                                  | <b>8.1%</b>         | 8.4%         | 8.5%         | 10.1%       | 10.5%       |
| Net interest income as a percentage of<br>average earning assets   | <b>2.7%</b>         | 3.0%         | 3.0%         | 3.2%        | 3.1%        |
| Net charge-offs (recoveries) as a<br>percentage of average loans   | <b>0.0%</b>         | 0.0%         | 0.0%         | 0.1%        | 0.3%        |

**LONE STAR, ACA**

**FIVE-YEAR SUMMARY OF SELECTED CONSOLIDATED FINANCIAL DATA**  
**(unaudited)**  
**(dollars in thousands)**

|  | <u>2016</u>      | <u>2015</u> | <u>2014</u> | <u>2013</u> | <u>2012</u> |
|--|------------------|-------------|-------------|-------------|-------------|
| <b><u>Key Financial Ratios at Year End</u></b>     |                  |             |             |             |             |
| Members' equity as a percentage of total assets    | <b>20.0%</b>     | 20.7%       | 22.1%       | 23.5%       | 22.3%       |
| Debt as a percentage of members' equity            | <b>399.5%</b>    | 383.1%      | 351.5%      | 325.5%      | 348.3%      |
| Allowance for loan losses as a percentage of loans | <b>0.4%</b>      | 0.4%        | 0.4%        | 0.8%        | 1.2%        |
| Permanent capital ratio                            | <b>18.9%</b>     | 19.7%       | 21.4%       | 21.5%       | 20.7%       |
| Core surplus ratio                                 | <b>18.3%</b>     | 19.3%       | 21.0%       | 21.1%       | 20.2%       |
| Total surplus ratio                                | <b>18.5%</b>     | 19.3%       | 21.0%       | 21.1%       | 20.2%       |
| <b><u>Net Income Distribution</u></b>              |                  |             |             |             |             |
| Cash dividends paid                                | \$ <b>15,923</b> | \$ 16,221   | \$ 16,447   | \$ 7,000    | \$ 2,000    |

## **MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

The following commentary explains management's assessment of the principal aspects of the consolidated financial condition and results of operations of Lone Star, ACA, including its wholly-owned subsidiaries, Lone Star, PCA and Lone Star, FLCA (association) for the years ended December 31, 2016, 2015 and 2014, and should be read in conjunction with the accompanying consolidated financial statements. The accompanying financial statements were prepared under the oversight of the association's audit committee.

### **Forward-Looking Information:**

This annual information statement contains forward-looking statements. These statements are not guarantees of future performance and involve certain risks, uncertainties and assumptions that are difficult to predict. Words such as "anticipates," "believes," "could," "estimates," "may," "should," "will" or other variations of these terms are intended to identify the forward-looking statements. These statements are based on assumptions and analyses made in light of experience and other historical trends, current conditions and expected future developments. However, actual results and developments may differ materially from our expectations and predictions due to a number of risks and uncertainties, many of which are beyond our control. These risks and uncertainties include, but are not limited to:

- political, legal, regulatory and economic conditions and developments in the United States and abroad;
- economic fluctuations in the agricultural, rural utility, international and farm-related business sectors;
- weather-related, disease-related and other adverse climatic or biological conditions that periodically occur that impact agricultural productivity and income;
- changes in United States government support of the agricultural industry; and
- actions taken by the Federal Reserve System in implementing monetary policy.

### **Significant Events:**

In December 2015, the board of Lone Star, ACA declared a 100 basis point (1.0 percent) cash patronage paid in March of 2016, based on 2015 earnings. The patronage was paid to eligible borrowers based on their average outstanding loan balance for the year ending December 31, 2015. The patronage amount paid was \$12,923,433. In October 2016, the board approved the distribution of \$3,000,029 of equities allocated to the stockholders of the former Texas Land Bank, ACA paid in November 2016. This distribution was set forth in the merger disclosure document. Total patronage paid in 2016 was \$15,923,462. The association's capital position remains strong and is 18.9 percent for the period ending December 2016.

Effective January 1, 2014, the association merged with Texas Land Bank, ACA through a business acquisition in accordance with authoritative accounting guidance. Texas Land Bank, ACA was previously headquartered in Waco, Texas, and served a territory covering 16 counties in Central Texas. The types of loans and commodities financed by Texas Land Bank, ACA were very similar to those of the association. The association's board of directors and management feel this acquisition provided the association with a stronger capital position through higher earnings, an increased market share of agricultural financing and extended an overall improved quality of Farm Credit lending to its stockholders and territory served.

In December 2016, the association received a direct loan patronage of \$5,320,436 from the bank, representing 41 basis points on the average daily balance of the association's direct loan with the bank. During 2016, the association received \$453,974 in patronage payments from the bank, based on the association's stock investment in the bank. Also, the association received a participation's patronage of \$62,033 from the bank, representing 75 basis points on the association's average balance of participations sold into the bank's patronage pool program.

Since 1917, the association and its predecessors have provided its members with quality financial services. The board of directors and management remain committed to maintaining the financial integrity of the association while offering competitive loan products that meet the financial needs of agricultural producers.

## Loan Portfolio:

The association makes and services loans to farmers, ranchers, rural homeowners and certain farm-related businesses. The association's loan volume consists of long-term farm mortgage loans, production and intermediate-term loans, and farm-related business loans. These loan products are available to eligible borrowers with competitive variable, fixed, adjustable, LIBOR-based and prime-based interest rates. Commercial loans primarily consist of operating loans and short-term loans for working capital, equipment and livestock. Mortgage loans primarily consist of 20- to 40- year maturities. Loans serviced by the association offer several installment payment cycles, the timing of which usually coincides with the seasonal cash-flow capabilities of the borrower.

The composition of the association's loan portfolio, including principal less funds held of \$1,653,166,308, \$1,553,141,676 and \$1,400,308,027 as of December 31, 2016, 2015 and 2014, respectively, is described more fully in detailed tables in Note 4 to the consolidated financial statements, "Loans and Allowance for Loan Losses" included in this annual report.

The \$100,024,632 increase of loan portfolio between December 31, 2015 and December 31, 2016, was the result of increased demand for real estate transactions and overall growth of accrual loan volume. The association anticipates continued, but moderated, growth in loan volume during 2017.

## Purchase and Sales of Loans:

During 2016, 2015 and 2014, the association purchased participation loans from other lenders. As of December 31, 2016, 2015 and 2014, participations purchased from other farm credit institutions totaled \$254,569,519, \$257,137,764 and \$198,352,764, or 15.4 percent, 16.6 percent and 14.2 percent of loans, respectively. The association had participations with entities outside the district totaling \$975,473, \$185,841 and \$0 for the years ended 2016, 2015 and 2014, respectively. The association has also sold participations of \$26,126,415, \$30,089,358 and \$18,544,108 as of December 31, 2016, 2015 and 2014, respectively.

Effective January 26, 2012 the Farm Credit Bank of Texas (the bank) purchased Lone Star, ACA's securitized Farmer Mac Agricultural Mortgage Backed Securities (AMBS) Investments. The purchase of \$35,459,508 included outstanding principal and accrued interest as of that date. There was no gain or loss recognized by the association on this transaction. The association will continue to service the underlying loans that were included in this security. Also, there is intended to be no effect to Lone Star, ACA's income based on this transaction as it is expected that the bank will be able to pay the association a patronage equivalent to the net interest that would have been earned on the AMBS investment. However, the bank's payment of patronage is at the discretion of the bank's board of directors. The remaining balance of the AMBS investment at December 31, 2016 was \$12,038,478.

## Risk Exposure:

High-risk assets include nonaccrual loans, loans that are past due 90 days or more and still accruing interest, formally restructured loans and other property owned, net.

The following table illustrates the association's components and trends of high-risk assets serviced for the prior three years as of December 31:

|                           | 2016         |        | 2015         |        | 2014          |        |
|---------------------------|--------------|--------|--------------|--------|---------------|--------|
|                           | Amount       | %      | Amount       | %      | Amount        | %      |
| Nonaccrual                | \$ 6,169,054 | 66.5%  | \$ 6,386,670 | 98.2%  | \$ 10,223,217 | 96.1%  |
| Formally restructured     | 3,106,032    | 33.5%  | 39,842       | 0.6%   | 208,621       | 2.0%   |
| Other property owned, net | -            | 0.0%   | 78,518       | 1.2%   | 201,363       | 1.9%   |
| Total                     | \$ 9,275,086 | 100.0% | \$ 6,505,030 | 100.0% | \$ 10,633,201 | 100.0% |

At December 31, 2016, 2015 and 2014, loans that were considered impaired were \$9,275,086, \$6,426,512 and \$10,431,838, representing 0.6 percent, 0.4 percent and 0.7 percent of loan volume, respectively. Impaired loans consist of all high-risk assets except other property owned, net.

During 2016, the association experienced a \$217,616 decrease in nonaccrual loan volume for a total outstanding volume of \$6,169,054 as of December 31, 2016. Of the \$6,169,054, beef cattle comprised \$3,074,710, rural home loans comprised \$887,983, cash grains comprised \$786,243, general farms, primarily crop, comprised \$671,386 and horses and other equines comprised \$611,641, with the remaining balance of nonaccrual volume being comprised by other various commodities.

During 2016, the association experienced a \$3,066,190 increase in formally restructured loans for a total outstanding volume of \$3,106,032. The increase was primarily attributed to the transition of a dairy farm relationship from nonaccrual to accruing interest receivable status. The transition was the result of a trend of improved profitability where the borrower could maintain adequate operation cash flow to support their ongoing debt service demands. Additionally, the borrower was able to reduce association debt levels to support the position that the association was adequately protected from loss in the event of a future default.

At December 31, 2016 the association held no property classified as other property owned.

Except for the relationship between installment due date and seasonal cash-flow capabilities of the borrower, the association is not materially affected by seasonal characteristics. The factors affecting the operations of the association are the same factors that would affect any agricultural lender.

#### **Allowance for Loan Losses:**

The following table provides relevant information regarding the allowance for loan losses as of, or for the year ended, December 31:

|   | <u>2016</u>  | <u>2015</u>  | <u>2014</u>  |
|---|--------------|--------------|--------------|
| Allowance for loan losses                     | \$ 7,046,323 | \$ 6,817,421 | \$ 5,683,210 |
| Allowance for loan losses to total loans      | 0.4%         | 0.4%         | 0.4%         |
| Allowance for loan losses to nonaccrual loans | 114.2%       | 106.7%       | 55.6%        |
| Allowance for loan losses to impaired loans   | 76.0%        | 106.1%       | 54.5%        |
| Net charge-offs to average loans              | 0.0%         | 0.0%         | 0.0%         |

The allowance is based on a periodic evaluation of the loan portfolio by management in which numerous factors are considered, including economic conditions, loan portfolio composition, collateral value, portfolio quality, current production conditions and economic conditions, and prior loan loss experience. Management considers the following factors in determining and supporting the level of allowance for loan losses: the concentration of lending in agriculture, combined with uncertainties associated with farmland values, commodity prices, exports, government assistance programs, regional economic effects and weather-related influences.

Based upon ongoing risk assessment and the allowance for loan losses procedures outlined above, the allowance for loan losses of \$7,046,323, \$6,817,421 and \$5,683,210 at December 31, 2016, 2015 and 2014, respectively, is considered adequate by management to compensate for inherent losses in the loan portfolio at such dates. Management's process for the evaluation of allowance for loan losses includes a portfolio analysis, peer comparison with similar Farm Credit Institutions and similar commercial banks, and an analysis of historical loss experience. Management utilizes an allowance pool to address the need for additional allowance for under-secured loans, should they deteriorate, and ultimately require a specific allowance. In addition, during 2014 management implemented an additional allowance pool to address the need for allowance for loan commitments that have been established, but are not yet drawn. This allowance pool on unfunded commitments is reflected in other liabilities and is not reflected in the allowance for loan losses balance. In view of portfolio analysis, historical trends, projected needs and the implementation of the additional allowance pool, management believes that the allowance is adequate.

#### **Results of Operations:**

The association's net income for the year ended December 31, 2016, was \$26,832,625 as compared to \$27,567,268 for the year ended December 31, 2015, reflecting a decrease of \$734,643, or 2.7 percent. The association's net income for the year ended December 31, 2014 was \$27,082,890. Net income increased \$484,378, or 1.8 percent, in 2015 versus 2014.

Net interest income for 2016, 2015 and 2014 was \$44,409,252, \$43,654,034 and \$40,942,907, respectively, reflecting increases of \$755,218, or 1.7 percent, for 2016 versus 2015 and \$2,711,127, or 6.6 percent, for 2015 versus 2014. Net interest income is the principal source of earnings for the association and is impacted by volume, yields on assets and cost of debt. The effects of changes in average volume and interest rates on net interest income over the past three years are presented in the following tables:

|                               | 2016             |               | 2015             |               | 2014             |               |
|-------------------------------|------------------|---------------|------------------|---------------|------------------|---------------|
|                               | Average Balance  | Interest      | Average Balance  | Interest      | Average Balance  | Interest      |
| Loans                         | \$ 1,615,659,972 | \$ 70,968,034 | \$ 1,473,132,045 | \$ 66,705,294 | \$ 1,362,346,543 | \$ 61,539,802 |
| Total interest-earning assets | 1,615,659,972    | 70,968,034    | 1,473,132,045    | 66,705,294    | 1,362,346,543    | 61,539,802    |
| Interest-bearing liabilities  | 1,294,961,169    | 26,558,782    | 1,160,560,406    | 23,051,260    | 1,060,984,184    | 20,596,895    |
| Impact of capital             | \$ 320,698,803   |               | \$ 312,571,639   |               | \$ 301,362,359   |               |
| Net interest income           | \$ 44,409,252    |               | \$ 43,654,034    |               | \$ 40,942,907    |               |

|   | 2016          | 2015          | 2014          |
|---|---------------|---------------|---------------|
|   | Average Yield | Average Yield | Average Yield |
| Yield on loans  | 4.39%         | 4.53%         | 4.52%         |
| Total yield on interest-earning assets                        | 4.39%         | 4.53%         | 4.52%         |
| Cost of interest-bearing liabilities                          | 2.05%         | 1.99%         | 1.94%         |
| Interest rate spread  | 2.34%         | 2.54%         | 2.58%         |
| Net interest income as a percentage of average earning assets | 2.75%         | 2.96%         | 3.01%         |

|                         | 2016 vs. 2015              |                |              | 2015 vs. 2014              |              |              |
|-------------------------|----------------------------|----------------|--------------|----------------------------|--------------|--------------|
|                         | Increase (decrease) due to |                |              | Increase (decrease) due to |              |              |
|                         | Volume                     | Rate           | Total        | Volume                     | Rate         | Total        |
| Interest income - loans | \$ 6,453,807               | \$ (2,191,067) | \$ 4,262,740 | \$ 5,004,403               | \$ 161,089   | \$ 5,165,492 |
| Total interest income   | 6,453,807                  | (2,191,067)    | 4,262,740    | 5,004,403                  | 161,089      | 5,165,492    |
| Interest expense        | 2,669,468                  | 838,054        | 3,507,522    | 1,933,073                  | 521,292      | 2,454,365    |
| Net interest income     | \$ 3,784,339               | \$ (3,029,121) | \$ 755,218   | \$ 3,071,330               | \$ (360,203) | \$ 2,711,127 |

Interest income for 2016 increased by \$4,262,740, or 6.4 percent, compared to 2015, primarily due to an increase in average loan volume. Interest expense for 2016 increased by \$3,507,522, or 15.2 percent, compared to 2015 due to an increase in average interest-bearing liabilities and the cost of those liabilities. The interest rate spread decreased by 20 basis points to 2.34 percent in 2016 from 2.54 percent in 2015, primarily because 2015 recognized an additional \$1,394,953 of interest on nonaccruals over 2016 leading to a higher yield, 4.53 percent, compared to 2016, 4.39 percent. The decrease in interest rate spread was also attributable to yield on loans decreasing on average during the year and the association's rate of borrowing from its lender was not as favorable in 2016, 2.05 percent, compared to 2015, 1.99 percent.

The interest rate spread decreased by 4 basis points to 2.54 percent in 2015 from 2.58 percent in 2014, primarily due to the association's rate of borrowing from its lender increasing from 2014, from 1.94 percent to 1.99 percent.

The association offers a number of different interest rate programs including fixed rate products lasting for a set period up to the term of a loan, products indexed to Prime or LIBOR, and a variety of adjustable interest rate products. The association's control over interest rate margins resides in its ability to add a spread over cost of funds, the goal of which is to achieve an acceptable level of income to fund operations and generate a return for shareholders. Net interest margin for year end 2016 was 2.75, versus 2.96 for the same period in 2015. This can be attributed to the aforementioned decrease in net interest spread.

Noninterest income for 2016 increased by \$407,746, or 6.2 percent, compared to 2015, due primarily to an increase in patronage income from the Farm Credit Bank of Texas. The increase in patronage income was a result of a significantly higher average note payable to the Farm Credit Bank of Texas in 2016 as compared to 2015. Noninterest income for 2015 decreased by \$136,762, or 2.0 percent, compared to 2014, due primarily to a decrease in gains on other property owned offset by an increase in loan fees.

Authoritative accounting guidance requiring the capitalization and amortization of loan origination fees and costs was implemented during 2010 for loans closed in 2010 and forward, resulting in the capitalization of \$2,340,269, \$1,941,558 and \$1,379,209 for 2016, 2015 and 2014 respectively, in origination fees, which will be amortized over the life of the loans as an adjustment to yield in net interest income.

Provisions for loan losses decreased by \$926,975, or 128.4 percent, compared to 2015, due to continuing improvements in association credit quality and recoveries on impaired loans during 2016.

Operating expenses consist primarily of salaries, employee benefits, purchased services, occupancy and equipment expenses, advertising and public and member relations expenses and insurance fund premiums. Expenses for purchased services include administrative services, marketing, accounting and loan processing, audit and credit review fees, and legal fees, among others. Net operating expense for 2016, 2015 and 2014 was \$24,754,012, \$21,844,071 and \$21,694,932, respectively, reflecting an increase of \$2,869,941 or 13.1 percent for 2016 and an increase of \$189,139 or 0.9 percent for 2015. The increase in operating expenses for 2016 was driven primarily by an increase in salaries and employee benefits of \$1,305,673; purchased services of \$367,190 resulting from increased legal expenses; occupancy and equipment of \$189,104 with the increase in association staff; and an increase in marketing expenses of \$112,280 for increased marketing efforts and events during the year. The increase in operating expenses also included an increase in premiums to Insurance Funds of \$656,737. The increase in premiums to the Insurance Fund was the result of an increase in the premium rates from 13 basis points in 2015 to 18 basis points in 2016. Authoritative accounting guidance requiring the capitalization and amortization of loan origination fees and costs resulted in the capitalization of \$2,105,609, \$2,105,609 and \$1,584,720 for 2016, 2015 and 2014, respectively, in origination costs and \$2,340,269, \$1,941,558 and \$1,379,209 for 2016, 2015 and 2014, respectively, in origination fees, which will be amortized over the life of the loans as an adjustment to yield in net interest income.

For the year ended December 31, 2016, the association's return on average assets was 1.6 percent, as compared to 1.8 percent and 1.9 percent for the years ended December 31, 2015 and 2014, respectively. For the year ended December 31, 2016, the association's return on average members' equity was 7.9 percent, as compared to 8.4 percent and 8.5 percent for the years ended December 31, 2015 and 2014, respectively.

#### **Liquidity and Funding Sources:**

The interest rate risk inherent in the association's loan portfolio is substantially mitigated through the funding relationship with the bank. The bank manages interest rate risk through its direct loan pricing and asset/liability management process.

Because the association depends on the bank for funding, any significant positive or negative factors affecting the operations of the bank may have an effect on the operations of the association.

The primary source of liquidity and funding for the association is a direct loan from the bank. The outstanding balance of \$1,320,377,658, \$1,229,343,523 and \$1,087,039,175 as of December 31, 2016, 2015 and 2014, respectively, is recorded as a liability on the association's balance sheet. The note carried a weighted average interest rate of 2.03 percent, 1.90 percent and 1.85 percent at December 31, 2016, 2015 and 2014, respectively. The indebtedness is collateralized by a pledge of substantially all of the association's assets to the bank and is governed by a general financing agreement. The increase in note payable to the bank and related accrued interest payable since December 31, 2015, correlates directly with the growth in association loan volume. The association's own funds, which represent the amount of the association's loan portfolio funded by the association's equity, were \$333,586,191, \$323,916,262 and \$313,542,721 at December 31, 2016, 2015 and 2014, respectively. The maximum amount the association may borrow from the bank as of December 31, 2016, was \$1,651,935,435 as defined by the general financing agreement. The indebtedness continues in effect until the expiration date of the general financing agreement, which is September 30, 2018, unless sooner terminated by the bank upon the occurrence of an event of default, or by the association, in the event of a breach of this agreement by the bank, upon giving the bank 30 calendar days' prior written notice, or in all other circumstances, upon giving the bank 120 days' prior written notice.

The liquidity policy of the association is to manage cash balances, to maximize debt reduction and to increase accrual loan volume. This policy will continue to be pursued during 2017. As borrower payments are received, they are applied to the association's note payable to the bank.

The association will continue to fund its operations through direct borrowings from the bank, capital surplus from prior years and borrower stock. It is management's opinion that funds available to the association are sufficient to fund its operations for the coming year.

#### **Capital Resources:**

The association's capital position remains strong, with total members' equity of \$337,726,841, \$327,714,176 and \$316,622,486 at December 31, 2016, 2015 and 2014, respectively. Under regulations governing minimum permanent capital adequacy and other capitalization issues, the association is required to maintain a minimum adjusted permanent capital of 7.0 percent of risk-adjusted

assets as defined by the FCA. The permanent capital ratio measures available at-risk capital relative to risk-adjusted assets and off-balance-sheet contingencies. The ratio is an indicator of the institution's financial capacity to absorb potential losses beyond that provided in the allowance for loss accounts. The association's permanent capital ratio at December 31, 2016, 2015 and 2014 was 18.9 percent, 19.7 percent and 21.4 percent, respectively.

The core surplus ratio measures available core surplus capital relative to risk-adjusted assets and off-balance-sheet contingencies. The ratio is an indicator of the quality of capital that exists to maintain stable earnings and financial strength. The association's core surplus ratio at December 31, 2016, 2015 and 2014 was 18.3 percent, 19.3 percent and 21.0 percent, respectively, which is in compliance with the FCA's minimum ratio requirement of 3.5 percent. The total surplus ratio measures available surplus capital relative to risk-adjusted assets and off-balance-sheet contingencies. The ratio is an indicator of the reserves existing to protect borrowers' investments in the association. The association's total surplus ratio at December 31, 2016, 2015 and 2014 was 18.5 percent, 19.3 percent and 21.0 percent, respectively, which is in compliance with the FCA's minimum ratio requirement of 7.0 percent.

The association's members' equity includes accumulated other comprehensive loss (AOCL) related to certain health care benefits to qualifying retired employees (other postretirement benefits). These benefits are not characterized as multi-employer and, consequently, the liability for these benefits is included in other liabilities. The AOCL includes net actuarial losses and prior service costs/credits that have been included in liabilities, but have not yet been amortized into earnings.

In 2016, the association paid patronage of \$15,923,462, comprised of distributions of \$12,923,433, which represents the 100 basis point cash patronage declared in December 2015 by the board of Lone Star, ACA and \$3,000,029, which represents the distribution of equities allocated to the stockholders of the former Texas Land Bank, ACA. In 2015 and 2014, the association paid patronage of \$16,220,729 and \$16,447,152, respectively. In December 2016, the board of directors approved a 100-basis-point cash patronage. The patronage will be paid to eligible borrowers based on their average outstanding loan balance for the year ending December 31, 2016. The patronage amount is estimated to be \$13,824,603 and will be paid in March 2017.

#### **Significant Recent Accounting Pronouncements:**

In June 2016, the Financial Accounting Standards Board (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 association is currently evaluating 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 association is currently evaluating the impact of adoption on its financial condition and results of operations. The adoption of this guidance is not expected to impact the Association's financial condition or its 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. For public entities, the guidance eliminates the requirement to disclose the methods and significant assumptions used to estimate the fair value of financial instruments carried at amortized cost. 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 association'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. The association adopted this guidance in the fourth quarter of 2016 and management made 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 association is in the process of reviewing contracts to determine the effect, if any, on their financial condition or results of operations. The adoption of this guidance is not expected to impact the Association’s financial condition or its results of operations.

### **Regulatory Matters:**

On March 10, 2016, the Farm Credit Administration approved a final rule to modify the regulatory capital requirements for System banks and associations. The stated objectives of the proposed rule are as follows:

- To modernize capital requirements while ensuring that the institutions continue to hold sufficient regulatory capital to fulfill their 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 is effective on January 1, 2017. Based on preliminary calculations, the association expects to be in compliance with the regulatory minimum capital ratios under the final rule.

### **Relationship With the Bank:**

The association’s statutory obligation to borrow only from the bank is discussed in Note 9 to the consolidated financial statements, “Note Payable to the Bank,” included in this annual report.

The bank’s ability to access capital of the association is discussed in Note 2 to the consolidated financial statements, “Summary of Significant Accounting Policies,” included in this annual report, within the section “Capital Stock Investment in the Bank.”

The bank’s role in mitigating the association’s exposure to interest rate risk is described in the section “Liquidity and Funding Sources” of Management’s Discussion and Analysis and in Note 9 to the consolidated financial statements, “Note Payable to the Bank,” included in this annual report.

The bank provides computer systems to support the critical operations of all district associations. In addition, each association has operating systems and facility-based systems that are not supported by the bank. As disclosed in Note 13 to the consolidated financial statements, “Related Party Transactions,” included in this annual report, the bank provides many services that the association can utilize, such as administrative, marketing, information systems and accounting services. Additionally, the bank bills district expenses to the associations, such as the Farm Credit System Insurance Corporation insurance premiums.

### **Summary:**

Over the past 100 years, regardless of the state of the agricultural economy, your association’s board of directors and management, as well as the board of directors and management of the bank, have been committed to offering their borrowers a ready source of financing at a competitive price. Your continued support will be critical to the success of this association.



## Report of Independent Auditors

To the Board of Directors of Lone Star, ACA

We have audited the accompanying consolidated financial statements of Lone Star, ACA and its subsidiaries (the Association), which comprise the consolidated balance sheets as of December 31, 2016, 2015 and 2014, and the related consolidated statements of comprehensive income, changes in members' equity and cash flows for the years then ended.

### ***Management's Responsibility for the Consolidated Financial Statements***

Management is responsible for the preparation and fair presentation of the consolidated financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

### ***Auditors' Responsibility***

Our responsibility is to express an opinion on the consolidated financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on our judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, we consider internal control relevant to the Association's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Association's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

### ***Opinion***

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Lone Star, ACA and its subsidiaries as of December 31, 2016, 2015 and 2014, and the results of their operations and their cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

*PricewaterhouseCoopers LLP*

March 14, 2017

**LONE STAR, ACA**

**BALANCE SHEET**

|   | December 31,                   |                                |                                |
|---|--------------------------------|--------------------------------|--------------------------------|
|   | 2016                           | 2015                           | 2014                           |
| <b><u>Assets</u></b>                          |                                |                                |                                |
| Cash  | \$ 60,478                      | \$ 55,698                      | \$ 72,550                      |
| Loans   | 1,653,166,308                  | 1,553,141,676                  | 1,400,308,027                  |
| Less: allowance for loan losses               | (7,046,323)                    | (6,817,421)                    | (5,683,210)                    |
| Net loans                                     | <u>1,646,119,985</u>           | <u>1,546,324,255</u>           | <u>1,394,624,817</u>           |
| Accrued interest receivable                   | 9,260,706                      | 8,422,280                      | 7,228,983                      |
| Investment in and receivable from the Farm    |                                |                                |                                |
| Credit Bank of Texas:                         |                                |                                |                                |
| Capital stock                                 | 26,002,180                     | 23,280,780                     | 21,608,055                     |
| Other   | 1,556,926                      | 1,047,251                      | 1,697,818                      |
| Other property owned, net                     | -                              | 78,518                         | 201,363                        |
| Premises and equipment                        | 3,160,358                      | 3,082,233                      | 3,287,896                      |
| Other assets                                  | 889,148                        | 824,830                        | 864,995                        |
| Total assets                                  | <u><u>\$ 1,687,049,781</u></u> | <u><u>\$ 1,583,115,845</u></u> | <u><u>\$ 1,429,586,477</u></u> |
| <b><u>Liabilities</u></b>                     |                                |                                |                                |
| Note payable to the Farm Credit Bank of Texas | \$ 1,320,377,658               | \$ 1,229,343,523               | \$ 1,087,039,175               |
| Accrued interest payable                      | 2,293,082                      | 2,027,520                      | 1,766,688                      |
| Drafts outstanding                            | 229,275                        | 219,479                        | 345,770                        |
| Dividends payable                             | 13,824,603                     | 12,847,681                     | 12,105,352                     |
| Other liabilities                             | 12,598,322                     | 10,963,466                     | 11,707,006                     |
| Total liabilities                             | <u><u>1,349,322,940</u></u>    | <u><u>1,255,401,669</u></u>    | <u><u>1,112,963,991</u></u>    |
| <b><u>Members' Equity</u></b>                 |                                |                                |                                |
| Capital stock and participation certificates  | 6,431,805                      | 6,339,120                      | 6,366,550                      |
| Additional paid-in capital                    | 91,343,553                     | 91,343,553                     | 91,343,553                     |
| Allocated retained earnings                   | -                              | 3,000,029                      | 7,115,406                      |
| Unallocated retained earnings                 | 240,784,491                    | 227,852,221                    | 213,132,634                    |
| Accumulated other comprehensive income (loss) | (833,008)                      | (820,747)                      | (1,335,657)                    |
| Total members' equity                         | <u><u>337,726,841</u></u>      | <u><u>327,714,176</u></u>      | <u><u>316,622,486</u></u>      |
| Total liabilities and members' equity         | <u><u>\$ 1,687,049,781</u></u> | <u><u>\$ 1,583,115,845</u></u> | <u><u>\$ 1,429,586,477</u></u> |

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

*Lone Star, ACA—2016 Annual Report*

LONESTAR, ACA

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

|   | Year Ended December 31, |                      |                      |
|---|-------------------------|----------------------|----------------------|
|   | 2016                    | 2015                 | 2014                 |
| <b><u>Interest Income</u></b>                         |                         |                      |                      |
| Loans   | \$ 70,968,034           | \$ 66,705,294        | \$ 61,539,802        |
| Total interest income                                 | 70,968,034              | 66,705,294           | 61,539,802           |
| <b><u>Interest Expense</u></b>                        |                         |                      |                      |
| Note payable to the Farm Credit Bank of Texas         | 26,558,764              | 23,051,254           | 20,596,883           |
| Advance conditional payments                          | 18                      | 6                    | 12                   |
| Total interest expense                                | 26,558,782              | 23,051,260           | 20,596,895           |
| Net interest income                                   | 44,409,252              | 43,654,034           | 40,942,907           |
| <b><u>(Reversal of) Provision for Loan Losses</u></b> |                         |                      |                      |
| Net interest income after provision for losses        | (204,767)               | 722,208              | (1,079,699)          |
|   | 44,614,019              | 42,931,826           | 42,022,606           |
| <b><u>Noninterest Income</u></b>                      |                         |                      |                      |
| Income from the Farm Credit Bank of Texas:            |                         |                      |                      |
| Patronage income                                      | 6,151,906               | 5,724,417            | 5,656,782            |
| Loan fees   | 481,259                 | 481,922              | 112,784              |
| Financially related services income                   | 11,689                  | 11,743               | 36,279               |
| Gain on other property owned, net                     | 76,180                  | 126,946              | 700,208              |
| (Loss) gain on sale of premises and equipment, net    | (4,298)                 | (1,870)              | (12,160)             |
| Other noninterest income                              | 255,858                 | 221,690              | 207,717              |
| Total noninterest income                              | 6,972,594               | 6,564,848            | 6,701,610            |
| <b><u>Noninterest Expenses</u></b>                    |                         |                      |                      |
| Salaries and employee benefits                        | 14,785,302              | 13,479,629           | 13,535,110           |
| Directors' expense                                    | 471,429                 | 476,498              | 590,456              |
| Purchased services                                    | 1,354,265               | 987,075              | 914,407              |
| Travel  | 865,946                 | 817,061              | 898,855              |
| Occupancy and equipment                               | 1,456,512               | 1,267,408            | 1,241,230            |
| Communications  | 347,228                 | 362,926              | 316,536              |
| Advertising   | 936,177                 | 842,580              | 844,445              |
| Public and member relations                           | 1,143,980               | 1,031,700            | 894,847              |
| Supervisory and exam expense                          | 484,476                 | 399,621              | 427,679              |
| Insurance Fund premiums                               | 2,268,342               | 1,611,605            | 1,374,385            |
| Provisions for acquired property losses               | -                       | 13,818               | 36,381               |
| Other noninterest expense                             | 640,355                 | 594,150              | 620,601              |
| Total noninterest expenses                            | 24,754,012              | 21,884,071           | 21,694,932           |
| Income before income taxes                            | 26,832,601              | 27,612,603           | 27,029,284           |
| (Benefit from) provision for income taxes             | (24)                    | 45,335               | (53,606)             |
| <b>NET INCOME</b>                                     | <b>26,832,625</b>       | <b>27,567,268</b>    | <b>27,082,890</b>    |
| Other comprehensive income:                           |                         |                      |                      |
| Change in postretirement benefit plans                | (12,261)                | 514,910              | (970,993)            |
| Other comprehensive income, net of tax                | (12,261)                | 514,910              | (970,993)            |
| <b>COMPREHENSIVE INCOME</b>                           | <b>\$ 26,820,364</b>    | <b>\$ 28,082,178</b> | <b>\$ 26,111,897</b> |

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

Lone Star, ACA—2016 Annual Report

LONE STAR, ACA

CONSOLIDATED STATEMENT OF CHANGES IN MEMBERS' EQUITY

|  | Capital Stock/<br>Participation<br>Certificates | Additional<br>Paid-in-Capital | Retained Earnings |                       | Accumulated<br>Other<br>Comprehensive<br>Income (Loss) | Total<br>Members'<br>Equity |
|--|---|-------------------------------|-------------------|-----------------------|--|-----------------------------|
|  |   |                               | Allocated         | Unallocated           |  |                             |
| Balance at December 31, 2013   | \$ 3,716,310                                    | \$ -                          | \$ -              | \$ 198,155,096        | \$ (364,664)   | \$ 201,506,742              |
| Net income   | -   | -                             | -                 | 27,082,890            | (970,993)  | 26,111,897                  |
| Capital stock/participation certificates issued                                  | 3,496,405                                       | -                             | -                 | -                     | -  | 3,496,405                   |
| Capital stock/participation certificates and allocated retained earnings retired | (846,165)                                       | -                             | -                 | -                     | -  | (846,165)                   |
| Dividends declared   | -   | -                             | -                 | (12,105,352)          | -  | (12,105,352)                |
| Equity issued or re-characterized upon merger                                    | -   | 91,343,553                    | -                 | -                     | -  | 91,343,553                  |
| Patronage dividends:   |   |                               |                   |                       |  |                             |
| Capital stock/participation certificates and allocated retained earnings         | -   | -                             | 7,115,406         | -                     | -  | 7,115,406                   |
| <b>Balance at December 31, 2014</b>  | <b>6,366,550</b>                                | <b>91,343,553</b>             | <b>7,115,406</b>  | <b>213,132,634</b>    | <b>(1,335,657)</b>                                     | <b>316,622,486</b>          |
| Comprehensive income   | -   | -                             | -                 | 27,567,268            | 514,910  | 28,082,178                  |
| Capital stock/participation certificates issued                                  | 820,925   | -                             | -                 | -                     | -  | 820,925                     |
| Capital stock/participation certificates and allocated retained earnings retired | (848,355)                                       | -                             | -                 | -                     | -  | (848,355)                   |
| Dividends declared   | -   | -                             | -                 | (12,847,681)          | -  | (12,847,681)                |
| Patronage dividends:   |   |                               |                   |                       |  |                             |
| Capital stock/participation certificates and allocated retained earnings         | -   | -                             | (4,115,377)       | -                     | -  | (4,115,377)                 |
| <b>Balance at December 31, 2015</b>  | <b>6,339,120</b>                                | <b>91,343,553</b>             | <b>3,000,029</b>  | <b>227,852,221</b>    | <b>(820,747)</b>                                       | <b>327,714,176</b>          |
| Comprehensive income   | -   | -                             | -                 | 26,832,625            | (12,261)   | 26,820,364                  |
| Capital stock/participation certificates issued                                  | 891,385   | -                             | -                 | -                     | -  | 891,385                     |
| Capital stock/participation certificates and allocated retained earnings retired | (798,700)                                       | -                             | -                 | -                     | -  | (798,700)                   |
| Dividends declared   | -   | -                             | -                 | (13,900,355)          | -  | (13,900,355)                |
| Patronage dividends:   |   |                               |                   |                       |  |                             |
| Capital stock/participation certificates and allocated retained earnings         | -   | -                             | (3,000,029)       | -                     | -  | (3,000,029)                 |
| <b>Balance at December 31, 2016</b>  | <b>\$ 6,431,805</b>                             | <b>\$ 91,343,553</b>          | <b>\$ -</b>       | <b>\$ 240,784,491</b> | <b>\$ (833,008)</b>                                    | <b>\$ 337,726,841</b>       |

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

Lone Star, ACA—2016 Annual Report

**LONE STAR, ACA**

**CONSOLIDATED STATEMENT OF CASH FLOWS**

|   | Year Ended December 31, |                      |                     |
|---|-------------------------|----------------------|---------------------|
|   | 2016                    | 2015                 | 2014                |
| <b>Cash flows from operating activities:</b>                                      |                         |                      |                     |
| Net income  | \$ 26,832,625           | \$ 27,567,268        | \$ 27,082,890       |
| Adjustments to reconcile net income to net cash provided by operating activities: |                         |                      |                     |
| Provision for loan losses or (loan loss reversal)                                 | (204,767)               | 722,208              | (1,079,699)         |
| Gain on sale of other property owned, net   | (76,180)                | (113,128)            | (663,827)           |
| Depreciation  | 982,164                 | 791,481              | 742,531             |
| Accretion of yield related to loans and notes payable acquired in merger          | (246,981)               | (246,981)            | (246,981)           |
| Loss (gain) on sale of premises and equipment, net                                | 4,298                   | 1,870                | (12,160)            |
| (Increase) decrease in accrued interest receivable                                | (838,426)               | (1,193,297)          | 25,597              |
| (Increase) decrease in other receivables from the Farm Credit Bank of             | (509,675)               | 650,567              | (200,129)           |
| (Increase) decrease in other assets   | (64,318)                | 40,165               | 222,723             |
| Increase in accrued interest payable  | 265,562                 | 260,832              | 95,182              |
| Increase (decrease) in other liabilities  | 1,575,431               | (123,089)            | 2,775,314           |
| Net cash provided by operating activities   | <u>27,719,733</u>       | <u>28,357,896</u>    | <u>28,741,441</u>   |
| <b>Cash flows from investing activities:</b>                                      |                         |                      |                     |
| Increase in loans, net  | (99,406,490)            | (152,612,162)        | (56,594,991)        |
| Cash recoveries of loans previously charged off                                   | 515,367                 | 516,293              | 318,791             |
| Proceeds from purchase of investment in the Farm Credit Bank of Texas             | (2,721,400)             | (1,672,725)          | (206,065)           |
| Unfunded disbursements acquired in merger   | -                       | -                    | 1,058,752           |
| Purchases of premises and equipment   | (927,229)               | (451,210)            | (1,019,700)         |
| Proceeds from sales of premises and equipment                                     | 88,690                  | 48,680               | 49,910              |
| Proceeds from sales of other property owned                                       | 116,911                 | 460,434              | 1,979,567           |
| Net cash used in investing activities   | <u>(102,334,151)</u>    | <u>(153,710,690)</u> | <u>(54,413,736)</u> |

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

*Lone Star, ACA—2016 Annual Report*

LONE STAR, ACA

CONSOLIDATED STATEMENT OF CASH FLOWS

|  | Year Ended December 31, |              |              |
|--|-------------------------|--------------|--------------|
|  | 2016                    | 2015         | 2014         |
| <b>Cash flows from financing activities:</b>               |                         |              |              |
| Net draws on note payable to the Farm Credit Bank of Texas | 90,440,179              | 141,710,392  | 43,113,596   |
| Increase (decrease) in drafts outstanding                  | 9,796                   | (126,291)    | (775,731)    |
| Issuance of capital stock and participation certificates   | 891,385                 | 820,925      | 672,500      |
| Retirement of capital stock and participation certificates | (798,700)               | (848,355)    | (846,165)    |
| Cash dividends paid  | (15,923,462)            | (16,220,729) | (16,447,152) |
| Net cash provided by financing activities                  | 74,619,198              | 125,335,942  | 25,717,048   |
| Net increase (decrease) in cash                            | 4,780                   | (16,852)     | 44,753       |
| Cash at the beginning of the year                          | 55,698                  | 72,550       | 27,797       |
| Cash at the end of the year                                | \$ 60,478               | \$ 55,698    | \$ 72,550    |

**Supplemental schedule of noncash investing and financing activities:**

|  |            |            |               |
|--|------------|------------|---------------|
| Loans transferred to other property owned  | 39,885     | 269,886    | 674,269       |
| Receivable from sales of other property owned                                      |            | 88,000     | 43,650        |
| Loans charged off  | 34,534     | 209,831    | 160,534       |
| Patronage distributions declared   | 13,824,603 | 12,847,681 | 12,105,352    |
| Acquisition-related transactions   |            |            |               |
| Cash   | -          | -          | (1,058,752)   |
| Loans acquired   | -          | -          | (501,427,038) |
| Accrued interest receivable  | -          | -          | (2,686,485)   |
| Investment in Farm Credit Bank of Texas  | -          | -          | (8,064,226)   |
| Other property owned, net  | -          | -          | (425,948)     |
| Premises and equipment   | -          | -          | (1,503,278)   |
| Other assets   | -          | -          | (380,929)     |
| Note payable to the Farm Credit Bank of Texas                                      | -          | -          | 400,970,158   |
| Accrued interest payable   | -          | -          | 724,947       |
| Drafts outstanding   | -          | -          | 483,098       |
| Patronage distributions payable  | -          | -          | 4,551,813     |
| Other liabilities  | -          | -          | 3,038,437     |
| Stock  | -          | -          | 2,823,905     |
| Equity transferred   | -          | -          | 102,954,298   |
| Transfer of allowance for loan losses from (into) reserve for unfunded commitments | (47,164)   | 105,541    | (275,171)     |

**Supplemental cash information:**

|                                |               |               |               |
|--------------------------------|---------------|---------------|---------------|
| Cash paid during the year for: |               |               |               |
| Interest                       | \$ 25,964,807 | \$ 22,790,428 | \$ 20,501,713 |

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

Lone Star, ACA—2016 Annual Report

**LONE STAR, ACA**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**NOTE 1 — ORGANIZATION, MERGER AND OPERATIONS:**

- A. Organization: Lone Star, ACA, including its wholly-owned subsidiaries, Lone Star, PCA and Lone Star, FLCA (collectively called “the association”), is a member-owned cooperative which provides credit and credit-related services to, or for the benefit of, eligible borrowers/stockholders for qualified agricultural purposes in the counties of Bell, Borden, Bosque, Bowie, Burnet, Camp, Cass, Cooke, Coryell, Dallas, Delta, Denton, Eastland, Ellis, Erath, Falls, Fannin, Fisher, Freestone, Grayson, Hamilton, Hill, Hood, Johnson, Kent, Lamar, Lampasas, Limestone, McLennan, Milam, Mitchell, Morris, Navarro, Nolan, Palo Pinto, Parker, Red River, Scurry, Shackelford, Somerville, Stephens, Tarrant, Taylor, Throckmorton, Titus, Williamson, Wise and Young in the state of Texas.

The association is a lending institution of the Farm Credit System (System), a nationwide system of cooperatively owned banks and associations that was established by Acts of Congress to meet the credit needs of American agriculture and is subject to the provisions of the Farm Credit Act of 1971, as amended (Act). At December 31, 2016, the System consisted of three Farm Credit Banks (FCBs) and their affiliated associations, one Agricultural Credit Bank (ACB) and its affiliated associations, the Federal Farm Credit Banks Funding Corporation (Funding Corporation) and various service and other organizations.

The Farm Credit Bank of Texas (bank) and its related associations are collectively referred to as the “district.” The bank provides funding to all associations within the district and is responsible for supervising certain activities of the district associations. At December 31, 2016, the district consisted of the bank, one FLCA and 13 ACA parent companies, which have two wholly-owned subsidiaries, an FLCA and a PCA, operating in or servicing the states of Alabama, Louisiana, Mississippi, New Mexico and Texas. ACA parent companies provide financing and related services through their FLCA and PCA subsidiaries. The FLCA makes secured long-term agricultural real estate and rural home mortgage loans. The PCA makes short- and intermediate-term loans for agricultural production or operating purposes.

The Farm Credit Administration (FCA) is delegated authority by Congress to regulate the System banks and associations. The FCA examines the activities of System associations to ensure their compliance with the Farm Credit Act, FCA regulations, and safe and sound banking practices.

The Act established the Farm Credit System Insurance Corporation (FCSIC) to administer the Farm Credit Insurance Fund (Insurance Fund). The Insurance Fund is required to be used (1) to ensure the timely payment of principal and interest on Systemwide debt obligations, (2) to ensure the retirement of protected borrower capital at par or stated value and (3) for other specified purposes. The Insurance Fund is also available for the discretionary uses by the FCSIC of providing assistance to certain troubled System institutions and to cover the operating expenses of the FCSIC. Each System bank has been required to pay premiums, which may be passed on to the association, into the Insurance Fund, based on its annual average adjusted outstanding insured debt until the monies in the Insurance Fund reach the “secure base amount,” which is defined in the Farm Credit Act as 2.0 percent of the aggregate insured obligations (adjusted to reflect the reduced risk on loans or investments guaranteed by federal or state governments) or other such percentage of the aggregate obligations as the Insurance Corporation in its sole discretion determines to be actuarially sound. When the amount in the Insurance Fund exceeds the secure base amount, the FCSIC is required to reduce premiums as necessary to maintain the Insurance Fund at the 2 percent level. As required by the Farm Credit Act, as amended, the FCSIC may return excess funds above the secure base amount to System institutions.

FCA regulations require borrower information to be held in strict confidence by Farm Credit institutions, their directors, officers and employees. Directors and employees of the Farm Credit institutions are prohibited, except under specified circumstances, from disclosing nonpublic personal information about members.

**B. Intra-District Restructurings:**

Effective January 1, 2014, the association merged with Texas Land Bank, ACA. The primary reason for the merger was based on a determination that the combined organization would be financially and operationally stronger than either association on a stand-alone basis. The merger was accounted for under the acquisition method of accounting.

Since the association operates for the mutual benefit of its customer-owners and other customers and not for the benefit of any other equity investors, capital stock provides no significant interest in corporate earnings or growth. Specifically, due to restrictions in applicable regulations and their bylaws, the associations can issue stock only at its par value of \$5 per share, the stock is not tradable, and the stock can be retired only for the lesser of par value or book value. In these and other respects, the

shares of stock in one association that were converted to shares of another association had identical rights and attributes. For this reason, the conversion of stock pursuant to the merger occurred at a one-for-one exchange ratio. Management believes that because the stock in each association is fixed in value, the stock issued pursuant to the merger provides no basis for estimating the fair value of the consideration transferred pursuant to the merger. In the absence of a purchase price determination, the acquiring association identified and estimated the acquisition date fair value of the net assets of the acquired association instead of the acquisition date fair value of the equity interests transferred as consideration. The fair value of the assets acquired, including specific intangible assets and liabilities assumed, were measured based on various estimates using assumptions that management believes are reasonable utilizing information currently available. This evaluation produced a fair value of identifiable assets acquired and liabilities assumed that was substantially equal to the fair value of the member interests transferred in the merger. The excess value received, by the acquiring association from the acquired association, over the par value of capital stock and participation certificates issued in the merger is considered to be additional paid-in capital.

The following table summarizes the fair values of the identifiable assets acquired and liabilities assumed as of date of merger:

|                           | <u>Fair Value</u> |
|---------------------------|-------------------|
| Total assets acquired     | \$ 515,546,656    |
| Total liabilities assumed | 409,768,453       |
| Net assets acquired       | 105,778,203       |

The assets acquired included gross loans at fair value of \$501 million with a contractual amount of \$508 million. As of January 1, 2014 the gross contractual amount of loans not expected to be collected was \$7 million.

- C. Operations: The Act sets forth the types of authorized lending activity, persons eligible to borrow and financial services that can be offered by the association. The association is authorized to provide, either directly or in participation with other lenders, credit, credit commitments and related services to eligible borrowers. Eligible borrowers include farmers, ranchers, producers or harvesters of aquatic products, rural residents and farm-related businesses. The association makes and services short- and intermediate-term loans for agricultural production or operating purposes, and secured long-term real estate mortgage loans, with funding from the bank.

The association provides a service facilitating the origination of residential loans that are funded by other lenders as well as acting as an intermediary in offering credit life insurance.

The association's financial condition may be affected by factors that affect the bank. The financial condition and results of operations of the bank may materially affect stockholders' investments in the association. Upon request, stockholders of the association will be provided with the Farm Credit Bank of Texas and District Associations' Annual Report to Stockholders, which includes the combined financial statements of the bank and all of the district associations. The district's annual report discusses the material aspects of the financial condition, changes in financial condition, and results of operations for the bank and the district. In addition, the district's annual report identifies favorable and unfavorable trends, significant events, uncertainties and the impact of activities of the Insurance Fund.

The lending and financial services offered by the bank are described in Note 1, "Organization and Operations," of the district's annual report to stockholders.

**NOTE 2 — SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES:**

The accounting and reporting policies of the association conform to accounting principles generally accepted in the United States of America (GAAP) and prevailing practices within the banking industry. The preparation of consolidated financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. Significant estimates are discussed in these footnotes, as applicable. Actual results could differ from those estimates. Certain amounts in prior years' consolidated financial statements have been reclassified to conform to current financial statement presentation. The consolidated financial statements include the accounts of Lone Star, PCA and Lone Star, FLCA. All significant intercompany transactions have been eliminated in consolidation.

- A. Effective January 1, 2014, the association merged with Texas Land Bank, ACA, a Farm Credit System association within the Farm Credit Bank of Texas district. The primary reason to merge was based on a determination that the combined organization should be financially and operationally stronger than either association on a stand-alone basis. The merger was accounted for under the acquisition method of accounting. Pursuant to these rules, as the accounting acquirer, the association acquired the assets and assumed the liabilities of Texas Land Bank, ACA at their acquisition-date fair value.

As cooperative organizations, Farm Credit associations operate for the mutual benefit of their borrowers and other customers and not for the benefit of equity investors. As such, their capital stock provides no significant interest in corporate earnings or growth. Specifically, due to restrictions in applicable regulations and the bylaws, the associations can issue stock only at its par value of \$5 per share, the stock is not tradable, and the stock can be retired only for the lesser of par value or book value. In these and other respects, the shares of Texas Land Bank, ACA stock that were converted in the merger and the shares of the association's stock to which they were converted had identical rights and attributes. For this reason, the conversion of Texas Land Bank, ACA's stock pursuant to the merger occurred at a one-for-one exchange ratio (i.e., each Texas Land Bank, ACA share was converted into one share of the association's stock with an equal par value).

Management believes that because the stock in each association is fixed in value (although subject to impairment), the association's stock issued pursuant to the merger provides no basis for estimating the fair value of the consideration transferred pursuant to the merger. In the absence of a purchase price determination, the association undertook a process to identify and estimate the acquisition-date fair value of Texas Land Bank, ACA's equity interest (net assets) instead of the acquisition-date fair value of Texas Land Bank, ACA's equity interests transferred as consideration. The fair value of the assets acquired and liabilities assumed from Texas Land Bank, ACA were measured based on various estimates using assumptions that the association's management believes are reasonable utilizing information currently available. Use of different estimates and judgments could yield materially different results. This evaluation produced a fair value of identifiable assets acquired and liabilities assumed that was substantially equal to the fair value of the member interests transferred in the merger. As a result, management recorded no goodwill.

The following table summarizes the fair values of the identifiable assets acquired and liabilities assumed from Texas Land Bank, ACA as of January 1, 2014:

|   | Fair Value            | Contractual<br>Amount | Contractual<br>Amounts Not<br>Expected to be<br>Collected |
|---|-----------------------|-----------------------|---|
| <b>Assets</b>                                 |                       |                       |   |
| Cash  | \$ 1,058,752          |                       |   |
| Loans receivable                              | 501,427,038           | \$ 508,020,985        | \$ 6,593,947  |
| Accrued interest receivable                   | 2,686,485             |                       |   |
| Investment in Farm Credit Bank of Texas       | 8,064,226             |                       |   |
| Other property owned, net                     | 425,948               |                       |   |
| Premises and equipment                        | 1,503,278             |                       |   |
| Other assets                                  | 380,929               |                       |   |
| Total assets                                  | <u>\$ 515,546,656</u> |                       |   |
| <b>Liabilities</b>                            |                       |                       |   |
| Note payable to the Farm Credit Bank of Texas | \$ 400,970,158        | \$ 405,616,084        | \$ 4,645,926  |
| Accrued interest payable                      | 724,947               |                       |   |
| Drafts outstanding                            | 483,098               |                       |   |
| Patronage distributions payable               | 4,551,813             |                       |   |
| Other liabilities                             | 3,038,437             |                       |   |
| Total liabilities                             | <u>\$ 409,768,453</u> |                       |   |
| <b>Net assets acquired</b>                    | <b>\$ 105,778,203</b> |                       |   |

The fair value of the impaired loans acquired as of January 1, 2014, was \$1,439,961. The gross contractual amount of these impaired loans was \$1,573,513. At December 31, 2016, the balance of these impaired loans was \$230,734. The amount of accretable yield relating to impaired loans acquired, with a weighted average amortization period of 4.0 years, was \$133,552 at January 1, 2014, and \$33,388 at December 31, 2016. The amount of accretable yield relating to nonimpaired loans acquired, with a weighted average amortization period of 8.0 years, was \$5,739,807 at January 1, 2014, and \$3,587,380 at December 31, 2016. The amount of nonaccretable yield relating to all loans acquired was \$720,558 at January 1, 2014, and \$450,368 at December 31, 2016.

Costs associated with the merger implementation and restructuring totaled \$0, \$29,231 and \$131,729 in 2016, 2015 and 2014, respectively, and are included in purchased services in the Consolidated Statements of Comprehensive Income.

The acquisition method of accounting requires the financial statement presentations of combined balances as of the date of the merger, but not for previous periods. The Consolidated Balance Sheets reflects the merged entity balances as of December 31, 2016, December 31, 2015 and December 31, 2014. The Consolidated Statements of Comprehensive Income reflects the results of

operations for the merged entity for 2016, 2015 and 2014. The Consolidated Statements of Changes in Members' Equity reflects the changes in equity for the merged entity for 2016, 2015 and 2014. The Consolidated Statements of Cash Flows reflects the cash flows for the merged entity for 2016, 2015 and 2014. Information presented in the footnotes to the Consolidated Financial Statements reflects information for the merged entity for 2016, 2015 and 2014.

The capital position of the association is measured by regulatory standards issued by the Farm Credit Administration (FCA). At December 31, 2016, the association's Permanent Capital Ratio, as prescribed by regulation, was 18.9 percent. The impact of the merger on capital was to decrease the Permanent Capital Ratio by approximately 60 basis points. The year-end Permanent Capital Ratio is also affected by annual net earnings, patronage dividends, asset size and other factors. There were no regulatory conditions affecting the use of capital as a result of the merger.

#### B. Recently Issued or Adopted Accounting Pronouncements:

In June 2016, the Financial Accounting Standards Board (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 association is currently evaluating 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 association is currently evaluating the impact of adoption on its financial condition and results of operations. The adoption of this guidance is not expected to impact the Association's financial condition or its 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. For public entities, the guidance eliminates the requirement to disclose the methods and significant assumptions used to estimate the fair value of financial instruments carried at amortized cost. 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 association'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. The association adopted this guidance in the fourth quarter of 2016 and management made 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 association is in the process of reviewing contracts to determine the effect, if any, on their financial condition or results of operations. The adoption of this guidance is not expected to impact the Association's financial condition or its results of operations.

C. Cash: Cash, as included in the statement of cash flows, represents cash on hand and on deposit at local banks.

D. Loans and Allowance for Loan Losses: Long-term real estate mortgage loans generally have original maturities ranging from five to 40 years. Substantially all short- and intermediate-term loans for agricultural production or operating purposes have maturities

of 10 years or less. Loans are carried at their principal amount outstanding adjusted for charge-offs and net deferred loan fees or costs. Interest on loans is accrued and credited to interest income based upon the daily principal amount outstanding. Authoritative accounting guidance requires loan origination fees and direct loan origination costs, if material, to be capitalized and the net fee or cost to be amortized over the life of the related loan as an adjustment to yield. The guidance was implemented in 2010 for loans closed in 2010 and forward, resulting in the capitalization of \$2,340,269, \$1,941,558 and \$1,379,209 for 2016, 2015 and 2014 respectively, in origination fees and \$2,105,609, \$2,105,609 and \$1,584,720 for 2016, 2015 and 2014 respectively, in origination costs, primarily salaries and benefits related to the origination of loans.

Loans acquired in a business combination are initially recognized at fair value, and therefore, no “carryover” of the allowance for loan losses is permitted. Those loans with evidence of credit quality deterioration at purchase are required to follow the authoritative accounting guidance on “Accounting for Certain Loans or Debt Securities Acquired in a Transfer.” This guidance addresses accounting for differences between contractual cash flows and cash flows expected to be collected from the initial investment in loans if those differences are attributable, at least in part, to credit quality. The initial fair values for these types of loans are determined by discounting both principal and interest cash flows expected to be collected using an observable discount rate for similar instruments with adjustments that management believes a market participant would consider in determining fair value. Subsequent decreases to expected principal cash flows will result in a charge to the provision for loan losses and a corresponding increase to allowance for loan losses. Subsequent increases in expected principal cash flows will result in recovery of any previously recorded allowance for loan losses, to the extent applicable, and a reclassification from nonaccretable difference to accretable yield for any remaining increase. For variable rate loans, expected future cash flows were initially based on the rate in effect at acquisition; expected future cash flows are recalculated as rates change over the lives of the loans.

Impaired loans are loans for which it is probable that not all principal and interest will be collected according to the contractual terms of the loan and are generally considered substandard or doubtful, which is in accordance with the loan rating model, as described below. Impaired loans include nonaccrual loans, restructured loans, and loans past due 90 days or more and still accruing interest. A loan is considered contractually past due when any principal repayment or interest payment required by the loan instrument is not received on or before the due date. A loan shall remain contractually past due until it is formally restructured or until the entire amount past due, including principal, accrued interest and penalty interest incurred as a result of past-due status, is collected or otherwise discharged in full.

Impaired loans are generally placed in nonaccrual status when principal or interest is delinquent for 90 days (unless adequately secured and in the process of collection) or circumstances indicate that collection of principal and/or interest is in doubt. Additionally, all loans over 180 days past due are placed in nonaccrual status. When a loan is placed in nonaccrual status, accrued interest deemed uncollectible is either reversed (if accrued in the current year) or charged against the allowance for loan losses (if accrued in prior years). Loans are charged off at the time they are determined to be uncollectible.

A restructured loan constitutes a troubled debt restructuring (TDR) if for economic or legal reasons related to the debtor’s financial difficulties the association grants a concession to the debtor that it would not otherwise consider. A concession is generally granted in order to minimize the association’s economic loss and avoid foreclosure. Concessions vary by program and are borrower-specific and may include interest rate reductions, term extensions, payment deferrals or the acceptance of additional collateral in lieu of payments. In limited circumstances, principal may be forgiven. A loan restructured in a troubled debt restructuring is an impaired loan.

Payments received on nonaccrual loans are generally applied to the recorded investment in the loan asset. If collection of the recorded investment in the loan is fully expected and the loan does not have a remaining unrecovered prior charge-off associated with it, the interest portion of payments is recognized as current interest income. Nonaccrual loans may be returned to accrual status when principal and interest are current, the borrower has demonstrated payment performance, there are no unrecovered prior charge-offs and collection of future payments is no longer in doubt. If previously unrecognized interest income exists at the time the loan is transferred to accrual status, cash received at the time of or subsequent to the transfer is first recorded as interest income until such time as the recorded balance equals the contractual indebtedness of the borrower.

The bank and related associations use a two-dimensional loan rating model based on an internally generated combined system risk-rating guidance that incorporates a 14-point risk-rating scale to identify and track the probability of borrower default and a separate scale addressing loss given default over a period of time. Probability of default is the probability that a borrower will experience a default within 12 months from the date of the determination of the risk rating. A default is considered to have occurred if the lender believes the borrower will not be able to pay its obligation in full or the borrower is past due more than 90 days. The loss given default is management’s estimate as to the anticipated economic loss on a specific loan, assuming default has occurred or is expected to occur within the next 12 months.

Each of the probability of default categories carries a distinct percentage of default probability. The 14-point risk-rating scale provides for granularity of the probability of default, especially in the acceptable ratings. There are nine acceptable categories that range from a borrower of the highest quality to a borrower of minimally acceptable quality. The probability of default between 1 and 9 is very narrow and would reflect almost no default to a minimal default percentage. The probability of default grows more rapidly as a loan moves from a “9” to other assets especially mentioned (OAEM) and grows significantly as a loan moves to a substandard (viable) level. A substandard (nonviable) rating indicates that the probability of default is almost certain.

The credit risk-rating methodology is a key component of the association’s allowance for loan losses evaluation, and is generally incorporated into its loan underwriting standards and internal lending limit. The allowance for loan losses is maintained at a level considered adequate by management to provide for probable losses inherent in the loan portfolio.

The allowance is based on a periodic evaluation of the loan portfolio by management in which numerous factors are considered, including agricultural economy, loan portfolio composition, collateral value, management’s process for classification of risk of the loans within the portfolio and the portfolio’s prior loss experience. The allowance for loan losses encompasses various judgments, evaluations and appraisals with respect to the loans and their underlying security that, by their nature, contain elements of uncertainty and imprecision. Changes in the agricultural economy and their impact on borrower repayment capacity will cause these various judgments, evaluations and appraisals to change over time. Accordingly, actual circumstances could vary significantly from the institutions’ expectations and predictions of those circumstances. The allowance for loan losses process is supported by loan portfolio stress testing, which simulates stress in the current portfolio and the correlating allowance that would be needed.

The allowance for loan losses includes components for loans individually evaluated for impairment and loans collectively evaluated for impairment. Generally, for loans individually evaluated the allowance for loan losses represents the difference between the recorded investment in the loan and the present value of the cash flows expected to be collected discounted at the loan’s effective interest rate, or at the fair value of the collateral, less estimated costs to sell, if the loan is collateral-dependent. For those loans collectively evaluated for impairment, the allowance for loan losses is determined using the risk-rating model.

- E. **Capital Stock Investment in the Farm Credit Bank of Texas:** The association’s investment in the bank is in the form of Class A voting capital stock and allocated retained earnings. This investment is adjusted periodically based on the association’s proportional utilization of the bank compared to other district associations. The bank requires a minimum stock investment of 2 percent of the association’s average borrowing from the bank. This investment is carried at cost plus allocated equities in the accompanying consolidated balance sheet.

If needed to meet regulatory capital adequacy requirements, the board of directors of the bank may increase the percentage of stock held by an association from 2 percent of the average outstanding balance of borrowings from the bank to a maximum of 5 percent of the average outstanding balance of borrowings from the bank.

- F. **Other Property Owned, Net:** Other property owned, net, consists of real and personal property acquired through foreclosure or deed in lieu of foreclosure, and is recorded at fair value less estimated selling costs upon acquisition. Any initial reduction in the carrying amount of a loan to the fair value of the collateral received is charged to the allowance for loan losses. On at least an annual basis, revised estimates to the fair value less cost to sell are reported as adjustments to the carrying amount of the asset, provided that such adjusted value is not in excess of the carrying amount at acquisition. Income and expenses from operations and carrying value adjustments are included in net gains (losses) on other property owned in the statements of comprehensive income.
- G. **Premises and Equipment:** Premises and equipment are carried at cost less accumulated depreciation. Land is carried at cost. Depreciation is provided on the straight-line method using estimated useful lives of the assets. Gains and losses on dispositions are reflected in current operations. Maintenance and repairs are charged to operating expense, and improvements are capitalized.
- H. **Advance Conditional Payments:** The association is authorized under the Act to accept advance payments from borrowers. To the extent that the borrower’s access to such funds is restricted, the advance conditional payments are netted against the borrower’s related loan balance. Amounts in excess of the related loan balance and amounts to which the borrower has unrestricted access are presented as liabilities in the accompanying consolidated balance sheet. Advance conditional payments are not insured. Interest is generally paid by the association on such accounts at rates established by the board of directors.
- I. **Employee Benefit Plans:** Employees of the association participate in either the district defined benefit retirement plan (DB Plan) or the defined contribution plan (DC Plan). All eligible employees may participate in the Farm Credit Benefits Alliance 401(k) Plan. The DB Plan is closed to new participants. Participants generally include employees hired prior to January 1, 1996. The DB

Plan is noncontributory and provides benefits based on salary and years of service. The “projected unit credit” actuarial method is used for financial reporting and funding purposes for the DB Plan.

Participants in the DC plan generally include employees who elected to transfer from the DB plan prior to January 1, 1996, and employees hired on or after January 1, 1996. Participants in the DC plan direct the placement of their employers’ contributions, 5.0 percent of eligible pay for the years ended December 31, 2016, 2015 and 2014, respectively, made on their behalf into various investment alternatives.

The structure of the district’s DB plan is characterized as multi-employer, since neither the assets, liabilities nor costs of the plan are segregated or separately accounted for by the associations. No portion of any surplus assets is available to the associations, nor are the associations required to pay for plan liabilities upon withdrawal from the plans. As a result, the associations recognize as pension cost the required contribution to the plans for the year. Contributions due and unpaid are recognized as a liability. The association recognized pension costs for the DC plan of \$513,843, \$478,084 and \$357,204 for the years ended December 31, 2016, 2015 and 2014 respectively. For the DB plan, the association recognized pension costs of \$625,890, \$575,340 and \$842,447 for the years ended December 31, 2016, 2015 and 2014, respectively.

The association also participates in the Farm Credit Benefits Alliance 401(k) Plan, which requires the associations to match 100 percent of employee contributions up to 3.0 percent of eligible earnings and to match 50 percent of employee contributions for the next 2.0 percent of employee contributions, up to a maximum employer contribution of 4.0 percent of eligible earnings. Association 401(k) plan costs are expensed as incurred. The association’s contributions to the 401(k) plan were \$440,950, \$419,357 and \$315,393 for the years ended December 31, 2016, 2015 and 2014, respectively.

In addition to pension benefits, the association provides certain health care and life insurance benefits to qualifying retired employees (other postretirement benefits). These benefits are not characterized as multi-employer and, consequently, the liability for these benefits is included in other liabilities. In 2004, the district discontinued its multi-employer health and welfare plan, which provided substantially all employees with health care, life insurance and postretirement benefits during their working lives and after retirement if they reach a normal retirement age and met the years of service criteria while working for the association. At that time, the association adopted a new plan to provide the same benefits to its retirees and employees. Under the new plan, the association no longer participates in the joint and several liability with any other entities, which was intrinsic to the multi-employer plan. For employers providing these benefits outside of a multi-employer plan, FASB guidance, “Employers Accounting for Postretirement Benefits Other than Pensions,” requires the liability for the contractual obligation of these benefits to be recognized as employees render the services necessary to earn the benefits. Accordingly, in December 2004, the association recognized as an expense the unfunded liability for these postretirement benefits. Since that time, the net periodic expense for these benefits has been accrued in accordance with this guidance.

- J. **Income Taxes:** The ACA holding company conducts its business activities through two wholly-owned subsidiaries. Long-term mortgage lending activities are operated through the wholly-owned FLCA subsidiary, which is exempt from federal and state income tax. Short- and intermediate-term lending activities are operated through the wholly-owned PCA subsidiary. Operating expenses are allocated to each subsidiary based on estimated relative service. All significant transactions between the subsidiaries and the parent company have been eliminated in consolidation. The ACA, along with the PCA subsidiary, is subject to income tax. The association is eligible to operate as a cooperative that qualifies for tax treatment under Subchapter T of the Internal Revenue Code. Accordingly, under specified conditions, the association can exclude from taxable income amounts distributed as qualified patronage refunds in the form of cash, stock or allocated retained earnings. Provisions for income taxes are made only on those earnings that will not be distributed as qualified patronage refunds. Deferred taxes are provided on the association’s taxable income on the basis of a proportionate share of the tax effect of temporary differences not allocated in patronage form. A valuation allowance is provided against deferred tax assets to the extent that it is more likely than not (over 50 percent probability), based on management’s estimate, that they will not be realized. The consideration of valuation allowances involves various estimates and assumptions as to future taxable earnings, including the effects of the association’s expected patronage program, which reduces taxable earnings.
- K. **Patronage Refunds From the Farm Credit Bank of Texas:** The association records patronage refunds from the bank on an accrual basis.
- L. **Fair Value Measurement:** The FASB guidance defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. It describes three levels of inputs that may be used to measure fair value:

Level 1 — Quoted prices in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date. Level 1 assets and liabilities include debt and equity securities and derivative contracts that are traded in an active exchange market, as well as certain U.S. Treasury, other U.S. government and agency mortgage-backed debt securities that are highly liquid and are actively traded in over-the-counter markets. Also included in Level 1 are assets held

in trust funds, which relate to deferred compensation and our supplemental retirement plan. The trust funds include investments that are actively traded and have quoted net asset values that are observable in the marketplace. Pension plan assets that are invested in equity securities, including mutual funds and fixed-income securities that are actively traded, are also included in Level 1.

Level 2 — Observable inputs other than quoted prices included within Level 1 that are observable for the asset or liability either directly or indirectly. Level 2 inputs include the following: (a) quoted prices for similar assets or liabilities in active markets; (b) quoted prices for identical or similar assets or liabilities in markets that are not active so that they are traded less frequently than exchange-traded instruments, the prices are not current or principal market information is not released publicly; (c) inputs other than quoted prices that are observable such as interest rates and yield curves, prepayment speeds, credit risks and default rates; and (d) inputs derived principally from or corroborated by observable market data by correlation or other means. This category generally includes certain U.S. government and agency mortgage-backed debt securities, corporate debt securities, and derivative contracts. Pension plan assets that are derived from observable inputs, including corporate bonds and mortgage-backed securities, are reported in Level 2.

Level 3 — Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities are considered Level 3. These unobservable inputs reflect the reporting entity's own assumptions about assumptions that market participants would use in pricing the asset or liability. Level 3 assets and liabilities include financial instruments whose value is determined using pricing models, discounted cash flow methodologies or similar techniques, as well as instruments for which the determination of fair value requires significant management judgment or estimation. This category generally includes certain private equity investments, retained residual interests in securitizations, asset-backed securities, highly structured or long-term derivative contracts, certain loans and other property owned. Pension plan assets such as certain mortgage-backed securities that are supported by little or no market data in determining the fair value are included in Level 3.

The fair value disclosures are presented in Note 14, "Fair Value Measurements."

- M. Off-balance-sheet credit exposures: Commitments to extend credit are agreements to lend to customers, generally having fixed expiration dates or other termination clauses that may require payment of a fee. Commercial letters of credit are conditional commitments issued to guarantee the performance of a customer to a third party. These letters of credit are issued to facilitate commerce and typically result in the commitment being funded when the underlying transaction is consummated between the customer and third party. The credit risk associated with commitments to extend credit and commercial letters of credit is essentially the same as that involved with extending loans to customers and is subject to normal credit policies. Collateral may be obtained based on management's assessment of the customer's creditworthiness. The association's exposure in off balance-sheet credit exposures is further disclosed in Note 15 "Commitments and Contingencies."

### NOTE 3 — INVESTMENTS:

The association may hold mission-related and other investments. The Farm Credit Administration approves mission-related programs and other mission-related investments. The following is a summary of mission-related and other investments that are held to maturity:

During 2010, the association exchanged loans totaling \$59,626,146 for Federal Agricultural Mortgage Corporation (Farmer Mac) guaranteed mortgage-backed securities (AMBS). The loans were previously covered under the Long-Term Standby Commitment to Purchase Agreements with Farmer Mac. No gain or loss was recognized in the financial statements upon completion of the exchange transactions.

Effective January 26, 2012, The Farm Credit Bank of Texas (the bank) purchased Lone Star's securitized Farmer Mac Agricultural Mortgage Backed Securities (AMBS) Investments. The purchase of \$35,459,508 included outstanding principal and accrued interest as of that date. There was no gain or loss recognized by the association on this transaction. The association will continue to service the underlying loans that were included in this security. Also, for 2012 there was no effect to Lone Star's income based on this transaction as the bank was able to pay the association a patronage equivalent to the net interest that it would have earned on the AMBS investment. The amount of patronage received in 2016, 2015 and 2014 was \$315,464, \$367,320 and \$554,771, respectively. However, for future years, the bank's payment of patronage is at the discretion of the bank's board of directors. The remaining balance of the AMBS investment at December 31, 2016 was \$12,038,478.

### NOTE 4 — LOANS AND ALLOWANCE FOR LOAN LOSSES:

A summary of loans as of December 31 follows:

| Loan Type                        | 2016             |        | 2015             |        | 2014             |        |
|----------------------------------|------------------|--------|------------------|--------|------------------|--------|
|                                  | Amount           | %      | Amount           | %      | Amount           | %      |
| Real estate mortgage             | \$ 1,302,128,320 | 78.8%  | \$ 1,203,918,222 | 77.5%  | \$ 1,126,484,993 | 80.4%  |
| Production and intermediate term | 130,142,461      | 7.9%   | 127,913,676      | 8.2%   | 114,955,076      | 8.2%   |
| Agribusiness:                    |                  |        |                  |        |                  |        |
| Loans to cooperatives            | 14,557,951       | 0.9%   | 5,281,321        | 0.3%   | 1,388,174        | 0.1%   |
| Processing and marketing         | 117,989,550      | 7.1%   | 114,463,149      | 7.4%   | 60,054,115       | 4.3%   |
| Farm-related business            | 13,514,114       | 0.8%   | 17,751,374       | 1.1%   | 14,501,674       | 1.0%   |
| Communication                    | 8,068,303        | 0.5%   | 5,627,078        | 0.4%   | 4,972,189        | 0.4%   |
| Energy                           | 45,294,868       | 2.7%   | 52,821,315       | 3.4%   | 55,828,771       | 4.0%   |
| Water and waste water            | 6,398,890        | 0.4%   | 5,505,528        | 0.4%   | 1,586,580        | 0.1%   |
| Rural residential real estate    | 15,071,851       | 0.9%   | 19,860,013       | 1.3%   | 20,536,455       | 1.5%   |
| Total                            | \$ 1,653,166,308 | 100.0% | \$ 1,553,141,676 | 100.0% | \$ 1,400,308,027 | 100.0% |

The association may purchase or sell 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 participations purchased and sold as of December 31, 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           | \$ 23,693,057       | \$ 25,436,885                | \$ -                | \$ -                     | \$ 23,693,057       |
| Production and intermediate term | 39,275,158                     | 689,530             | -                            | -                   | 39,275,158               | 689,530             |
| Agribusiness                     | 133,289,716                    | -                   | -                            | -                   | 133,289,716              | -                   |
| Communication                    | 8,068,303                      | -                   | -                            | -                   | 8,068,303                | -                   |
| Energy                           | 45,294,868                     | -                   | -                            | -                   | 45,294,868               | -                   |
| Water and waste water            | 4,948,417                      | -                   | 975,473                      | -                   | 5,923,890                | -                   |
| Total                            | \$ 254,569,519                 | \$ 26,126,415       | \$ 975,473                   | \$ -                | \$ 255,544,992           | \$ 26,126,415       |

Loan volume by office or geographic location:

| Branch                   | 2016          | 2015          | 2014          |
|--------------------------|---------------|---------------|---------------|
| Sherman                  | 16.9%         | 15.2%         | 14.3%         |
| Capital Markets          | 14.5%         | 15.5%         | 13.3%         |
| Waco                     | 11.1%         | 11.3%         | 11.9%         |
| Denton                   | 8.4%          | 7.9%          | 7.9%          |
| Stephenville             | 8.4%          | 9.6%          | 10.2%         |
| Temple                   | 5.0%          | 5.1%          | 6.5%          |
| Lampasas                 | 5.0%          | 4.6%          | 4.9%          |
| Cleburne                 | 4.6%          | 4.5%          | 4.8%          |
| New Boston               | 4.4%          | 4.1%          | 4.4%          |
| Paris                    | 3.9%          | 3.8%          | 4.0%          |
| Corsicana                | 3.9%          | 4.7%          | 5.4%          |
| Abilene                  | 3.7%          | 3.7%          | 3.4%          |
| Hillsboro                | 3.4%          | 3.9%          | 4.4%          |
| Sweetwater               | 1.7%          | 1.8%          | 2.0%          |
| Fort Worth               | 1.5%          | 1.1%          | 0.7%          |
| Round Rock               | 1.4%          | 1.1%          | 0.0%          |
| Weatherford              | 1.3%          | 1.2%          | 1.2%          |
| Participations Purchased | 0.9%          | 0.9%          | 0.7%          |
| <b>Totals</b>            | <b>100.0%</b> | <b>100.0%</b> | <b>100.0%</b> |

The association's concentration of credit risk in various agricultural commodities is shown in the following table. While the amounts represent the association's maximum potential credit risk as it relates to recorded loan principal, a substantial portion of the association's lending activities is collateralized, and the association's exposure to credit loss associated with lending activities is reduced accordingly. An estimate of the association's credit risk exposure is considered in the determination of the allowance for loan losses.

| Operation/Commodity                              | 2016                    |               | 2015                    |               | 2014                    |               |
|--|-------------------------|---------------|-------------------------|---------------|-------------------------|---------------|
|  | Amount                  | %             | Amount                  | %             | Amount                  | %             |
| Livestock, except dairy and poultry              | \$ 1,081,611,057        | 65.4%         | \$ 999,228,903          | 64.2%         | \$ 909,889,911          | 64.8%         |
| Hunting, trapping and game propagation           | 81,984,893              | 5.0%          | 76,089,750              | 4.9%          | 62,854,411              | 4.5%          |
| General farms, primarily crops                   | 74,834,060              | 4.5%          | 66,316,370              | 4.3%          | 65,872,649              | 4.7%          |
| Field crops except cash grains                   | 51,883,595              | 3.1%          | 50,718,878              | 3.3%          | 53,831,073              | 3.8%          |
| Food and kindred products                        | 51,321,395              | 3.1%          | 39,724,072              | 2.6%          | 27,018,338              | 1.9%          |
| Electric services                                | 49,402,615              | 3.0%          | 54,432,499              | 3.5%          | 52,555,513              | 3.8%          |
| Timber   | 46,902,035              | 2.8%          | 48,870,010              | 3.1%          | 41,577,554              | 3.0%          |
| Wholesale trade - nondurable goods               | 42,285,626              | 2.6%          | 41,214,224              | 2.7%          | 35,628,566              | 2.5%          |
| Cash grains                                      | 39,873,707              | 2.4%          | 43,563,588              | 2.8%          | 45,095,770              | 3.2%          |
| Animal specialties                               | 34,437,958              | 2.1%          | 25,272,242              | 1.6%          | 18,952,505              | 1.4%          |
| Paper and allied products                        | 24,461,913              | 1.5%          | 24,800,730              | 1.6%          | 13,612,858              | 1.0%          |
| Rural home loans                                 | 16,158,786              | 1.0%          | 20,854,124              | 1.3%          | 20,752,172              | 1.5%          |
| Other  | 12,054,858              | 0.7%          | 13,316,240              | 0.9%          | 9,050,573               | 0.6%          |
| Dairy farms                                      | 10,041,091              | 0.6%          | 10,887,699              | 0.7%          | 13,862,940              | 1.0%          |
| Communication                                    | 8,068,303               | 0.5%          | 5,627,078               | 0.4%          | 4,972,189               | 0.4%          |
| Farm and garden machinery equipment              | 6,941,461               | 0.4%          | 7,483,965               | 0.5%          | 5,093,198               | 0.4%          |
| Agricultural services                            | 6,220,609               | 0.4%          | 6,725,582               | 0.4%          | 2,220,442               | 0.2%          |
| Chemical and allied products                     | 4,365,662               | 0.3%          | 7,038,904               | 0.5%          | 5,282,639               | 0.4%          |
| Horticultural specialties                        | 3,627,955               | 0.2%          | 4,192,103               | 0.3%          | 5,085,463               | 0.4%          |
| Poultry and eggs                                 | 3,066,838               | 0.2%          | 3,045,934               | 0.2%          | 3,145,578               | 0.2%          |
| Fruit and tree nuts                              | 2,449,647               | 0.1%          | 1,718,191               | 0.1%          | 1,276,408               | 0.1%          |
| General farms, primarily livestock               | 917,629                 | 0.1%          | 982,954                 | 0.1%          | 868,244                 | 0.1%          |
| Fish hatcheries and preserves                    | 131,620                 | 0.0%          | 141,201                 | 0.0%          | 157,772                 | 0.0%          |
| Real estate                                      | 94,800                  | 0.0%          | -                       | 0.0%          | -                       | 0.0%          |
| Vegetables and melons                            | 28,195                  | 0.0%          | 30,699                  | 0.0%          | 32,687                  | 0.0%          |
| Public warehousing and storage                   | -                       | 0.0%          | 569,651                 | 0.0%          | 658,631                 | 0.0%          |
| Lumber and wood products, except furniture       | -                       | 0.0%          | 295,138                 | 0.0%          | 946,838                 | 0.1%          |
| Building materials, hardware and garden supplies | -                       | 0.0%          | 947                     | 0.0%          | 13,105                  | 0.0%          |
| <b>Total</b>                                     | <b>\$ 1,653,166,308</b> | <b>100.0%</b> | <b>\$ 1,553,141,676</b> | <b>100.0%</b> | <b>\$ 1,400,308,027</b> | <b>100.0%</b> |

The amount of collateral obtained, if deemed necessary upon extension of credit, is based on management’s credit evaluation of the borrower. Collateral held varies but typically includes farmland and income-producing property, such as crops and livestock, as well as receivables. Long-term real estate loans are secured by the first liens on the underlying real property. Federal regulations state that long-term real estate loans are not to exceed 85 percent (or 97 percent if guaranteed by a government agency) of the property’s appraised value. However, a decline in a property’s market value subsequent to loan origination or advances, or other actions necessary to protect the financial interest of the association in the collateral, may result in the loan-to-value ratios in excess of the regulatory maximum.

To mitigate the risk of loan losses, the association has obtained loan guarantees in the form of standby commitments to purchase qualifying loans from Farmer Mac through an arrangement with the bank. The agreements, which will remain in place until the loans are paid in full, give the association the right to sell the loans identified in the agreements to Farmer Mac in the event of defaults (typically four months past due), subject to certain conditions. At December 31, 2016, 2015 and 2014, loans totaling \$480,178, \$523,062 and \$562,062, respectively, were guaranteed by these commitments. Fees paid for these guarantees totaled \$1,624, \$1,746 and \$2,238 in 2016, 2015 and 2014, respectively, and are included in “other noninterest expense.”

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

|                                     | <b>December 31,<br/>2016</b> | December 31,<br>2015 | December 31,<br>2014 |
|-------------------------------------|------------------------------|----------------------|----------------------|
| <b>Nonaccrual loans:</b>            |                              |                      |                      |
| Real estate mortgage                | \$ 3,163,755                 | \$ 6,213,342         | \$ 9,498,629         |
| Production and intermediate term    | 2,117,316                    | 21,576               | 498,067              |
| Agribusiness                        | -                            | -                    | 20,957               |
| Rural residential real estate       | 887,983                      | 151,752              | 205,564              |
| Total nonaccrual loans              | <b>6,169,054</b>             | 6,386,670            | 10,223,217           |
| <b>Accruing restructured loans:</b> |                              |                      |                      |
| Real estate mortgage                | 3,106,032                    | 35,213               | 198,562              |
| Production and intermediate term    | -                            | 4,629                | 10,059               |
| Total accruing restructured loans   | <b>3,106,032</b>             | 39,842               | 208,621              |
| Total nonperforming loans           | <b>9,275,086</b>             | 6,426,512            | 10,431,838           |
| Other property owned                | -                            | 78,518               | 201,363              |
| Total nonperforming assets          | <b>\$ 9,275,086</b>          | \$ 6,505,030         | \$ 10,633,201        |

One credit quality indicator utilized by the bank and the association is the Farm Credit Administration’s 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 classified under the Farm Credit Administration's Uniform Loan Classification System as a percentage of total loans and related accrued interest receivable by loan type as of December 31:

|                                  | <u>2016</u> | <u>2015</u> | <u>2014</u> |
|----------------------------------|-------------|-------------|-------------|
| Real estate mortgage             |             |             |             |
| Acceptable                       | <b>98%</b>  | 97%         | 96%         |
| OAEM                             | <b>1%</b>   | 2%          | 2%          |
| Substandard/doubtful             | <b>1%</b>   | 1%          | 2%          |
|                                  | <b>100%</b> | 100%        | 100%        |
| Production and intermediate term |             |             |             |
| Acceptable                       | <b>98%</b>  | 100%        | 99%         |
| OAEM                             | <b>0%</b>   | 0%          | 1%          |
| Substandard/doubtful             | <b>2%</b>   | 0%          | 0%          |
|                                  | <b>100%</b> | 100%        | 100%        |
| Loans to cooperatives            |             |             |             |
| Acceptable                       | <b>100%</b> | 100%        | 100%        |
| OAEM                             | <b>0%</b>   | 0%          | 0%          |
| Substandard/doubtful             | <b>0%</b>   | 0%          | 0%          |
|                                  | <b>100%</b> | 100%        | 100%        |
| Processing and marketing         |             |             |             |
| Acceptable                       | <b>97%</b>  | 97%         | 100%        |
| OAEM                             | <b>3%</b>   | 3%          | 0%          |
| Substandard/doubtful             | <b>0%</b>   | 0%          | 0%          |
|                                  | <b>100%</b> | 100%        | 100%        |
| Farm-related business            |             |             |             |
| Acceptable                       | <b>93%</b>  | 94%         | 99%         |
| OAEM                             | <b>0%</b>   | 5%          | 0%          |
| Substandard/doubtful             | <b>7%</b>   | 1%          | 1%          |
|                                  | <b>100%</b> | 100%        | 100%        |
| Communication                    |             |             |             |
| Acceptable                       | <b>100%</b> | 81%         | 76%         |
| OAEM                             | <b>0%</b>   | 0%          | 0%          |
| Substandard/doubtful             | <b>0%</b>   | 19%         | 24%         |
|                                  | <b>100%</b> | 100%        | 100%        |
| Energy                           |             |             |             |
| Acceptable                       | <b>98%</b>  | 100%        | 100%        |
| OAEM                             | <b>2%</b>   | 0%          | 0%          |
| Substandard/doubtful             | <b>0%</b>   | 0%          | 0%          |
|                                  | <b>100%</b> | 100%        | 100%        |
| Water and waste water            |             |             |             |
| Acceptable                       | <b>100%</b> | 100%        | 100%        |
| OAEM                             | <b>0%</b>   | 0%          | 0%          |
| Substandard/doubtful             | <b>0%</b>   | 0%          | 0%          |
|                                  | <b>100%</b> | 100%        | 100%        |
| Rural residential real estate    |             |             |             |
| Acceptable                       | <b>91%</b>  | 93%         | 93%         |
| OAEM                             | <b>1%</b>   | 1%          | 1%          |
| Substandard/doubtful             | <b>8%</b>   | 6%          | 6%          |
|                                  | <b>100%</b> | 100%        | 100%        |
| Total Loans                      |             |             |             |
| Acceptable                       | <b>98%</b>  | 97%         | 96%         |
| OAEM                             | <b>1%</b>   | 2%          | 2%          |
| Substandard/doubtful             | <b>1%</b>   | 1%          | 2%          |
|                                  | <b>100%</b> | 100%        | 100%        |

The following tables provide an age analysis of past due loans (including accrued interest) as of December 31, 2016, 2015 and 2014:

| December 31, 2016:               | 30-89<br>Days<br>Past Due | 90 Days<br>or More<br>Past Due | Total<br>Past<br>Due | Not Past Due or<br>less than 30<br>Days Past Due | Total<br>Loans          |
|----------------------------------|---------------------------|--------------------------------|----------------------|--|-------------------------|
| Real estate mortgage             | \$ 964,121                | \$ 517,454                     | \$ 1,481,575         | \$ 1,308,635,460                                 | \$ 1,310,117,035        |
| Production and intermediate term | 1,177,454                 | 110,821                        | 1,288,275            | 129,707,077                                      | 130,995,352             |
| Loans to cooperatives            | -                         | -                              | -                    | 14,576,489                                       | 14,576,489              |
| Processing and marketing         | -                         | -                              | -                    | 118,138,963                                      | 118,138,963             |
| Farm-related business            | -                         | -                              | -                    | 13,549,986                                       | 13,549,986              |
| Communication                    | -                         | -                              | -                    | 8,069,218  | 8,069,218               |
| Energy                           | -                         | -                              | -                    | 45,468,243                                       | 45,468,243              |
| Water and waste water            | -                         | -                              | -                    | 6,406,716  | 6,406,716               |
| Rural residential real estate    | 43,803                    | 701,898                        | 745,701              | 14,359,311                                       | 15,105,012              |
| <b>Total</b>                     | <b>\$ 2,185,378</b>       | <b>\$ 1,330,173</b>            | <b>\$ 3,515,551</b>  | <b>\$ 1,658,911,463</b>                          | <b>\$ 1,662,427,014</b> |

| December 31, 2015:               | 30-89<br>Days<br>Past Due | 90 Days<br>or More<br>Past Due | Total<br>Past<br>Due | Not Past Due or<br>less than 30<br>Days Past Due | Total<br>Loans          |
|----------------------------------|---------------------------|--------------------------------|----------------------|--|-------------------------|
| Real estate mortgage             | \$ 580,298                | \$ 385,948                     | \$ 966,246           | \$ 1,210,322,703                                 | \$ 1,211,288,949        |
| Production and intermediate term | 1,004                     | 20,628                         | 21,632               | 128,556,293                                      | 128,577,925             |
| Loans to cooperatives            | -                         | -                              | -                    | 5,297,043  | 5,297,043               |
| Processing and marketing         | -                         | -                              | -                    | 114,554,886                                      | 114,554,886             |
| Farm-related business            | -                         | -                              | -                    | 17,798,766                                       | 17,798,766              |
| Communication                    | -                         | -                              | -                    | 5,628,201  | 5,628,201               |
| Energy                           | -                         | -                              | -                    | 52,990,544                                       | 52,990,544              |
| Water and waste water            | -                         | -                              | -                    | 5,509,822  | 5,509,822               |
| Rural residential real estate    | 831,640                   | -                              | 831,640              | 19,086,180                                       | 19,917,820              |
| <b>Total</b>                     | <b>\$ 1,412,942</b>       | <b>\$ 406,576</b>              | <b>\$ 1,819,518</b>  | <b>\$ 1,559,744,438</b>                          | <b>\$ 1,561,563,956</b> |

| December 31, 2014:               | 30-89<br>Days<br>Past Due | 90 Days<br>or More<br>Past Due | Total<br>Past<br>Due | Not Past Due or<br>less than 30<br>Days Past Due | Total<br>Loans          |
|----------------------------------|---------------------------|--------------------------------|----------------------|--|-------------------------|
| Real estate mortgage             | \$ 674,941                | \$ 1,240,304                   | \$ 1,915,245         | \$ 1,131,103,650                                 | \$ 1,133,018,895        |
| Production and intermediate term | 29,848                    | 466,399                        | 496,247              | 114,853,903                                      | 115,350,150             |
| Loans to cooperatives            | -                         | -                              | -                    | 1,393,775  | 1,393,775               |
| Processing and marketing         | -                         | -                              | -                    | 60,091,347                                       | 60,091,347              |
| Farm-related business            | -                         | 20,957                         | 20,957               | 14,505,189                                       | 14,526,146              |
| Communication                    | -                         | -                              | -                    | 4,973,124  | 4,973,124               |
| Energy                           | -                         | -                              | -                    | 56,004,154                                       | 56,004,154              |
| Water and waste water            | -                         | -                              | -                    | 1,587,476  | 1,587,476               |
| Rural residential real estate    | 103,686                   | -                              | 103,686              | 20,488,257                                       | 20,591,943              |
| <b>Total</b>                     | <b>\$ 808,475</b>         | <b>\$ 1,727,660</b>            | <b>\$ 2,536,135</b>  | <b>\$ 1,405,000,875</b>                          | <b>\$ 1,407,537,010</b> |

**Troubled Debt Restructuring:** A restructuring of a debt constitutes a troubled debt restructuring 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 December 31, 2016, the total recorded investment of troubled debt restructured loans was \$3,358,316 including \$252,284 classified as nonaccrual and \$3,106,032 classified as accrual, with specific allowance for loan losses of \$0. As of December 31, 2016, commitments to lend funds to borrowers whose loan terms have been modified in a troubled debt restructuring were \$0.

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 years ended December 31, 2016, 2015 and 2014. The pre-modification outstanding recorded investment represents the recorded investment of the loans as of the quarter end

prior to the restructuring. The post-modification outstanding recorded investment represents the recorded investment of the loans as of the quarter end the restructuring occurred.

| <b>December 31, 2016:</b>            | <b>Pre-modification Outstanding<br/>Recorded Investment</b> | <b>Post-modification Outstanding<br/>Recorded Investment</b> |
|--------------------------------------|---|--|
| <b>Troubled debt restructurings:</b> |   |  |
| Real estate mortgage                 | \$ 86,863   | \$ 85,388  |
| <b>Total</b>                         | <b>\$ 86,863</b>  | <b>\$ 85,388</b>   |
| <br>December 31, 2015:               | <br>Pre-modification Outstanding<br>Recorded Investment     | <br>Post-modification Outstanding<br>Recorded Investment     |
| Troubled debt restructurings:        |   |  |
| Real estate mortgage                 | \$ 221,473  | \$ 218,845   |
| <b>Total</b>                         | <b>\$ 221,473</b>   | <b>\$ 218,845</b>  |
| <br>December 31, 2014:               | <br>Pre-modification Outstanding<br>Recorded Investment     | <br>Post-modification Outstanding<br>Recorded Investment     |
| Troubled debt restructurings:        |   |  |
| Real estate mortgage                 | \$ 164,433  | \$ 164,350   |
| <b>Total</b>                         | <b>\$ 164,433</b>   | <b>\$ 164,350</b>  |

In restructurings where principal is forgiven, the amount of the forgiveness is immediately charged off. In restructurings where accrued interest is forgiven, the interest is reversed (if current year interest) or charged off (if prior year interest). Charge-offs recorded at the modification date were \$34,534 for the year ending December 31, 2016.

The predominant form of concession granted for troubled debt restructuring includes a delay in the repayment of principal. At times these terms might be offset with incremental payments, collateral or new borrower guarantees, in which case the association assesses all of the modified terms to determine if the overall modification qualifies as a troubled debt restructuring.

The following table presents information regarding loans that met the accounting criteria as a troubled debt restructuring and that occurred within the previous 12 months of that year and for which there was a payment default during the period. A payment default is defined as a payment that is 30 days past due after the date the loan was restructured.

| Troubled debt restructurings that<br>subsequently defaulted: | <b>Recorded Investment<br/>at December 31, 2016</b> | Recorded Investment<br>at December 31, 2015 | Recorded Investment<br>at December 31, 2014 |
|--|---|---|---|
| Real estate mortgage   | \$ 88,140   | \$ -  | \$ -  |
| <b>Total</b>   | <b>\$ 88,140</b>                                    | <b>\$ -</b>                                 | <b>\$ -</b>                                 |

There were no additional commitments to lend to borrowers whose loans have been modified in TDRs at December 31, 2016, December 31, 2015 or December 31, 2014.

The following table provides information on outstanding loans restructured in troubled debt restructurings at period end. These loans are included as impaired loans in the impaired loan table:

|                                  | Loans Modified as TDRs     |                      |                      |
|----------------------------------|----------------------------|----------------------|----------------------|
|                                  | December 31,<br>2016       | December 31,<br>2015 | December 31,<br>2014 |
| Troubled debt restructurings:    |                            |                      |                      |
| Real estate mortgage             | \$ 3,358,316               | \$ 4,123,426         | \$ 5,440,540         |
| Production and intermediate term | -                          | 4,629                | 10,059               |
| Total                            | <u>\$ 3,358,316</u>        | <u>\$ 4,128,055</u>  | <u>\$ 5,450,599</u>  |
|                                  |                            |                      |                      |
|                                  | TDRs on Nonaccrual Status* |                      |                      |
|                                  | December 31,<br>2016       | December 31,<br>2015 | December 31,<br>2014 |
| Troubled debt restructurings:    |                            |                      |                      |
| Real estate mortgage             | \$ 252,284                 | \$ 4,088,213         | \$ 5,241,978         |
| Total                            | <u>\$ 252,284</u>          | <u>\$ 4,088,213</u>  | <u>\$ 5,241,978</u>  |

\* represents the portion of loans modified as TDRs that are in nonaccrual status

Additional impaired loan information is as follows:

|  | Recorded<br>Investment at<br>12/31/2015 | Unpaid<br>Principal<br>Balance <sup>a</sup> | Related<br>Allowance | Average<br>Impaired<br>Loans | Interest<br>Income<br>Recognized |
|--|---|---|----------------------|------------------------------|----------------------------------|
| <b>Impaired loans with a related allowance for credit losses:</b>  |   |   |                      |                              |                                  |
| Real estate mortgage   | \$ 158,029                              | \$ 158,029                                  | \$ 40,866            | \$ 3,786,562                 | \$ 541                           |
| Production and intermediate term                                   | -                                       | -   | -                    | 32,924                       | -                                |
| Farm-related business  | -                                       | -   | -                    | -                            | -                                |
| Energy and water/waste water                                       | -                                       | -   | -                    | -                            | -                                |
| Rural residential real estate                                      | -                                       | -   | -                    | -                            | -                                |
| Total  | <u>\$ 158,029</u>                       | <u>\$ 158,029</u>                           | <u>\$ 40,866</u>     | <u>\$ 3,819,486</u>          | <u>\$ 541</u>                    |
| <b>Impaired loans with no related allowance for credit losses:</b> |   |   |                      |                              |                                  |
| Real estate mortgage   | \$ 6,090,526                            | \$ 6,187,062                                | \$ -                 | \$ 3,505,031                 | \$ 27,273                        |
| Production and intermediate term                                   | 26,205                                  | 418,417                                     | -                    | 68,337                       | 288                              |
| Farm-related business  | -                                       | -   | -                    | 8,186                        | 9,438                            |
| Energy and water/waste water                                       | -                                       | 1,706,959                                   | -                    | -                            | -                                |
| Rural residential real estate                                      | 151,752                                 | 151,946                                     | -                    | 155,843                      | -                                |
| Total  | <u>\$ 6,268,483</u>                     | <u>\$ 8,464,384</u>                         | <u>\$ -</u>          | <u>\$ 3,737,397</u>          | <u>\$ 36,999</u>                 |
| <b>Total impaired loans:</b>                                       |   |   |                      |                              |                                  |
| Real estate mortgage   | \$ 6,248,555                            | \$ 6,345,091                                | \$ 40,866            | \$ 7,291,593                 | \$ 27,814                        |
| Production and intermediate term                                   | 26,205                                  | 418,417                                     | -                    | 101,261                      | 288                              |
| Farm-related business  | -                                       | -   | -                    | 8,186                        | 9,438                            |
| Energy and water/waste water                                       | -                                       | 1,706,959                                   | -                    | -                            | -                                |
| Rural residential real estate                                      | 151,752                                 | 151,946                                     | -                    | 155,843                      | -                                |
| Total  | <u>\$ 6,426,512</u>                     | <u>\$ 8,622,413</u>                         | <u>\$ 40,866</u>     | <u>\$ 7,556,883</u>          | <u>\$ 37,540</u>                 |
| <b>Impaired loans with a related allowance for credit losses:</b>  |   |   |                      |                              |                                  |
| Real estate mortgage   | \$ 559,032                              | \$ 559,032                                  | \$ 21,683            | \$ 325,567                   | \$ 1,946                         |
| Production and intermediate term                                   | 997,749                                 | 997,749                                     | 327,955              | 73,298                       | 18,370                           |
| Farm-related business  | -                                       | -   | -                    | -                            | -                                |
| Rural residential real estate                                      | -                                       | -   | -                    | 109,025                      | -                                |
| Total  | <u>\$ 1,556,781</u>                     | <u>\$ 1,556,781</u>                         | <u>\$ 349,638</u>    | <u>\$ 507,890</u>            | <u>\$ 20,316</u>                 |
| <b>Impaired loans with no related allowance for credit losses:</b> |   |   |                      |                              |                                  |
| Real estate mortgage   | \$ 5,710,755                            | \$ 5,746,870                                | \$ -                 | \$ 5,983,951                 | \$ 306,029                       |
| Production and intermediate term                                   | 1,119,567                               | 1,450,405                                   | -                    | 228,306                      | 61,573                           |
| Farm-related business  | -                                       | -   | -                    | -                            | 9,574                            |
| Rural residential real estate                                      | 887,983                                 | 888,177                                     | -                    | 537,837                      | 2,559                            |
| Total  | <u>\$ 7,718,305</u>                     | <u>\$ 8,085,452</u>                         | <u>\$ -</u>          | <u>\$ 6,750,094</u>          | <u>\$ 379,735</u>                |
| <b>Total impaired loans:</b>                                       |   |   |                      |                              |                                  |
| Real estate mortgage   | \$ 6,269,787                            | \$ 6,305,902                                | \$ 21,683            | \$ 6,309,518                 | \$ 307,975                       |
| Production and intermediate term                                   | 2,117,316                               | 2,448,154                                   | 327,955              | 301,604                      | 79,943                           |
| Farm-related business  | -                                       | -   | -                    | -                            | 9,574                            |
| Rural residential real estate                                      | 887,983                                 | 888,177                                     | -                    | 646,862                      | 2,559                            |
| Total  | <u>\$ 9,275,086</u>                     | <u>\$ 9,642,233</u>                         | <u>\$ 349,638</u>    | <u>\$ 7,257,984</u>          | <u>\$ 400,051</u>                |

|  | Recorded<br>Investment at<br>12/31/2014 | Unpaid<br>Principal<br>Balance <sup>a</sup> | Related<br>Allowance | Average<br>Impaired<br>Loans | Interest<br>Income<br>Recognized |
|--|---|---|----------------------|------------------------------|----------------------------------|
| <b>Impaired loans with a related allowance for credit losses:</b>  |   |   |                      |                              |                                  |
| Real estate mortgage   | \$ 5,881,649                            | \$ 5,995,724                                | \$ 1,257,660         | \$ 6,665,267                 | \$ 14,647                        |
| Production and intermediate term                                   | 62,705                                  | 456,768                                     | 53,655               | 47,845                       | 85                               |
| Farm-related business  | -                                       | -   | -                    | -                            | -                                |
| Energy and water/waste water                                       | -                                       | -   | -                    | -                            | -                                |
| Rural residential real estate                                      | -                                       | -   | -                    | -                            | -                                |
| Total  | <u>\$ 5,944,354</u>                     | <u>\$ 6,452,492</u>                         | <u>\$ 1,311,315</u>  | <u>\$ 6,713,112</u>          | <u>\$ 14,732</u>                 |
| <b>Impaired loans with no related allowance for credit losses:</b> |   |   |                      |                              |                                  |
| Real estate mortgage   | \$ 3,815,542                            | \$ 3,900,613                                | \$ -                 | \$ 4,016,602                 | \$ 16,309                        |
| Production and intermediate term                                   | 445,421                                 | 500,619                                     | -                    | 503,203                      | 10,198                           |
| Farm-related business  | 20,957                                  | 20,957                                      | -                    | 48,438                       | 9,337                            |
| Energy and water/waste water                                       | -                                       | 1,706,959                                   | -                    | -                            | -                                |
| Rural residential real estate                                      | 205,564                                 | 205,758                                     | -                    | 220,107                      | -                                |
| Total  | <u>\$ 4,487,484</u>                     | <u>\$ 6,334,906</u>                         | <u>\$ -</u>          | <u>\$ 4,788,350</u>          | <u>\$ 35,844</u>                 |
| <b>Total impaired loans:</b>                                       |   |   |                      |                              |                                  |
| Real estate mortgage   | \$ 9,697,191                            | \$ 9,896,337                                | \$ 1,257,660         | \$ 10,681,869                | \$ 30,956                        |
| Production and intermediate term                                   | 508,126                                 | 957,387                                     | 53,655               | 551,048                      | 10,283                           |
| Farm-related business  | 20,957                                  | 20,957                                      | -                    | 48,438                       | 9,337                            |
| Energy and water/waste water                                       | -                                       | 1,706,959                                   | -                    | -                            | -                                |
| Rural residential real estate                                      | 205,564                                 | 205,758                                     | -                    | 220,107                      | -                                |
| Total  | <u>\$ 10,431,838</u>                    | <u>\$ 12,787,398</u>                        | <u>\$ 1,311,315</u>  | <u>\$ 11,501,462</u>         | <u>\$ 50,576</u>                 |

<sup>a</sup> Unpaid principal balance represents the recorded principal balance of the loan.

There were no material commitments to lend additional funds to debtors whose loans were classified as impaired at December 31, 2016, 2015 and 2014.

Interest income on nonaccrual and accruing restructured loans that would have been recognized under the original terms of the loans at December 31:

|   | 2016              | 2015              | 2014                |
|---|-------------------|-------------------|---------------------|
| Interest income which would have been recognized under the original terms | \$ 699,051        | \$ 733,507        | \$ 1,715,336        |
| Less: interest income recognized  | (400,051)         | (37,540)          | (50,576)            |
| Foregone interest income  | <u>\$ 299,000</u> | <u>\$ 695,967</u> | <u>\$ 1,664,760</u> |

A summary of the changes in the allowance for credit losses and the ending balance of loans outstanding are as follows:

|  | Real Estate<br>Mortgage | Production and<br>Intermediate<br>Term | Agribusiness          | Communication       | Energy               | Water and<br>Waste<br>Water | Rural<br>Residential<br>Real Estate | Total                   |
|--|-------------------------|--|-----------------------|---------------------|----------------------|-----------------------------|-------------------------------------|-------------------------|
| <b>Allowance for Credit Losses:</b>                                      |                         |  |                       |                     |                      |                             |                                     |                         |
| Balance at   |                         |  |                       |                     |                      |                             |                                     |                         |
| December 31, 2015  | \$ 5,884,916            | \$ 299,660                             | \$ 285,442            | \$ 88,173           | \$ 94,434            | \$ 6,262                    | \$ 158,534                          | \$ 6,817,421            |
| Charge-offs  | (34,534)                | -                                      | -                     | -                   | -                    | -                           | -                                   | (34,534)                |
| Recoveries   | 2,769                   | 82,919                                 | 429,679               | -                   | -                    | -                           | -                                   | 515,367                 |
| Provision for loan losses  | (450,239)               | 477,531                                | (111,630)             | (75,315)            | (41,802)             | 92,755                      | (96,067)                            | (204,767)               |
| Other  | 1,038                   | (17,078)                               | (19,414)              | 1,462               | 14,002               | (27,570)                    | 396                                 | (47,164)                |
| Balance at   |                         |  |                       |                     |                      |                             |                                     |                         |
| December 31, 2016  | <u>\$ 5,403,950</u>     | <u>\$ 843,032</u>                      | <u>\$ 584,077</u>     | <u>\$ 14,320</u>    | <u>\$ 66,634</u>     | <u>\$ 71,447</u>            | <u>\$ 62,863</u>                    | <u>\$ 7,046,323</u>     |
| Ending Balance:<br>individually evaluated for<br>impairment              | \$ 21,683               | \$ 327,955                             | \$ -                  | \$ -                | \$ -                 | \$ -                        | \$ -                                | \$ 349,638              |
| Ending Balance:<br>collectively evaluated for<br>impairment              | <u>\$ 5,382,267</u>     | <u>\$ 515,077</u>                      | <u>\$ 584,077</u>     | <u>\$ 14,320</u>    | <u>\$ 66,634</u>     | <u>\$ 71,447</u>            | <u>\$ 62,863</u>                    | <u>\$ 6,696,685</u>     |
| <b>Recorded Investment in Loans Outstanding:</b>                         |                         |  |                       |                     |                      |                             |                                     |                         |
| Ending Balance at  |                         |  |                       |                     |                      |                             |                                     |                         |
| December 31, 2016  | \$ 1,310,117,035        | \$ 130,995,352                         | \$ 146,265,438        | \$ 8,069,218        | \$ 45,468,243        | \$ 6,406,716                | \$ 15,105,012                       | \$ 1,662,427,014        |
| Ending balance for loans<br>individually evaluated for<br>impairment     | \$ 6,048,829            | \$ 2,107,540                           | \$ -                  | \$ -                | \$ -                 | \$ -                        | \$ 887,983                          | \$ 9,044,352            |
| Ending balance for loans<br>collectively evaluated for<br>impairment     | <u>\$ 1,303,847,248</u> | <u>\$ 128,878,036</u>                  | <u>\$ 146,265,438</u> | <u>\$ 8,069,218</u> | <u>\$ 45,468,243</u> | <u>\$ 6,406,716</u>         | <u>\$ 14,217,029</u>                | <u>\$ 1,653,151,928</u> |
| Ending balance for loans<br>acquired with deteriorated<br>credit quality | \$ 220,958              | \$ 9,776                               | \$ -                  | \$ -                | \$ -                 | \$ -                        | \$ -                                | \$ 230,734              |
|  | Real Estate<br>Mortgage | Production and<br>Intermediate<br>Term | Agribusiness          | Communication       | Energy               | Water and<br>Waste<br>Water | Rural<br>Residential<br>Real Estate | Total                   |
| <b>Allowance for Credit Losses:</b>                                      |                         |  |                       |                     |                      |                             |                                     |                         |
| Balance at   |                         |  |                       |                     |                      |                             |                                     |                         |
| December 31, 2014  | \$ 5,026,771            | \$ 218,384                             | \$ 164,934            | \$ 26,522           | \$ 95,258            | \$ 1,392                    | \$ 149,949                          | \$ 5,683,210            |
| Charge-offs  | (209,831)               | -                                      | -                     | -                   | -                    | -                           | -                                   | (209,831)               |
| Recoveries   | 66,085                  | 67,858                                 | 378,872               | -                   | -                    | -                           | 3,478                               | 516,293                 |
| Provision for loan losses  | 1,001,327               | (40,252)                               | (286,423)             | 59,587              | (23,531)             | 5,997                       | 5,503                               | 722,208                 |
| Other  | 564                     | 53,670                                 | 28,059                | 2,064               | 22,707               | (1,127)                     | (396)                               | 105,541                 |
| Balance at   |                         |  |                       |                     |                      |                             |                                     |                         |
| December 31, 2015  | <u>\$ 5,884,916</u>     | <u>\$ 299,660</u>                      | <u>\$ 285,442</u>     | <u>\$ 88,173</u>    | <u>\$ 94,434</u>     | <u>\$ 6,262</u>             | <u>\$ 158,534</u>                   | <u>\$ 6,817,421</u>     |
| Ending Balance:<br>individually evaluated for<br>impairment              | \$ 40,866               | \$ -                                   | \$ -                  | \$ -                | \$ -                 | \$ -                        | \$ -                                | \$ 40,866               |
| Ending Balance:<br>collectively evaluated for<br>impairment              | <u>\$ 5,844,050</u>     | <u>\$ 299,660</u>                      | <u>\$ 285,442</u>     | <u>\$ 88,173</u>    | <u>\$ 94,434</u>     | <u>\$ 6,262</u>             | <u>\$ 158,534</u>                   | <u>\$ 6,776,555</u>     |
| <b>Recorded Investment in Loans Outstanding:</b>                         |                         |  |                       |                     |                      |                             |                                     |                         |
| Ending Balance at  |                         |  |                       |                     |                      |                             |                                     |                         |
| December 31, 2015  | \$ 1,211,288,949        | \$ 128,577,925                         | \$ 137,650,695        | \$ 5,628,201        | \$ 52,990,544        | \$ 5,509,822                | \$ 19,917,820                       | \$ 1,561,563,956        |
| Ending balance for loans<br>individually evaluated for<br>impairment     | \$ 5,992,251            | \$ 9,415                               | \$ -                  | \$ -                | \$ -                 | \$ -                        | \$ 151,752                          | \$ 6,153,418            |
| Ending balance for loans<br>collectively evaluated for<br>impairment     | <u>\$ 1,205,040,394</u> | <u>\$ 128,551,720</u>                  | <u>\$ 137,650,695</u> | <u>\$ 5,628,201</u> | <u>\$ 52,990,544</u> | <u>\$ 5,509,822</u>         | <u>\$ 19,766,068</u>                | <u>\$ 1,555,137,444</u> |
| Ending balance for loans<br>acquired with deteriorated<br>credit quality | \$ 256,304              | \$ 16,790                              | \$ -                  | \$ -                | \$ -                 | \$ -                        | \$ -                                | \$ 273,094              |

|  | Real Estate<br>Mortgage | Production and<br>Intermediate<br>Term | Agribusiness         | Communication       | Energy              | Water and<br>Waste<br>Water | Rural<br>Residential<br>Real Estate | Total                  |
|--|-------------------------|--|----------------------|---------------------|---------------------|-----------------------------|-------------------------------------|------------------------|
| <b>Allowance for Credit Losses:</b>              |                         |  |                      |                     |                     |                             |                                     |                        |
| Balance at                                       |                         |  |                      |                     |                     |                             |                                     |                        |
| December 31, 2013                                | \$ 6,234,650            | \$ 134,781                             | \$ 299,381           | \$ (36,789)         | \$ 185,444          | \$ 679                      | \$ 61,677                           | \$ 6,879,823           |
| Charge-offs                                      | (66,649)                | (62,549)                               | (24,196)             | -                   | (112)               | -                           | (7,028)                             | (160,534)              |
| Recoveries                                       | 3,282                   | 106,938                                | 200,357              | -                   | 8,209               | -                           | 5                                   | 318,791                |
| Provision for loan losses                        | (1,135,735)             | 137,202                                | (197,627)            | 75,877              | (58,613)            | 3,902                       | 95,295                              | (1,079,699)            |
| Other  | (8,777)                 | (97,988)                               | (112,981)            | (12,566)            | (39,670)            | (3,189)                     | -                                   | (275,171)              |
| Balance at                                       |                         |  |                      |                     |                     |                             |                                     |                        |
| December 31, 2014                                | <u>\$ 5,026,771</u>     | <u>\$ 218,384</u>                      | <u>\$ 164,934</u>    | <u>\$ 26,522</u>    | <u>\$ 95,258</u>    | <u>\$ 1,392</u>             | <u>\$ 149,949</u>                   | <u>\$ 5,683,210</u>    |
| Ending Balance:                                  |                         |  |                      |                     |                     |                             |                                     |                        |
| individually evaluated for                       |                         |  |                      |                     |                     |                             |                                     |                        |
| impairment                                       | <u>\$ 1,244,435</u>     | <u>\$ 29,177</u>                       | <u>\$ -</u>          | <u>\$ -</u>         | <u>\$ -</u>         | <u>\$ -</u>                 | <u>\$ -</u>                         | <u>\$ 1,273,612</u>    |
| Ending Balance:                                  |                         |  |                      |                     |                     |                             |                                     |                        |
| collectively evaluated for                       |                         |  |                      |                     |                     |                             |                                     |                        |
| impairment                                       | <u>\$ 3,769,111</u>     | <u>\$ 164,729</u>                      | <u>\$ 164,934</u>    | <u>\$ 26,522</u>    | <u>\$ 95,258</u>    | <u>\$ 1,392</u>             | <u>\$ 149,949</u>                   | <u>\$ 4,371,895</u>    |
| Ending Balance: loans                            |                         |  |                      |                     |                     |                             |                                     |                        |
| acquired with deteriorated                       |                         |  |                      |                     |                     |                             |                                     |                        |
| credit quality                                   | <u>\$ 13,225</u>        | <u>\$ 24,478</u>                       | <u>\$ -</u>          | <u>\$ -</u>         | <u>\$ -</u>         | <u>\$ -</u>                 | <u>\$ -</u>                         | <u>\$ 37,703</u>       |
| <b>Recorded Investment in Loans Outstanding:</b> |                         |  |                      |                     |                     |                             |                                     |                        |
| Ending Balance at                                |                         |  |                      |                     |                     |                             |                                     |                        |
| December 31, 2014                                | <u>\$ 1,133,018,895</u> | <u>\$ 115,350,150</u>                  | <u>\$ 76,011,268</u> | <u>\$ 4,973,124</u> | <u>\$56,004,154</u> | <u>\$ 1,587,476</u>         | <u>\$ 20,591,943</u>                | <u>\$1,407,537,010</u> |
| Ending balance for loans                         |                         |  |                      |                     |                     |                             |                                     |                        |
| individually evaluated for                       |                         |  |                      |                     |                     |                             |                                     |                        |
| impairment                                       | <u>\$ 8,827,266</u>     | <u>\$ 466,991</u>                      | <u>\$ 20,957</u>     | <u>\$ -</u>         | <u>\$ -</u>         | <u>\$ -</u>                 | <u>\$ 205,564</u>                   | <u>\$ 9,520,778</u>    |
| Ending balance for loans                         |                         |  |                      |                     |                     |                             |                                     |                        |
| collectively evaluated for                       |                         |  |                      |                     |                     |                             |                                     |                        |
| impairment                                       | <u>\$ 1,123,321,704</u> | <u>\$ 114,842,024</u>                  | <u>\$ 75,990,311</u> | <u>\$ 4,973,124</u> | <u>\$56,004,154</u> | <u>\$ 1,587,476</u>         | <u>\$ 20,386,379</u>                | <u>\$1,397,105,172</u> |
| Ending balance for loans                         |                         |  |                      |                     |                     |                             |                                     |                        |
| acquired with deteriorated                       |                         |  |                      |                     |                     |                             |                                     |                        |
| credit quality                                   | <u>\$ 869,925</u>       | <u>\$ 41,135</u>                       | <u>\$ -</u>          | <u>\$ -</u>         | <u>\$ -</u>         | <u>\$ -</u>                 | <u>\$ -</u>                         | <u>\$ 911,060</u>      |

## NOTE 5 — INVESTMENT IN THE FARM CREDIT BANK OF TEXAS

The association operates under a general financing agreement (GFA) with the bank. The current GFA is effective through September 30, 2018. The investment in the Farm Credit Bank of Texas is a requirement of borrowing from the bank and is carried at cost plus allocated equities, not fair value, in the accompanying balance sheet. Estimating the fair value of the association's investment in the Farm Credit Bank of Texas is not practicable because the stock is not traded. The association owns 9.15 percent of the issued stock of the bank as of December 31, 2016. As of that date, the bank's assets totaled \$21.2 billion and members' equity totaled \$1.6 billion. The bank's earnings were \$192.4 million during 2016.

## NOTE 6 — PREMISES AND EQUIPMENT:

Premises and equipment consisted of the following at December 31:

|                                 | 2016                | 2015         | 2014         |
|---------------------------------|---------------------|--------------|--------------|
| Land and improvements           | <u>\$ 564,498</u>   | \$ 564,498   | \$ 564,498   |
| Building and improvements       | <u>2,988,283</u>    | 2,860,167    | 2,845,878    |
| Furniture and equipment         | <u>422,231</u>      | 441,972      | 494,771      |
| Computer equipment and software | <u>741,465</u>      | 580,251      | 536,730      |
| Automobiles                     | <u>1,216,796</u>    | 1,162,135    | 1,174,642    |
|                                 | <u>5,933,273</u>    | 5,609,023    | 5,616,519    |
| Accumulated depreciation        | <u>(2,772,915)</u>  | (2,526,790)  | (2,328,623)  |
| Total                           | <u>\$ 3,160,358</u> | \$ 3,082,233 | \$ 3,287,896 |

The association leases office space in Fort Worth, Sherman, Abilene, Weatherford, Temple and Round Rock. Lease expense was \$521,035, \$520,030 and \$470,032 for 2016, 2015 and 2014, respectively. Minimum annual lease payments for the next five years are as follows:

|            | <u>Operating</u>           |
|------------|----------------------------|
| 2017       | \$ 469,276                 |
| 2018       | 421,994                    |
| 2019       | 277,396                    |
| 2020       | 268,184                    |
| 2021       | 138,253                    |
| Thereafter | -                          |
| Total      | <u><u>\$ 1,575,103</u></u> |

**NOTE 7 — OTHER PROPERTY OWNED, NET:**

Net gain (loss) on other property owned, net consists of the following for the years ended December 31:

|   | <u>2016</u>             | <u>2015</u>              | <u>2014</u>              |
|---|-------------------------|--------------------------|--------------------------|
| Gain (loss) on sale, net                | \$ 77,026               | \$ 169,146               | \$ 728,325               |
| Operating income (expense), net         | (846)                   | (42,200)                 | (28,117)                 |
| Net gain (loss) on other property owned | <u><u>\$ 76,180</u></u> | <u><u>\$ 126,946</u></u> | <u><u>\$ 700,208</u></u> |

**NOTE 8 — OTHER ASSETS AND OTHER LIABILITIES:**

Other assets comprised the following at December 31:

|  | <u>2016</u>              | <u>2015</u>              | <u>2014</u>              |
|--|--------------------------|--------------------------|--------------------------|
| Accounts receivable (other than members) - Other | \$ 737,373               | \$ 710,407               | \$ 653,333               |
| Other assets - Other                             | 151,775                  | 114,423                  | 211,662                  |
| Total  | <u><u>\$ 889,148</u></u> | <u><u>\$ 824,830</u></u> | <u><u>\$ 864,995</u></u> |

Other liabilities comprised the following at December 31:

|  | <u>2016</u>                 | <u>2015</u>                 | <u>2014</u>                 |
|--|-----------------------------|-----------------------------|-----------------------------|
| Accounts payable - Total                 | \$ 6,763,089                | \$ 5,380,423                | \$ 5,888,044                |
| Accumulated postretirement obligation    | 4,754,167                   | 4,573,751                   | 4,890,426                   |
| Funds held/advanced conditional payments | 64,684                      | 8,773                       | 31,521                      |
| Other liabilities                        | 1,016,382                   | 1,000,519                   | 897,015                     |
| Total                                    | <u><u>\$ 12,598,322</u></u> | <u><u>\$ 10,963,466</u></u> | <u><u>\$ 11,707,006</u></u> |

## **NOTE 9 — NOTE PAYABLE TO THE BANK:**

The interest rate risk inherent in the association's loan portfolio is substantially mitigated through the funding relationship with the bank. The bank manages interest rate risk through its direct loan pricing and asset/liability management process. The association's indebtedness to the bank represents borrowings by the association to fund the majority of its loan portfolio. The indebtedness is collateralized by a pledge of substantially all of the association's assets, and is governed by a general financing agreement. The interest rate on the direct loan is based upon the bank's cost of funding the loans the association has outstanding to its borrowers. The indebtedness continues in effect until the expiration date of the general financing agreement, which is September 30, 2018, unless sooner terminated by the bank upon the occurrence of an event of default, or by the association, in the event of a breach of this agreement by the bank, upon giving the bank 30 calendar days' prior written notice, or in all other circumstances, upon giving the bank 120 days' prior written notice.

The total amount and the weighted average interest rate of the association's direct loan from the bank at December 31, 2016, 2015 and 2014, was \$1,320,377,658 at 2.03 percent, \$1,229,343,523 at 1.90 percent and \$1,087,039,175 at 1.85 percent, respectively.

Under the Act, the association is obligated to borrow only from the bank unless the bank approves borrowing from other funding sources. The bank and FCA regulations have established limitations on the association's ability to borrow funds based on specified factors or formulas relating primarily to credit quality and financial condition. At December 31, 2016, 2015 and 2014, the association's note payable was within the specified limitations. The maximum amount the association may borrow from the bank as of December 31, 2016, was \$1,651,935,435, as defined by the general financing agreement.

In addition to borrowing limits, the financing agreement establishes certain covenants including limits on leases, investments, other debt, and dividend and patronage distributions; minimum standards for return on assets and for liquidity; and provisions for conducting business, maintaining records, reporting financial information, and establishing policies and procedures. Remedies specified in the general financing agreement associated with the covenants include additional reporting requirements, development of action plans, increases in interest rates on indebtedness, reduction of lending limits or repayment of indebtedness. As of and for the years ended December 31, 2016, 2015 and 2014, the association was not subject to remedies associated with the covenants in the general financing agreement.

## **NOTE 10 — MEMBERS' EQUITY:**

A description of the association's capitalization requirements, protection mechanisms, regulatory capitalization requirements and restrictions, and equities are provided below.

Protection of certain borrower equity is provided under the Act that requires the association, when retiring protected borrower equity, to retire such equity at par or stated value regardless of its book value. Protected borrower equity includes capital stock, participation certificates and allocated equities that were outstanding as of January 6, 1988, or were issued or allocated prior to October 6, 1988. If an association is unable to retire protected borrower equity at par value or stated value, amounts required to retire this equity would be obtained from the Insurance Fund.

In accordance with the Act and the association's capitalization bylaws, each borrower is required to invest in the association as a condition of borrowing. The investment in Class B capital stock (for farm loans), or participation certificates (for rural home loans) is equal to 2 percent of the loan amount, up to a maximum amount of \$1,000. The borrower acquires ownership of the capital stock or participation certificates at the time the loan is made, usually by adding the aggregate par value of the capital stock or participation certificates to the principal amount of the related loan obligation. The capital stock or participation certificates are subject to a first lien by the association. Retirement of such equities will generally be at the lower of par or book value, and repayment of a loan does not automatically result in retirement of the corresponding capital stock or participation certificates.

If needed to meet regulatory capital adequacy requirements, the board of directors of the association may increase the percentage of stock requirement for each borrower up to a maximum of 10 percent of the loan amount.

Each owner of Class B capital stock is entitled to a single vote, while participation certificates provide no voting rights to their owners.

Within two years of repayment of a loan, the association capital bylaws require the conversion of any borrower's outstanding Class B to Class A stock. Class A stock has no voting rights except in a case where a new issuance of preferred stock has been submitted to stockholders affected by the preference. Redemption of Class A shares is made solely at the discretion of the association's board of directors. At December 31, 2016, 2015 and 2014, the association had no Class A stock.

All borrower stock is at-risk. As such, losses that result in impairment of capital stock or participation certificates shall be borne on a pro rata basis by all holders of Class A capital stock, Class B capital stock and participation certificates. In the event of liquidation of the association, capital stock and participation certificates would be utilized as necessary to satisfy any remaining obligations in excess of the amounts realized on the sale or liquidation of assets. Any excess of the amounts realized on the sale or liquidation of assets over the association's obligations to external parties and to the bank would be distributed to the association's stockholders.

Dividends and patronage distributions may be paid on the capital stock and participation certificates of the association, as the board of directors may determine by resolution, subject to capitalization requirements as defined by the FCA. Amounts not distributed are retained as unallocated retained earnings. The following dividends and patronage distributions were declared and paid in 2016, 2015 and 2014, respectively:

| <u>Date Declared</u> | <u>Date Paid (to be Paid)</u> | <u>Patronage</u>     |
|----------------------|-------------------------------|----------------------|
| <b>December 2016</b> | <b>March 2017</b>             | <b>\$ 13,824,603</b> |
| <b>October 2016</b>  | <b>November 2016</b>          | <b>\$ 3,000,029</b>  |
| December 2015        | March 2016                    | \$ 12,923,433        |
| October 2015         | November 2015                 | \$ 4,115,377         |
| December 2014        | April 2015                    | \$ 12,105,352        |
| October 2014         | December 2014                 | \$ 4,495,338         |

As a result of the merger, the association recognized \$91,343,553 in additional paid-in capital (APIC). The APIC represents the excess value received over the par value of capital stock and participation certificates issued and arose from the issuance of the association's capital stock and participation certificates in connection with the acquisition of Texas Land Bank, ACA.

The FCA's capital adequacy regulations require the association to achieve permanent capital and total surplus of at least 7.0 percent and core surplus of at least 3.5 percent of risk-adjusted assets and off-balance-sheet commitments. Failure to meet the ratio requirements can initiate certain mandatory and possibly additional discretionary actions by the FCA that, if undertaken, could have a direct material effect on the association's financial statements. The association is prohibited from reducing permanent capital by retiring stock or making certain other distributions to stockholders unless prescribed capital standards are met. As of December 31, 2016, the association is not prohibited from retiring stock or distributing earnings. The association's permanent capital ratio, core surplus ratio and total surplus ratio at December 31, 2016, were 18.9 percent, 18.3 percent and 18.5 percent, respectively.

The association Capital Adequacy Plan directs association management to manage the capital position in a manner which:

- Permits the association to operate profitably over the long term;
- Provides reasonable protection against risks inherent in association operations;
- Meets all regulatory requirements;
- Recognizes the cost to stockholders related to investing capital in the association; and
- Is an integral part of the association's business plan.

An FCA regulation empowers the FCA to direct a transfer of funds or equities by one or more System institutions to another System institution under specified circumstances. The association has not been called upon to initiate any transfers and is not aware of any proposed action under this regulation.

At December 31, the association had the following shares of Class A capital stock, Class B stock and participation certificates outstanding at a par value of \$5 per share:

|                            | <u>2016</u>             | <u>2015</u>             | <u>2014</u>             |
|----------------------------|-------------------------|-------------------------|-------------------------|
| Class B stock              | <u>1,230,121</u>        | <u>1,206,129</u>        | <u>1,204,867</u>        |
| Participation certificates | <u>56,240</u>           | <u>61,695</u>           | <u>68,443</u>           |
| Total                      | <u><u>1,286,361</u></u> | <u><u>1,267,824</u></u> | <u><u>1,273,310</u></u> |

An additional component of equity is accumulated other comprehensive income (AOCI), which is reported net of taxes. As of December 31, 2016, 2015 and 2014, the balance of AOCI represented net actuarial gains and prior service credits related to other postretirement benefits of (\$833,008), (\$820,747) and (\$1,335,657), respectively.

**NOTE 11 — INCOME TAXES:**

The provision for (benefit from) income taxes follows for the years ended December 31:

|   | <u>2016</u>    | <u>2015</u>      | <u>2014</u>        |
|---|----------------|------------------|--------------------|
| Current:  |                |                  |                    |
| Federal   | \$ -           | \$ -             | \$ -               |
| Total current                                   | <u>-</u>       | <u>-</u>         | <u>-</u>           |
| Deferred:                                       |                |                  |                    |
| Federal   | (24)           | 45,335           | (53,606)           |
| Total deferred                                  | <u>(24)</u>    | <u>45,335</u>    | <u>(53,606)</u>    |
| Total provision for (benefit from) income taxes | <u>\$ (24)</u> | <u>\$ 45,335</u> | <u>\$ (53,606)</u> |

The provision for (benefit from) income tax differs from the amount of income tax determined by applying the applicable U.S. statutory federal income tax rate to pretax income as follows for the years ended December 31:

|   | <u>2016</u>    | <u>2015</u>      | <u>2014</u>        |
|---|----------------|------------------|--------------------|
| Federal tax at statutory rate             | \$ 9,391,411   | \$ 9,665,863     | \$ 9,459,719       |
| Effect of nontaxable FLCA subsidiary      | (9,949,933)    | (9,796,467)      | (9,772,216)        |
| Change in valuation allowance             | 538,460        | 172,207          | 249,963            |
| Other                                     | 20,038         | 3,732            | 8,928              |
| Provision for (benefit from) income taxes | <u>\$ (24)</u> | <u>\$ 45,335</u> | <u>\$ (53,606)</u> |

Deferred tax assets and liabilities in accordance with accounting guidance, “Accounting for Income Taxes,” are comprised of the following at December 31:

|  | <u>2016</u>         | <u>2015</u>         | <u>2014</u>         |
|--|---------------------|---------------------|---------------------|
| <u>Deferred Tax Assets</u>             |                     |                     |                     |
| Allowance for loan losses              | \$ 211,889          | \$ 60,110           | \$ 59,598           |
| Loss carryforwards                     | 14,325,430          | 13,934,670          | 13,762,975          |
| Other                                  | -                   | 4,079               | 4,079               |
| Gross deferred tax assets              | <u>14,537,319</u>   | <u>13,998,859</u>   | <u>13,826,652</u>   |
| Deferred tax asset valuation allowance | <u>(14,537,319)</u> | <u>(13,998,859)</u> | <u>(13,826,652)</u> |
| <u>Deferred Tax Liabilities</u>        |                     |                     |                     |
| Other                                  | (89,556)            | (89,580)            | (44,245)            |
| Gross deferred tax liabilities         | <u>(89,556)</u>     | <u>(89,580)</u>     | <u>(44,245)</u>     |
| Net deferred tax asset (liability)     | <u>\$ (89,556)</u>  | <u>\$ (89,580)</u>  | <u>\$ (44,245)</u>  |

The association recorded valuation allowances of \$14,537,319, \$13,998,859 and \$13,826,652 during 2016, 2015 and 2014, respectively. The association will continue to evaluate the realizability of the deferred tax assets and adjust the valuation allowance accordingly.

**NOTE 12 — EMPLOYEE BENEFIT PLANS:**

**Employee Retirement Plans:** Employees of the association participate in either the defined benefit retirement plan (DB plan) or the defined contributions plan (DC plan) and are eligible to participate in the Farm Credit Benefits Alliance 401(k) Plan. These plans are described more fully in section I of Note 2, “Summary of Significant Accounting Policies.” The structure of the district’s DB plan is characterized as multi-employer, since neither the assets, liabilities nor cost of any plan is segregated or separately accounted for by participating employers (bank and associations). No portion of any surplus assets is available to any participating employer. As a result, participating employers of the plan only recognize as cost the required contributions for the period and a liability for any unpaid contributions required for the period of their financial statements. Plan obligations, assets and the components of annual benefit expenses are recorded and reported upon district combination only. The association records current contributions to the DB plan as an expense in the current year.

The CEO and certain executive or highly-compensated employees in the association are eligible to participate in a separate nonqualified supplemental 401(k) plan, named the Farm Credit Benefits Alliance Nonqualified Supplemental 401(k) Plan (supplemental 401(k) plan). This plan allows district employers to elect to participate in any or all of the following benefits:

- Restored Employer Contributions – to allow “make-up” contributions for eligible employees whose benefits to the qualified 401(k) plan were limited by the Internal Revenue Code during the year
- Elective Deferrals – to allow eligible employees to make pre-tax deferrals of compensation above and beyond any deferrals into the qualified 401(k) plan
- Discretionary Contributions – to allow participating employers to make a discretionary contribution to an eligible employee’s account in the plan, and to designate a vesting schedule

The association elected to participate in Restored Employer Contributions of \$32,943, \$3,151 and \$20,609 for the years ended December 31, 2016, 2015 and 2014. There were no payments made from the supplemental 401(k) plan to active employees during 2016, 2015 or 2014.

The DB plan is noncontributory and benefits are based on salary and years of service. The legal name of the plan is Farm Credit Bank of Texas Pension Plan; its employer identification number is 74-1110170. The DB plan is not subject to any contractual expiration dates. The DB plan’s funding policy is to fund current year benefits expected to be earned by covered employees plus an amount to improve the accumulated benefit obligation funded status by a percentage approved by the plan sponsor. The plan sponsor is the board of the Farm Credit Bank of Texas. The “projected unit credit” actuarial method is used for both financial reporting and funding purposes. District employers have the option of providing enhanced retirement benefits, under certain conditions, within the DB plan, to facilitate reorganization and/or restructuring. Actuarial information regarding the DB pension plan accumulated benefit obligation and plan asset is calculated for the district as a whole and is presented in the district’s Annual Report to Stockholders. The actuarial present value of vested and nonvested accumulated benefit obligation exceeded the net assets of the DB plan as of December 31, 2016.

The risks of participating in these multi-employer plans are different from single-employer plans in the following aspects:

- a. Assets contributed to the multi-employer plan by one employer may be used to provide benefits to employees of other participating employers.
- b. If a participating employer stops contributing to the plan, the unfunded obligations of the plan may be borne by the remaining participating employers.
- c. If the association chooses to stop participating in some of its multi-employer plans, it may be required to pay the plan an amount based on the underfunded status of the plan, referred to as a withdrawal liability.

The following table includes additional information regarding the funded status of the plan, the association’s contributions, and the percentage of association contribution to total plan contributions for the years ended December 31, 2016, 2015 and 2014:

|   | <u>2016</u>       | <u>2015</u> | <u>2014</u> |
|---|-------------------|-------------|-------------|
| Funded status of plan   | <b>66.4 %</b>     | 66.8 %      | 67.5 %      |
| Association's contribution                                      | <b>\$ 625,890</b> | \$ 573,340  | \$ 842,447  |
| Percentage of association's contribution to total contributions | <b>5.3 %</b>      | 5.4 %       | 6.9 %       |

The funded status presented above is based on the percentage of plan assets to projected benefit obligations. DB plan funding is based on the percentage of plan assets to the accumulated benefit obligation, which was 70.6 percent, 72.5 percent and 74.5 percent at December 31, 2016, 2015 and 2014, respectively.

**Other Postretirement Benefits:** In addition to pension benefits, the association provides certain health care benefits to qualifying retired employees (other postretirement benefits). These benefits are not characterized as multi-employer and, consequently, the liability for these benefits is included in other liabilities.

The following table reflects the benefit obligation, cost and actuarial assumptions for the association's other postretirement benefits:  
**Retiree Welfare Benefit Plans**

| <b>Disclosure Information Related to Retirement Benefits</b>                  | <b>2016</b>    | <b>2015</b>    | <b>2014</b>    |
|---|----------------|----------------|----------------|
| <b>Change in Accumulated Postretirement Benefit Obligation</b>                |                |                |                |
| Accumulated postretirement benefit obligation, beginning of year              | \$ 4,573,751   | \$ 4,908,282   | \$ 3,902,872   |
| Service cost  | 77,737         | 94,952         | 78,201         |
| Interest cost   | 211,483        | 219,583        | 198,997        |
| Plan participants' contributions  | 45,003         | 51,112         | 46,481         |
| Plan amendments   | -              | -              | -              |
| Special termination benefits  | -              | -              | -              |
| Actuarial loss (gain)   | 26,203         | (477,482)      | 891,447        |
| Benefits paid   | (180,010)      | (222,696)      | (209,716)      |
| Accumulated postretirement benefit obligation, end of year                    | \$ 4,754,167   | \$ 4,573,751   | \$ 4,908,282   |
| <b>Change in Plan Assets</b>  |                |                |                |
| Plan assets at fair value, beginning of year                                  | \$ -           | \$ -           | \$ -           |
| Actual return on plan assets  | -              | -              | -              |
| Company contributions   | 135,007        | 171,584        | 163,235        |
| Plan participants' contributions  | 45,003         | 51,112         | 46,481         |
| Benefits paid   | (180,010)      | (222,696)      | (209,716)      |
| Plan assets at fair value, end of year  | \$ -           | \$ -           | \$ -           |
| Funded status of the plan   | \$ (4,754,167) | \$ (4,573,751) | \$ (4,908,282) |
| <b>Amounts Recognized in Statement of Financial Position</b>                  |                |                |                |
| Other liabilities   | \$ (4,754,167) | \$ (4,573,751) | \$ (4,908,282) |
| <b>Amounts Recognized in Accumulated Other Comprehensive Income</b>           |                |                |                |
| Net actuarial loss (gain)   | \$ 893,834     | \$ 916,333     | \$ 1,495,958   |
| Prior service cost (credit)   | (60,826)       | (95,586)       | (160,301)      |
| Net transition obligation (asset)   | -              | -              | -              |
| Total   | \$ 833,008     | \$ 820,747     | \$ 1,335,657   |
| <b>Weighted-Average Assumptions Used to Determine Obligations at Year End</b> |                |                |                |
| Measurement date  | 12/31/2016     | 12/31/2015     | 12/31/2014     |
| Discount rate   | 4.60%          | 4.70%          | 4.55%          |
| Health care cost trend rate assumed for next year (pre-/post-65) - medical    | 6.75%/6.50%    | 7.00%/6.50%    | 7.25%/6.75%    |
| Health care cost trend rate assumed for next year - Rx                        | 6.50%          | 6.50%          | 6.75%          |
| Ultimate health care cost trend rate  | 4.50%          | 4.50%          | 5.00%          |
| Year that the rate reaches the ultimate trend rate                            | 2025           | 2025           | 2024           |

| <b>Total Cost</b>  | <b>2016</b> | <b>2015</b> | <b>2014</b> |
|--|-------------|-------------|-------------|
| Service cost   | \$ 77,737   | \$ 94,952   | \$ 78,201   |
| Interest cost  | 211,483     | 219,583     | 198,997     |
| Expected return on plan assets                                       | -           | -           | -           |
| Amortization of:   |             |             |             |
| Unrecognized net transition obligation (asset)                       | -           | -           | -           |
| Unrecognized prior service cost                                      | (34,757)    | (64,718)    | (121,736)   |
| Unrecognized net loss (gain)   | 48,702      | 102,143     | 42,190      |
| Net postretirement benefit cost                                      | \$ 303,165  | \$ 351,960  | \$ 197,652  |
| Accounting for settlements/curtailments/special termination benefits | \$ -        | \$ -        | \$ -        |

**Other Changes in Plan Assets and Projected Benefit Obligation Recognized in Other Comprehensive Income**

|  |           |              |            |
|--|-----------|--------------|------------|
| Net actuarial loss (gain)                      | \$ 26,203 | \$ (477,482) | \$ 891,447 |
| Amortization of net actuarial loss (gain)      | (48,702)  | (102,143)    | (42,190)   |
| Prior service cost (credit)                    | -         | -            | -          |
| Amortization of prior service cost             | 34,757    | 64,715       | 121,736    |
| Recognition of prior service cost              | -         | -            | -          |
| Amortization of transition liability (asset)   | -         | -            | -          |
| Total recognized in other comprehensive income | \$ 12,258 | \$ (514,910) | \$ 970,993 |

**AOCI Amounts Expected to be Amortized Into Expense in 2015**

|  |          |           |           |
|--|----------|-----------|-----------|
| Unrecognized net transition obligation (asset) | \$ -     | \$ -      | \$ -      |
| Unrecognized prior service cost                | (34,757) | (34,757)  | (64,718)  |
| Unrecognized net loss (gain)                   | 42,971   | 48,702    | 102,143   |
| Total  | \$ 8,214 | \$ 13,945 | \$ 37,425 |

**Weighted-Average Assumptions Used to Determine Benefit Cost**

|  | <b>12/31/2015</b> | <b>12/31/2014</b> | <b>12/31/2013</b> |
|--|-------------------|-------------------|-------------------|
| Measurement date   |                   |                   |                   |
| Discount rate  | 4.70%             | 4.55%             | 5.20%             |
| Health care cost trend rate assumed for next year (pre-/post-65) - medical | 7.00%/6.50%       | 7.25%/6.75%       | 7.50%/6.50%       |
| Health care cost trend rate assumed for next year - Rx                     | 6.50%             | 6.75%             | 6.50%             |
| Ultimate health care cost trend rate                                       | 4.50%             | 5.00%             | 5.00%             |
| Year that the rate reaches the ultimate trend rate                         | 2025              | 2024              | 2024              |

**Expected Future Cash Flows**

**Expected Benefit Payments (net of employee contributions)**

|                  |            |            |            |
|------------------|------------|------------|------------|
| Fiscal 2017      | \$ 150,165 | \$ 165,693 | \$ 184,851 |
| Fiscal 2018      | 165,988    | 179,158    | 197,540    |
| Fiscal 2019      | 197,922    | 210,992    | 228,672    |
| Fiscal 2020      | 207,895    | 218,227    | 1,220,950  |
| Fiscal 2021–2025 | 212,833    | 1,146,253  | -          |
| Fiscal 2022–2026 | 1,121,030  | -          | -          |

**Expected Contributions**

|             |            |            |            |
|-------------|------------|------------|------------|
| Fiscal 2017 | \$ 150,165 | \$ 165,693 | \$ 184,851 |
|-------------|------------|------------|------------|

**NOTE 13 — RELATED PARTY TRANSACTIONS:**

Directors of the association, except for any director-elected directors, are required to be borrowers/stockholders of the association. Also, in the ordinary course of business, the association may enter into loan origination or servicing transactions with its officers, relatives of officers and directors, or with organizations with which such persons are associated. Such loans are subject to special approval requirements contained in FCA regulations and are made on the same terms, including interest rates, amortization schedule and collateral, as those prevailing at the time for comparable transactions with unrelated borrowers.

Total loans to such persons for the association amounted to \$24,321,661, \$24,393,596 and \$26,285,874 at December 31, 2016, 2015 and 2014, respectively. During 2016, \$30,883,642 of new loans were made, and repayments totaled \$30,955,577. In the opinion of management, no such loans outstanding at December 31, 2016, 2015 and 2014 involved more than a normal risk of collectability.

Expenses included in purchased services may include purchased services such as administrative services, marketing, information systems and accounting services and allocations of expenses incurred by the bank and passed through to the associations, such as FCSIC expenses. The bank charges the individual associations directly for these services based on each association's proportionate usage. These expenses totaled \$115,502, \$221,979 and \$185,550 in 2016, 2015 and 2014, respectively.

The association received patronage payments from the bank totaling \$6,151,906, \$5,724,417 and \$5,656,782 during 2016, 2015 and 2014, respectively. Of the \$6,151,906 patronage received for 2016, \$315,464, or 5.1 percent, represented income that would have been earned based on the AMBS investment discussed in Note 3 – Investment Securities.

**NOTE 14 — 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 an orderly transaction between market participants in the principal or most advantageous market for the asset or liability. See Note 2, "Summary of Significant Accounting Policies," for additional information.

|                                    | <u>Valuation Technique(s)</u> | <u>Input</u>  |
|------------------------------------|-------------------------------|---|
| Cash                               | Carrying value                | Par/principal and appropriate interest yield                    |
| Loans                              | Discounted cash flow          | Prepayment forecasts<br>Probability of default<br>Loss severity |
| Other interest bearing liabilities | Carrying value                | Par/principal and appropriate interest yield                    |

Assets and liabilities measured at fair value on a recurring basis at December 31, 2016, 2015 and 2014 only include nonqualified benefit trusts. This level 1 asset was \$134,688, \$98,115 and \$188,971 at December 31, 2016, 2015 and 2014, respectively.

Assets and liabilities measured at fair value on a nonrecurring basis for each of the fair value hierarchy values are summarized below:

| <b>December 31, 2016</b> | <u>Fair Value Measurement Using</u> |                |                | <u>Total Fair Value</u> |
|--------------------------|-------------------------------------|----------------|----------------|-------------------------|
|                          | <u>Level 1</u>                      | <u>Level 2</u> | <u>Level 3</u> |                         |
| Assets:                  |                                     |                |                |                         |
| Loans                    | \$ -                                | \$ -           | \$ 1,168,534   | \$ 1,168,534            |
| Other property owned     | -                                   | -              | -              | -                       |
| <b>December 31, 2015</b> | <u>Fair Value Measurement Using</u> |                |                | <u>Total Fair Value</u> |
|                          | <u>Level 1</u>                      | <u>Level 2</u> | <u>Level 3</u> |                         |
| Assets:                  |                                     |                |                |                         |
| Loans                    | \$ -                                | \$ -           | \$ 47,755      | \$ 47,755               |
| Other property owned     | -                                   | -              | 78,518         | 78,518                  |
| <b>December 31, 2014</b> | <u>Fair Value Measurement Using</u> |                |                | <u>Total Fair Value</u> |
|                          | <u>Level 1</u>                      | <u>Level 2</u> | <u>Level 3</u> |                         |
| Assets:                  |                                     |                |                |                         |
| Loans                    | \$ -                                | \$ -           | \$ 4,633,039   | \$ 4,633,039            |
| Other property owned     | -                                   | -              | 201,363        | 201,363                 |

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:

| <b>December 31, 2016</b>            |                                  |                  |                |                         |                         |
|-------------------------------------|----------------------------------|------------------|----------------|-------------------------|-------------------------|
| <b>Fair Value Measurement Using</b> |                                  |                  |                |                         |                         |
|                                     | <b>Total Carrying<br/>Amount</b> | <b>Level 1</b>   | <b>Level 2</b> | <b>Level 3</b>          | <b>Total Fair Value</b> |
| <b>Assets:</b>                      |                                  |                  |                |                         |                         |
| Cash                                | \$ 60,478                        | \$ 60,478        | \$ -           | \$ -                    | \$ 60,478               |
| Net loans                           | <u>1,644,951,451</u>             | <u>-</u>         | <u>-</u>       | <u>1,614,245,727</u>    | <u>1,614,245,727</u>    |
| Total Assets                        | <u>\$ 1,645,011,929</u>          | <u>\$ 60,478</u> | <u>\$ -</u>    | <u>\$ 1,614,245,727</u> | <u>\$ 1,614,306,205</u> |
| <b>Liabilities:</b>                 |                                  |                  |                |                         |                         |
| Note payable to bank                | \$ 1,320,377,658                 | \$ -             | \$ -           | \$ 1,295,730,638        | \$ 1,295,730,638        |

| <b>December 31, 2015</b>            |                                  |                  |                |                         |                         |
|-------------------------------------|----------------------------------|------------------|----------------|-------------------------|-------------------------|
| <b>Fair Value Measurement Using</b> |                                  |                  |                |                         |                         |
|                                     | <b>Total Carrying<br/>Amount</b> | <b>Level 1</b>   | <b>Level 2</b> | <b>Level 3</b>          | <b>Total Fair Value</b> |
| <b>Assets:</b>                      |                                  |                  |                |                         |                         |
| Cash                                | \$ 55,698                        | \$ 55,698        | \$ -           | \$ -                    | \$ 55,698               |
| Net loans                           | <u>1,546,276,500</u>             | <u>-</u>         | <u>-</u>       | <u>1,527,536,788</u>    | <u>1,527,536,788</u>    |
| Total Assets                        | <u>\$ 1,546,332,198</u>          | <u>\$ 55,698</u> | <u>\$ -</u>    | <u>\$ 1,527,536,788</u> | <u>\$ 1,527,592,486</u> |
| <b>Liabilities:</b>                 |                                  |                  |                |                         |                         |
| Note payable to bank                | \$ 1,229,343,523                 | \$ -             | \$ -           | \$ 1,214,444,801        | \$ 1,214,444,801        |

| <b>December 31, 2014</b>            |                                  |                  |                |                         |                         |
|-------------------------------------|----------------------------------|------------------|----------------|-------------------------|-------------------------|
| <b>Fair Value Measurement Using</b> |                                  |                  |                |                         |                         |
|                                     | <b>Total Carrying<br/>Amount</b> | <b>Level 1</b>   | <b>Level 2</b> | <b>Level 3</b>          | <b>Total Fair Value</b> |
| <b>Assets:</b>                      |                                  |                  |                |                         |                         |
| Cash                                | \$ 72,550                        | \$ 72,550        | \$ -           | \$ -                    | \$ 72,550               |
| Net loans                           | <u>1,389,991,778</u>             | <u>-</u>         | <u>-</u>       | <u>1,379,025,948</u>    | <u>1,379,025,948</u>    |
| Total Assets                        | <u>\$ 1,390,064,328</u>          | <u>\$ 72,550</u> | <u>\$ -</u>    | <u>\$ 1,379,025,948</u> | <u>\$ 1,379,098,498</u> |
| <b>Liabilities:</b>                 |                                  |                  |                |                         |                         |
| Note payable to bank                | \$ 1,087,039,175                 | \$ -             | \$ -           | \$ 1,078,463,378        | \$ 1,078,463,378        |

## Valuation Techniques

As more fully discussed in Note 2, "Summary of Significant Accounting Policies," 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. Fair values of financial instruments represent the estimated amount to be received to sell an asset or paid to transfer or extinguish a liability in active markets among willing participants at the reporting date. Due to the uncertainty of expected cash flows resulting from financial instruments, the use of different assumptions and valuation methodologies could significantly affect the estimated fair value amounts. Accordingly, certain of the estimated fair values may not be indicative of the amounts for which the financial instruments could be exchanged in a current or future market transaction. The following represent a brief summary of the valuation techniques used by the association for assets and liabilities:

### Investments

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 that utilize observable inputs, quoted prices for similar securities received from pricing services or discounted cash flows. Generally, these securities would be classified as Level 2. 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. Securities classified within Level 3 include asset-based securities and certain mortgage-backed securities, including private label-FHA/VA securities and those issued by Farmer Mac.

### *Assets Held in Nonqualified Benefits 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 approximate the fees currently charged for similar agreements or the estimated cost to terminate or otherwise settle similar obligations.

### *Loans*

For certain loans evaluated for impairment under impairment guidance, the fair value is based upon the underlying collateral since the loans are collateral-dependent loans for which real estate is the collateral. 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.

### *Other Property Owned*

Other property owned is generally classified as Level 3. The process for measuring the fair value of other property owned involves the use of 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.

## **NOTE 15 — COMMITMENTS AND CONTINGENCIES**

In addition to those commitments and contingencies discussed in Note 2, "Summary of Significant Accounting Policies," the association is involved in various legal proceedings in the ordinary course of business. In the opinion of legal counsel and management, there are no legal proceedings at this time that are likely to materially affect the association.

The association may participate in financial instruments with off-balance-sheet risk to satisfy the financing needs of its borrowers in the form of commitments to extend credit and commercial letters of credit. These financial instruments involve, to varying degrees, elements of credit risk in excess of the amount recognized in the financial statements. Commitments to extend credit are agreements to lend to a borrower as long as there is not a violation of any condition established in the contract. Commercial letters of credit are agreements to pay a beneficiary under conditions specified in the letter of credit. Commitments and letters of credit generally have fixed expiration dates or other termination clauses and may require payment of a fee. At December 31, 2016, the association had outstanding commitments of \$193,815,236 to extend credit.

Since many of these commitments are expected to expire without being drawn upon, the total commitments do not necessarily represent future cash requirements. However, these credit-related financial instruments have off-balance-sheet credit risk because their amounts are not reflected on the balance sheet until funded or drawn upon. The credit risk associated with issuing commitments and letters of credit is substantially the same as that involved in extending loans to borrowers, and management applies the same credit policies to these commitments. Upon fully funding a commitment, the credit risk amounts are equal to the contract amounts, assuming that borrowers fail completely to meet their obligations and the collateral or other security is of no value. The amount of collateral obtained, if deemed necessary upon extension of credit, is based on management's credit evaluation of the borrower.

**NOTE 16 — QUARTERLY FINANCIAL INFORMATION (UNAUDITED):**

Quarterly results of operations for the years ended December 31 (in thousands) follow:

|  | <b>2016</b>      |                  |                  |                  |                  |
|--|------------------|------------------|------------------|------------------|------------------|
|  | <b>First</b>     | <b>Second</b>    | <b>Third</b>     | <b>Fourth</b>    | <b>Total</b>     |
| <b>Net interest income</b>                     | <b>\$ 10,762</b> | <b>\$ 10,900</b> | <b>\$ 11,200</b> | <b>\$ 11,547</b> | <b>\$ 44,409</b> |
| <b>(Provision for) reversal of loan losses</b> | <b>202</b>       | <b>(225)</b>     | <b>404</b>       | <b>(176)</b>     | <b>205</b>       |
| <b>Noninterest income (expense), net</b>       | <b>(3,682)</b>   | <b>(4,102)</b>   | <b>(4,460)</b>   | <b>(5,537)</b>   | <b>(17,781)</b>  |
| <b>Net income</b>                              | <b>\$ 7,282</b>  | <b>\$ 6,573</b>  | <b>\$ 7,144</b>  | <b>\$ 5,834</b>  | <b>\$ 26,833</b> |

|   | <b>2015</b>  |               |              |               |              |
|---|--------------|---------------|--------------|---------------|--------------|
|   | <b>First</b> | <b>Second</b> | <b>Third</b> | <b>Fourth</b> | <b>Total</b> |
| Net interest income                     | \$ 10,500    | \$ 10,831     | \$ 11,718    | \$ 10,605     | \$ 43,654    |
| (Provision for) reversal of loan losses | (5)          | 374           | (1,836)      | 745           | (722)        |
| Noninterest income (expense), net       | (3,842)      | (3,491)       | (4,249)      | (3,783)       | (15,365)     |
| Net income                              | \$ 6,653     | \$ 7,714      | \$ 5,633     | \$ 7,567      | \$ 27,567    |

|   | <b>2014</b>  |               |              |               |              |
|---|--------------|---------------|--------------|---------------|--------------|
|   | <b>First</b> | <b>Second</b> | <b>Third</b> | <b>Fourth</b> | <b>Total</b> |
| Net interest income                     | \$ 10,416    | \$ 10,106     | \$ 10,200    | \$ 10,221     | \$ 40,943    |
| (Provision for) reversal of loan losses | 151          | 387           | 930          | (388)         | 1,080        |
| Noninterest income (expense), net       | (3,987)      | (3,882)       | (3,222)      | (3,849)       | (14,940)     |
| Net income                              | \$ 6,580     | \$ 6,611      | \$ 7,908     | \$ 5,984      | \$ 27,083    |

**NOTE 17 — SUBSEQUENT EVENTS:**

The association has evaluated subsequent events through March 14, 2017, which is the date the financial statements were issued or available to be issued.

There are no subsequent events requiring disclosure as of March 14, 2017.

## **DISCLOSURE INFORMATION AND INDEX**

*Disclosures Required by Farm Credit Administration Regulations*

### **DESCRIPTION OF BUSINESS**

The description of the territory served, the persons eligible to borrow, the types of lending activities engaged in and the financial services offered, and related Farm Credit organizations required to be disclosed in this section is incorporated herein by reference from Note 1 to the consolidated financial statements, "Organization, Merger and Operations," included in this annual report.

The descriptions of significant developments that had or could have a material impact on earnings, interest rates to borrowers, patronage, or dividends and acquisitions or dispositions of material assets, changes in the reporting entity, changes in patronage policies or practices and financial assistance provided by or to the association through loss sharing or capital preservation agreements or from any other source, if any, required to be disclosed in this section are incorporated herein by reference from "Management's Discussion and Analysis of Financial Condition and Results of Operations," included in this annual report.

### **DESCRIPTION OF PROPERTY**

Lone Star, ACA (association) serves its 48-county territory through its main administrative and lending office at 1612 Summit Avenue, Suite 300, Fort Worth, Texas 76102. Additionally, there are 16 branch lending offices and two contact points located throughout the territory. The association owns the office buildings in Paris, New Boston, Denton, Cleburne, Stephenville, Sweetwater, Lampasas, Corsicana, Hillsboro and Waco, free of debt. The association leases office space in Fort Worth, Sherman, Abilene, Weatherford, Temple and Round Rock.

### **LEGAL PROCEEDINGS**

In the ordinary course of business, the association is involved in various legal proceedings. In the opinion of legal counsel and management, there are no legal proceedings at this time that are likely to materially affect the consolidated financial statements of the association.

### **DESCRIPTION OF CAPITAL STRUCTURE**

The information required to be disclosed in this section is incorporated herein by reference from Note 10 to the consolidated financial statements, "Members' Equity," included in this annual report.

### **DESCRIPTION OF LIABILITIES**

The description of liabilities required to be disclosed in this section is incorporated herein by reference from Note 9, "Note Payable to the Bank," Note 12, "Employee Benefit Plans" and in "Management's Discussion and Analysis of Financial Condition and Results of Operations," included in this annual report.

The description of contingent liabilities required to be disclosed in this section is incorporated herein by reference from Notes 2 and 15 to the consolidated financial statements, "Summary of Significant Accounting Policies" and "Commitments and Contingencies," respectively, included in this annual report.

### **RELATIONSHIP WITH THE FARM CREDIT BANK OF TEXAS**

The association's financial condition may be impacted by factors that affect the Farm Credit Bank of Texas (bank), as discussed in Note 1 to the consolidated financial statements, "Organization, Mergers and Operations," included in this annual report. The financial condition and results of operations of the bank may materially affect the stockholders' investment in the association.

The Farm Credit Bank of Texas and District Associations' (district) annual and quarterly stockholder reports are available free of charge, upon request. These reports can be obtained by writing to Farm Credit Bank of Texas, The Ag Agency, P.O. Box 202590, Austin, Texas 78720-2590 or calling (512) 483-9204. Copies of the district's annual and quarterly stockholder reports can also be requested by e-mailing [fcba@farmcreditbank.com](mailto:fcba@farmcreditbank.com). The district's annual and quarterly stockholder reports are also available on its website at [www.farmcreditbank.com](http://www.farmcreditbank.com).

The association's quarterly stockholder reports are also available free of charge, upon request. These reports will be available approximately 40 days after quarter end and can be obtained by writing to Lone Star, ACA 1612 Summit Avenue, Suite 300, Fort Worth, Texas 76102 or calling (817) 332-6565. Copies of the association's quarterly stockholder reports can also be requested by e-mailing

*Tonya.Arvin@lonestaragcredit.com*. The association's annual stockholder report is available on its website at [www.lonestaragcredit.com](http://www.lonestaragcredit.com) 75 days after the fiscal year end. Copies of the association's annual stockholder report can also be requested 90 days after the fiscal year end

## **SELECTED FINANCIAL DATA**

The selected financial data for the five years ended December 31, 2016, required to be disclosed, is incorporated herein by reference to the "Five-Year Summary of Selected Consolidated Financial Data" included in this annual report to stockholders.

## **MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

"Management's Discussion and Analysis," which precedes the consolidated financial statements in this annual report, is incorporated herein by reference.

## **BOARD OF DIRECTORS**

### **CORPORATE GOVERNANCE**

At year end, the board of directors of Lone Star, ACA was comprised of 13 positions. Ten director positions are elected by the voting membership. Each represents one of eight geographic regions that comprise Lone Star, ACA's lending territory. One of the 10 member-elected directors resigned in December 2016 leaving one open position. Three directors are appointed by the other members of the board and cannot be customers, stockholders, employees or agents of any Farm Credit institution. Two of these appointed outside directors bring specific financial, accounting and audit expertise to the board and one chairs the board's Audit Committee and the other serves as vice chairman. The other appointed outside director position is used to bring outside perspective and other areas of expertise to enhance board oversight capabilities.

As a part of the merger with Texas Land Bank on January 1, 2014, the stockholder-approved merger disclosure document contained a board reduction plan. As directed in the plan, the board initially consisted of 20 directors, comprised of 17 stockholder elected directors and three appointed directors. The number of stockholder-elected directors reduced by one, two and four during 2016, 2015 and 2014, respectively. The reduction plan is complete as of December 2016, which results in ten stockholder-elected director positions and three outside director positions. Further details on the reduction plan are available in reviewing the merger disclosure document approved by stockholders during 2013.

### **AUDIT COMMITTEE**

As of the end of December 31, 2016, this Committee was made up of five board members including at least one appointed outside director. All members of the Committee are expected to have practical knowledge of finance and accounting, be able to read and have a working understanding of the financial statements, or develop that understanding within a reasonable period of time after being appointed to the Committee. The two outside directors appointed to this Committee have significant financial and audit expertise and serve as chairman and vice chairman of this Committee. Don Crawford and David W. Conrad serve as chairman and vice chairman, respectively. The board of directors has determined that Mr. Crawford and Mr. Conrad have the qualifications and experience necessary to serve as an Audit Committee "financial expert" as defined by FCA regulation, and have been designated as such. Other Audit Committee members as of December 31, 2016 were Linda Floerke, David Harris and Bert Pruett.

The Audit Committee members are appointed by the board. All members of the Audit Committee are independent of management for Lone Star, ACA or any system entity. The Audit Committee has unrestricted access to representatives of the internal audit firm, independent public accountants, internal credit review firms and financial management.

The Committee assists the board in fulfilling its oversight responsibility related to accounting policies, internal controls, financial reporting practices and regulatory requirements. This Committee has a charter detailing its purpose and key objectives, authority, composition, meeting requirements and responsibilities. The charter among other things gives the Committee the authority to hire and compensate the internal and external auditors and credit reviewers, approve all audit and permitted non-audit services, review the audited financial statements and all public financial disclosures, meet privately with internal and external auditors and credit reviewers and review any complaints regarding accounting irregularities and fraud. The charter is posted on Lone Star, ACA's website at [www.lonestaragcredit.com](http://www.lonestaragcredit.com).

## COMPENSATION COMMITTEE

The Compensation Committee consists of five board members selected by the board of directors. Neither the CEO nor management can have any involvement in the selection of Committee members nor can they participate in any deliberations of the Committee on matters relating to their own compensation. The Committee is presently chaired by John Sawyer. Other Compensation Committee members as of December 31, 2016 were Richard Gaona, Chad Lee, Tom Johnson and Larry Stewart.

The Committee is responsible for reviewing and recommending for full board approval, the performance standards of the CEO and the evaluation of the CEO's performance against those standards. It also recommends to the board all actions necessary to administer the CEO's compensation plan. The board has delegated to the CEO the responsibility to administer the base salaries of senior officers and all other staff of Lone Star, ACA, within board approved guidelines. However, the CEO must review the base salary administration with the Compensation Committee and the Committee recommends for board approval the overall compensation program for senior officers. The Committee is also responsible for director compensation and for oversight of Lone Star, ACA's employee's salary and benefits plans and all board policies applicable to those plans.

## DIRECTORS AND SENIOR OFFICERS

The association's member-elected and director-elected board of directors and senior officers are as follows:

| <u>NAME</u>         | <u>POSITION</u>                   | <u>DATE<br/>ELECTED/<br/>EMPLOYED</u> | <u>TERM<br/>EXPIRES</u> |
|---------------------|-----------------------------------|---------------------------------------|-------------------------|
| Tom Johnson         | Chairman                          | 2000                                  | 2018                    |
| David Harris        | Vice Chairman                     | 2001                                  | 2019                    |
| Harlin Brown        | Director                          | 2013                                  | 2019                    |
| David Conrad        | Director-Elected Outside Director | 2014                                  | 2019                    |
| Don Crawford        | Director-Elected Outside Director | 2002                                  | 2019                    |
| Richard Gaona       | Director                          | 2000                                  | 2018                    |
| Chad Lee            | Director-Elected Outside Director | 2011                                  | 2019                    |
| Brent Neuhaus       | Director                          | 2016                                  | 2017                    |
| Bert Pruett         | Director                          | 1984                                  | 2017                    |
| John Sawyer         | Director                          | 2014                                  | 2017                    |
| Larry Stewart       | Director                          | 1984                                  | 2017                    |
| Linda Floerke*      | Director                          | 2014                                  | 2016                    |
| Burt Richards**     | Director                          | 2014                                  | 2016                    |
| James Hooser Jr.*** | Director                          | 2014                                  | 2016                    |
| Paul Young***       | Director                          | 2014                                  | 2016                    |
| Troy Bussmeir       | Chief Executive Officer           | 2010                                  | -                       |
| Sharla Chambers     | Chief Operating Officer           | 2014                                  | -                       |
| Keith Finstad       | Chief Credit Officer              | 2014                                  | -                       |
| M'Lissa Kiel        | Chief Financial Officer           | 1997                                  | -                       |
| Jim Bob Reynolds    | Chief Lending Officer             | 2010                                  | -                       |
| James Bearden       | Chief Compliance Officer          | 1997                                  | -                       |

\*Elected to the board of the Farm Credit Bank of Texas effective January 1, 2017.

\*\*Term expired in 2016 and position closed as part of board reduction plan.

\*\*\*Stepped down from the board during 2016 for personal reasons.

A brief statement of the business and employment background of each director and senior officer is provided for informational purposes.

**Tom Johnson**, 65, was elected to serve on the association's board in 2001, serves as the board's chairman, and serves on the association's Compensation Committee. Mr. Johnson has been active in the communications industry for more than 25 years, maintains a Black Angus cow/calf operation specializing in producing Waygu-Black Angus calves, and currently is: the president and director of First American Communications Enterprise, Inc. and First American Holdings, Inc., which are telecommunication businesses; the president and director of Christian.TV, Inc., which is an internet video streaming and content management business; the CEO and member of BEMA Media, LLC; an officer and director of Oklahoma Telephone and Telegraph, Inc. and North Texas Telephone Company, Inc.; the president and director of TLJ Management Inc., a management consulting business, River Creek LTD,

which is involved in ranching, TPJ Properties LTD, which is involved in real estate, and First American Sales and Service, which is involved in equipment sales; an officer and member of North Star, LLC, which is involved in real estate; the president and member of Johnson River, LLC, GYI Hanger, LLC, Covenant Denison Holdings, LLC, and Multifamily Investors GP, LLC, which are involved in ranching and/or real estate; vice president and member of Covenant Development, LLC, which is a management company, and Residence at Gateway Village GP, LLC, which is involved in real estate; a member of JW Media, LLC, which is involved in internet media and management systems; and a limited partner of Multifamily Investors, Ltd. and Multifamily Investors II, Ltd., which are involved in real estate. Mr. Johnson is also a director of First United Bank and Trust Company of Durant, Oklahoma, Texoma Medical Center Hospital, Varitronics, LLC, an education hardware and software business, and Saddle Creek at Gateway HOA, Inc. and Fawn Meadow Greenway Parks at Gateway HOA, Inc., which are homeowner association businesses, and serves on the Compensation and Strategic Development Committees for First United Bank and Trust Company and as a vice president and director of I Shine Ministries, Inc., Victory Life Church, and Zoe Life Outreach, Inc., non-profit ministries.

**Harlin Brown**, 68, was elected to the board in 2013. Mr. Brown lives in Woodland, Texas, and is a full-time farmer and rancher. Mr. Brown has been in the logging and timber business for most of his life, runs a commercial cow/calf operation, manages timber on owned and leased property in Red River County, and grows hay in Choctaw County, Oklahoma. Mr. Brown serves as a director of Red River Appraisal District and previously served on the Red River FSA County Committee and the 410 Water Supply Corporation. He has been a member of the Pine Creek Volunteer Fire Department for at least 25 years and has served in various capacities at the Woodland United Methodist Church.

**David W. Conrad**, 63, was elected to Texas Land Bank's Board in 2005 as a director-elected director, has served on the association's board since January 1, 2014 as a result of the merger, and serves as the vice chairman of the association's Audit Committee. Mr. Conrad is from Round Rock, Texas, is a certified public accountant, the owner of a professional accounting practice in Round Rock, a member of Pilot Peak Investments, LLC, a commercial real estate rental company, and a member of the Texas Society of CPAs. Mr. Conrad was previously employed by the Farm Credit Bank of Texas from 1982 to 1990, where he served as internal auditor and director of association financial operations.

**Don Crawford**, 69, was elected to the board in 2002 as a director-elected director and serves as the chairman of the association's Audit Committee. Mr. Crawford resides in Palo Pinto County and is a certified public accountant. He is a principal in Crawford, Carter and Durbin CPAs of Mineral Wells, a partner in Crawford Brothers Ranch of Strawn, Texas, a commercial beef cattle operation, and a general partner in Crawford Cross L, LP, a land holding company. Mr. Crawford is a director and chairman of the Audit Committee of Titan Bank, N.A. of Mineral Wells, Texas, a director of Palo Pinto Municipal Water District #1, a director and the treasurer of Mineral Wells Industrial Foundation, a non-profit foundation, and chairman of the Finance Committee of Our Lady of Lourdes Catholic Church in Mineral Wells, Texas.

**Richard Gaona**, 58, was elected to serve on the board in 2000 and serves on the association's Compensation Committee. Mr. Gaona is a full-time farmer and is the owner and operator of Richard & Judy Gaona Joint Venture Farms, which grows cotton, wheat, and hay, and maintains a beef cattle operation in Fisher County. Mr. Gaona serves as the chairman of the Fisher County Appraisal District Board, the president of the board of Rolling Plains Cotton Growers, a member of the Boll Weevil Steering Committee for Rolling Plains Cotton Growers, and a voting delegate member for the National Cotton Council. He previously served as the vice chairman of the board of Rolling Plains Cotton Growers, a member of the Boll Weevil Steering Committee for Rolling Plains Cotton Growers, a director of Cotton, Inc., and a director of Universal Cotton Standards and previously co-owned T. Terry's Cotton Gin in Roby, Texas.

**David Harris**, 57, was elected to the board in 2001 and serves on the association's Audit Committee. Mr. Harris lives in Johnson County, owns property in Somervell County, and is the president of Bob Harris Oil Company, which is involved in retail gasoline marketing, ranching (cow-calf), real estate development, and sand and gravel. He serves as the president of Harris Riverbend Farms, a purebred and commercial cow-calf operation, which was previously made part of Harris Farms, a partner in Mansfield Joint Venture, which is involved in warehouse development, the managing partner of Alvarado Joint Venture, which is involved in real estate development, a partner in Deli Partners, a deli and fast food operation, the managing partner in Brazos Aggregates, a sand and gravel operation, and a director of Cleburne Economic Development Board. Mr. Harris serves on the Somervell County Livestock and Forage Committee and previously served as the managing partner of Harco Cattle, a cow-calf operation, which merged into Harris Riverbend Farms, is a member of the Santa Gertrudis Association Breed Improvement Committee, a member of the Santa Gertrudis Association Performance Committee, and previously served as president of the Premier Santa Gertrudis Association and vice president of marketing for Santa Gertrudis Breeders International.

**Chad Lee**, 45, was elected to the board in 2011 as a director-elected director and serves on the association's Compensation Committee. Mr. Lee is a private practice attorney with an emphasis on criminal defense, employment, and various agricultural issues, including contracts and oil and gas leasing and real property disputes, and is a member of Trailhead Marketing, LLC, a marketing company. Mr. Lee maintains an operation of commercial cattle, wheat, and hay, is a committee member for the Fort Worth Stock

Show and Texas Southwestern Cattle Raisers, a director of Operation Orphans, a non-profit benefiting foster children, and a director of Tarrant County A&M Club, a nonprofit for Aggie Athletics.

**Brent Neuhaus**, 46, was appointed to the board in 2016 and serves on the association's Audit Committee. Mr. Neuhaus lives in Waco, Texas, and raises Angus cattle on 243 acres in McLennan County, Texas. Mr. Neuhaus is the: CEO, president and secretary of Brazos Valley Equipment Co., which operates John Deere dealerships in Central Texas; president and manager of TGBTG Property, LLC and JORE, LLC, and member of ERE Property, LLC and HILLRE, LLC, which are involved in real estate; and managing member of NTP Holdings, LLC, which owns business interests in John Deere dealership operations. Mr. Neuhaus also has an ownership interest in Neuhaus Trust Partnership through a trust of which he is the trustee, which partnership owns farm and commercial real estate and other business interests, is a director and shareholder of Alliance Bank Central Texas, is a director and chair-elect of Heart O' Texas Fair & Rodeo, and is a covenant partner (director) of Talitha Koum Institute, a faith-based, charitable organization that provides therapeutic care for young, at-risk children. Mr. Neuhaus is married to Kim Neuhaus, who is a first grade teacher in the Midway ISD, and they attend First Woodway Baptist Church.

**Bert Pruett**, 64, was elected to the board in 1984 and serves on the association's Audit Committee. Mr. Pruett lives in Slidell in Northwest Denton County, is a self-employed grain farmer, and maintains an operation of cattle, wheat, milo, corn, and hay. Mr. Pruett serves as the treasurer of the Greenwood-Slidell Volunteer Fire Department, president of the Denton-Wise County Farmers Union, and chairman of the deacons of the First Baptist Church in Slidell, Texas.

**John R. Sawyer**, 58, was elected vice chairman to Texas Land Bank's board in 2006, has served on the association's board since January 1, 2014 as a result of the merger, and is the chairman of the association's Compensation Committee. Mr. Sawyer resides in Hillsboro, Texas, is a farmer and rancher, and operates and is a partner in Sawyer Farms Partnership with his wife, Natasha, which engages in grain farming. Mr. Sawyer serves as a vice president of Apex Grain Company, LLC, a grain elevator company located in Hillsboro, the president of Sawyer Land, LLC, a commercial property business, president of Sawyer Property Management, LLC, which manages mineral interests, president of Blackland Logistics, a trucking company, chairman of Hill County Blackland Soil and Water Conservation District's Board, trustee of the Hillsboro Independent School District, and a deacon of the First Baptist Church in Hillsboro, Texas.

**Larry Stewart**, 67, was elected to the board in 1984 and serves on the association's Compensation Committee. Mr. Stewart lives between Granbury and Lipan in Hood County, operates a beef cattle operation as his primary business, and participates in hay production, as well. Mr. Stewart serves as a director of First National Bank Granbury and as a director of Hood County Acton Cemetery and previously served as a director of Cancer Care, which raises money to help cancer victims.

**Troy Bussmeir**, 44, became the chief executive officer effective January 1, 2014. Mr. Bussmeir joined the association in May 2010 as the chief credit officer and became the chief operating officer in March 2012. Before joining the association, he served five years as a relationship manager at the Farm Credit Bank of Texas in Austin and as a Capital Markets analyst for one year prior to that. Mr. Bussmeir began his banking career in 1999 with Farm Credit of South Florida, where he served as a credit analyst and later as a senior commercial loan officer. He left South Florida to work at AgFirst Farm Credit Bank in Columbia, South Carolina, as a commercial credit analyst in its Capital Markets Group. Mr. Bussmeir is a native of Seattle, Washington, and earned his bachelor's degree in finance and accounting from Palm Beach Atlantic University in West Palm Beach, Florida.

**Sharla Chambers**, 40, became the chief operating officer effective January 1, 2014. Ms. Chambers joined the association in January 2014 as a result of the merger with Texas Land Bank. Prior to the merger, Ms. Chambers served as the chief financial officer for Texas Land Bank and previously served as the controller for that association. Ms. Chambers is a certified public accountant, has experience in corporate accounting, as well as retirement plan administration and compliance, and has eight years of experience with the Farm Credit System.

**J. Keith Finstad**, 58, became chief credit officer effective January 1, 2014. Mr. Finstad joined the association in January 2014 as a result of the merger with Texas Land Bank. Prior to the merger, Mr. Finstad served as the chief credit officer for Texas Land Bank and previously served as a credit office president of Texas Land Bank's Waco office. Mr. Finstad also previously served as a loan officer and director of credit at Farm Credit Bank of Texas, vice president of the Federal Land Bank Association of Hillsboro, and a loan officer trainee of the Federal Land Bank Association of Hillsboro. Mr. Finstad has 35 years of experience with the Farm Credit System.

**M'Lissa Kiel**, 54, became the chief financial officer effective December 1997. Ms. Kiel joined the Farm Credit Bank of Texas in 1986 and served in various accounting and financial capacities before assuming the role of chief financial officer of the Association in December 1997.

**Jim Bob Reynolds**, 52, became the chief lending officer effective January 1, 2014. Mr. Reynolds joined the association in September 2010 as the senior vice president of commercial credit and later served as the chief credit officer for the association. Before joining the association, Mr. Reynolds worked for First State Bank in Dalhart, Texas, for 11 years, where he served as the senior vice president of commercial lending. Mr. Reynolds is a native of Dalhart, Texas, where he grew up on his family's farming/cattle operation. He earned his bachelor of science degree in ag economics from Texas Tech University and his master of business administration degree from the University of Texas at San Antonio.

**James Bearden**, 62, became the chief compliance officer effective January 1, 2014. Mr. Bearden has been employed by the association since 1997 and has served the Farm Credit System since 1980 in several capacities. Mr. Bearden is a native of Hillsboro, Texas, and is a graduate of Texas A&M University.

### COMPENSATION OF DIRECTORS

Directors were compensated for their service to the association in the form of an honorarium at the rate of \$600 per day for director meetings and special meetings, except for the board chairman and vice chairman. The board chairman and vice chairman rate are \$1,000 and \$800, respectively. The audit chairman and vice chairman receive an additional honorarium of \$500 and \$300 per month, respectively. Directors also receive an annual retention fee of \$700 per month. Committee meetings that are held in conjunction with another meeting are paid at the rate of \$300 per meeting, except for Audit Committee meetings which are paid at the rate of \$400 per meeting. Directors are paid honorarium for conference calls less than an hour at the rate of \$200 and for calls in excess of an hour they are compensated \$400. Directors were reimbursed for certain expenses incurred while representing the association in an official capacity. Mileage for attending official meetings during 2016 was paid at the IRS-approved rate of 54.0 cents per mile. A copy of the travel policy is available to stockholders of the association upon request.

| <u>DIRECTOR</u> | <u>Number of Days Served</u> |                                  | <u>2016</u> |
|-----------------|------------------------------|----------------------------------|-------------|
|                 | <u>Board Meeting</u>         | <u>Other Official Activities</u> |             |
| Harlin Brown    | 10                           | 7                                | \$18,600    |
| David Conrad    | 9                            | 13                               | \$23,000    |
| Don Crawford    | 10                           | 20                               | \$28,800    |
| Linda Floerke   | 10                           | 17                               | \$26,000    |
| Richard Gaona   | 9                            | 8                                | \$18,800    |
| David Harris    | 9                            | 13                               | \$25,200    |
| James Hooser    | 8                            | 6                                | \$17,100    |
| Tom Johnson     | 9                            | 10                               | \$26,600    |
| Chad Lee        | 10                           | 18.5                             | \$27,700    |
| Neuhaus, Brent  | 3                            | 3                                | \$7,800     |
| Bert Pruett     | 10                           | 10                               | \$21,800    |
| Burt Richards   | 4                            | 7                                | \$10,200    |
| John Sawyer     | 10                           | 9                                | \$21,600    |
| Larry Stewart   | 10                           | 7                                | \$18,800    |
| Paul Young      | 4                            | 6                                | \$9,500     |
|                 |                              |                                  | \$ 301,500  |

The aggregate compensation paid to directors in 2016, 2015 and 2014 was \$301,500, \$307,900 and \$407,100, respectively.

Additional detail regarding director compensation paid for committee service (which is included in the table above) is as follows:

| <b>DIRECTOR</b> | <b>Committee</b>       |                               | <b>Total</b>     |
|-----------------|------------------------|-------------------------------|------------------|
|                 | <b>Audit Committee</b> | <b>Compensation Committee</b> |                  |
| David Conrad    | \$ 8,200               | \$ -                          | \$ 8,200         |
| Don Crawford    | 11,000                 | -                             | 11,000           |
| Linda Floerke   | 5,000                  | -                             | 5,000            |
| Richard Gaona   | -                      | 2,700                         | 2,700            |
| David Harris    | 4,600                  | -                             | 4,600            |
| James Hooser    | 4,200                  | -                             | 4,200            |
| Tom Johnson     | -                      | 2,700                         | 2,700            |
| Chad Lee        | -                      | 3,000                         | 3,000            |
| Neuhaus, Brent  | -                      | 300                           | 300              |
| Bert Pruett     | 5,000                  | -                             | 5,000            |
| Burt Richards   | -                      | 1,200                         | 1,200            |
| John Sawyer     | -                      | 5,400                         | 5,400            |
| Larry Stewart   | -                      | 3,000                         | 3,000            |
|                 | <u>\$ 38,000</u>       | <u>\$ 18,300</u>              | <u>\$ 56,300</u> |

The aggregate amount of reimbursement for travel, subsistence and other related expenses paid to directors and on their behalf was \$113,629, \$116,098 and \$126,656 in 2016, 2015 and 2014, respectively.

## COMPENSATION OF SENIOR OFFICERS

### Compensation Discussion and Analysis – Senior Officers

#### Overview

The objective of the association’s salary administration program is to attract, develop, retain and motivate staff that is knowledgeable and efficient in the ability to support the association in the executions of its strategic objectives and delivery of association results that maximize the value received by its membership. The association operates utilizing a compensation program which focuses on the performance and contributions of its employees in achieving the association’s financial and operational objectives, all for the ultimate benefit of its membership. The association’s board of directors, through its Compensation Committee, establishes annual salary and incentive programs utilizing the services of the Human Resources Compensation Team at the bank to compile “Compensation Market Data” annually that is used by the board and management in establishing salary levels. Data sources used include the Federal Reserve Bank of Dallas 11<sup>th</sup> District survey, Texas Community Bank survey (Independent Bankers Association of Texas), Watson Wyatt Financial Institution surveys, Mercer Financial Services Commercial Lending survey and CompData surveys. The Compensation Market Data reveals salary and incentive levels for similar sized institutions operating in our geographic area. Studies provided by third-party compensation specialists form the foundation for the association’s evaluation and establishment of annual salary plans used by the association. Additional support is provided by an outside consultant engaged by the Compensation Committee.

#### Chief Executive Officer (CEO) Compensation Policy

| <b>Name of Individual</b>    | <b>Year</b> | <b>Salary (a)</b> | <b>Bonus (b)</b> | <b>Change in</b>         |                                | <b>Other (e)</b> | <b>Total</b>      |
|------------------------------|-------------|-------------------|------------------|--------------------------|--------------------------------|------------------|-------------------|
|                              |             |                   |                  | <b>Pension Value (c)</b> | <b>Deferred/Perquisite (d)</b> |                  |                   |
| <b>Troy Bussmeir<br/>CEO</b> | <b>2016</b> | <b>\$ 320,012</b> | <b>\$112,000</b> | <b>\$ -</b>              | <b>\$ 54,173</b>               | <b>\$26,535</b>  | <b>\$ 512,720</b> |
|                              | 2015        | \$ 310,012        | \$ 108,500       | \$ -                     | \$ 52,256                      | \$ 40,997        | \$ 511,765        |
|                              | 2014        | 295,011           | 88,500           | -                        | 37,474                         | -                | 420,985           |

(a) Gross Salary

(b) Bonuses earned in 2016, 2015 and 2014 were paid in the following year.

(c) Change in pension value (noncash)

(d) Deferred Perquisite: 2016, 2015 and 2014 include contribution to 401(k) and defined contribution

(e) Other 2016 and 2015 includes memberships to professional and social organizations, executive physicals and travel allowance.

On October 3, 2012, FCA adopted a regulation that requires all System institutions to hold advisory votes on the compensation for all senior officers and/or the CEO when the compensation of either the CEO or the senior officer group increases by 15 percent or more from the previous reporting period. In addition, the regulation requires associations to hold an advisory vote on CEO and/or senior officer compensation when 5 percent of the voting stockholders petition for the vote and to disclose the petition authority in the annual report to shareholders. The regulation became effective December 17, 2012, and the base year for determining whether there is a 15 percent or greater increase was 2013. No association held an advisory vote based on a stockholder petition in 2013.

On January 17, 2014, the President signed into law the Consolidated Appropriations Act (P.L. 113-76) which includes language prohibiting the FCA from using any funds available “to implement or enforce” the regulation. In addition, on February 7, 2014, the President signed into law the Agricultural Act of 2014. Section 5404 of the law directs FCA, to within 60 days of enactment of the law, “review its rules to reflect the Congressional intent that a primary responsibility of boards of directors of Farm Credit System institutions, as elected representatives of their stockholders, is to oversee compensation practices.” FCA has not yet taken any action with respect to their regulation in response to these actions.

The CEO’s salary is established for the period January 1 through December 31 of each year, and is set by the board using the Compensation Market Data as a guideline to arrive at a fair and competitive salary. As previously discussed Mr. Bussmeir was originally employed in May of 2010 as the association’s chief credit officer. Mr. Bussmeir was promoted to chief operating officer during 2012, and later named as the successor CEO upon the retirement of the CEO at that time, Mr. Steve Fowlkes. The CEO’s 2016 bonus was at board discretion and based upon its assessment of the association’s financial performance, credit administration and credit quality goals, and attainment of other goals and objectives specifically established in the association’s 2016 Business Plan. This incentive was based on the period from January 2016 through December of 2016.

### Compensation of Other Senior Officers

| <u>Name of Group</u>   | <u>Year</u> | <u>Salary (a)</u> | <u>Bonus (b)</u> | <u>Change in Pension Value (c)</u> | <u>Deferred/Perquisite (d)</u> | <u>Other (e)</u> | <u>Total</u> |
|--|-------------|-------------------|------------------|------------------------------------|--------------------------------|------------------|--------------|
| <b>Aggregate No. of Senior Officers in Year</b>  |             |                   |                  |                                    |                                |                  |              |
| 6  | 2016        | \$ 952,273        | \$285,670        | \$675,706                          | \$144,194                      | \$ 8,180         | \$2,066,023  |
| <b>Aggregate No. of Five Highest Compensated Senior Officers in Year Excluding CEO</b> |             |                   |                  |                                    |                                |                  |              |
| 6  | 2015        | \$ 1,375,347      | \$ 323,590       | \$ 350,812                         | \$ 201,229                     | \$ -             | \$ 2,250,978 |
| 6  | 2014        | 1,205,853         | 296,743          | 823,603                            | 143,442                        | 94,843           | 2,564,484    |

(a) Gross Salary includes temporary additional salary for single employee covering two positions

(b) Bonuses earned in 2016, 2015 and 2014 were paid in the following year.

(c) Change in pension value (noncash)

(d) Deferred Perquisite: 2016, 2015 and 2014 include contribution to 401(k) and defined contribution

(e) Other 2016 includes tenure awards and 2014 includes relocation costs

Disclosure of information on the total compensation paid and the arrangements of the compensation plans during the last fiscal year to any senior officer or to any other officer included in the aggregate are available and will be disclosed to shareholders of the institution upon request.

On October 3, 2012, FCA adopted a regulation that requires all System institutions to hold advisory votes on the compensation for all senior officers and/or the CEO when the compensation of either the CEO or the senior officer group increases by 15 percent or more from the previous reporting period. In addition, the regulation requires associations to hold an advisory vote on CEO and/or senior officer compensation when 5 percent of the voting stockholders petition for the vote and to disclose the petition authority in the annual report to shareholders. The regulation became effective December 17, 2012, and the base year for determining whether there is a 15 percent or greater increase was 2013. No association held an advisory vote based on a stockholder petition in 2013.

On January 17, 2014, the President signed into law the Consolidated Appropriations Act (P.L. 113-76) which includes language prohibiting the FCA from using any funds available “to implement or enforce” the regulation. In addition, on February 7, 2014, the President signed into law the Agricultural Act of 2014. Section 5404 of the law directs FCA, to within 60 days of enactment of the law, “review its rules to reflect the Congressional intent that a primary responsibility of boards of directors of Farm Credit System institutions, as elected representatives of their stockholders, is to oversee compensation practices.” FCA has not yet taken any action with respect to their regulation in response to these actions.

The association board’s Compensation Committee (Committee) approved an incentive plan for Lone Star senior officers and staff in 2016. The 2016 incentive plan was based on association performance goals and objectives, including credit quality, credit administration and correlations of credit risk ratings with the FCA, association Internal Credit Review and the FCBT reviews, loan volume and earnings goals, as defined by the board. All employees were eligible to participate except for the CEO, who was not a participant in this incentive program.

Personal mileage on association automobiles is reported as taxable income to employees and reported in the deferred/perquisite column in the table above. Employees who use their personal automobile for business purposes were reimbursed during 2016 at the IRS-approved rate of 54.0 cents per mile.

No senior officer received non-cash compensation exceeding \$5,000, other than disclosed previously in 2016, 2015 or 2014.

Senior officers, including the CEO, are reimbursed for reasonable travel, subsistence and other related expenses while conducting association business. A copy of the association’s travel policy is available to shareholders upon request.

Pension Benefits Table for the CEO and Senior Officers as a Group

The following table presents the total annual benefit provided from the defined benefit pension plan applicable to senior officers, excluding CEO, for the year ended December 31, 2016:

| <u>Name</u>                           | <u>Plan Name</u>                          | <u>Number of<br/>Years<br/>Credited Service</u> | <u>Present Value<br/>of Accumulated<br/>Benefit</u> | <u>Payments<br/>During 2016</u> |
|---------------------------------------|---|---|---|---------------------------------|
| Senior Officers, Excluding CEO<br>(2) | Farm Credit Bank of Texas<br>Pension Plan | 74.93   | \$ 4,982,687  | \$ -                            |

Defined Benefit Pension Plan:

The Defined Benefit Pension Plan (Pension Plan) is a final average pay plan which was closed to new participants in 1996, and later fully closed to all participants, including rehires who had formally participated in the plan. The Pension Plan benefits are based on the average monthly eligible compensation over the 60 consecutive months that produce the highest average after 1996 (“FAC60”). The Pension Plan’s benefit formula for a Normal Retirement Pension is the sum of (a) 1.65 percent of FAC60 times “Years of Benefit Service” and (b) 0.50 percent of (i) FAC60 in excess of Social Security covered compensation times (ii) “Years of Benefit Service” (not to exceed 35).

The Pension Plan’s benefit formula for the Normal Retirement Pension assumes that the employee’s retirement age is 65, that the employee is married on the date the annuity begins, that the spouse is exactly two years younger than the employee, and that the benefit is payable in the form of a 50 percent joint and survivor annuity. If any of those assumptions are incorrect, the benefit is recalculated to be the actuarial equivalent benefit. The Pension Plan benefit is offset by the pension benefits any employee may have from another Farm Credit System institution.

The Pension Plan was amended in 2013 to allow those retiring after September 1, 2013 to elect a lump sum distribution option. The plan was also amended to allow participating employers to exclude from pension compensation new long term incentive plans which began after January 1, 2014.

**TRANSACTIONS WITH DIRECTORS AND SENIOR OFFICERS**

The association’s policies on loans to and transactions with its officers and directors, required to be disclosed in this section, are incorporated herein by reference from Note 13 to the consolidated financial statements, “Related Party Transactions,” included in this annual report.

## **DIRECTORS' AND SENIOR OFFICERS' INVOLVEMENT IN CERTAIN LEGAL PROCEEDINGS**

During the past five years, none of the association's officers or directors has been involved in legal proceedings that are material to an evaluation of the ability or integrity of any person who served as director or senior officer on January 1, 2016, or any time during the year just ended.

## **RELATIONSHIP WITH INDEPENDENT AUDITOR**

No change in auditors has taken place since the last annual report to stockholders and no disagreements with auditors has occurred that the association is required to report to the Farm Credit Administration under part 621 of the FCA regulations governing this disclosure.

Fees for professional services rendered for the association by PricewaterhouseCoopers, LLP for the year ending December 31, 2016 were between \$99,300 and \$107,300; and were comprised of audit services ranging from \$92,000 and \$100,000 and tax services for \$7,300.

## **FINANCIAL STATEMENTS**

The financial statements, together with the report thereon of PriceWaterhouseCoopers dated March 14, 2017, and the report of management in this annual report to stockholders, are incorporated herein by reference.

## **MEMBER/SHAREHOLDER PRIVACY**

Members' nonpublic personal financial information is protected by Farm Credit Administration regulation. Our directors and employees are restricted from disclosing information not normally contained in published reports or press releases about the association or its members.

## **CREDIT AND SERVICES TO YOUNG, BEGINNING AND SMALL FARMERS AND RANCHERS, AND PRODUCERS OR HARVESTERS OF AQUATIC PRODUCTS**

Lone Star, ACA is obligated to establish programs that respond to the credit and related service needs of Young, Beginning and Small (YBS) farmers and ranchers. It is the association's responsibility to fulfill its public policy role by extending credit and related services to this important sector of our customer base. YBS farmers and ranchers face continuing challenges in agriculture, including access to capital and credit needs, limited financial resources for land and equipment, urbanization demands and increasing competition from larger and highly capitalized operations.

The board of directors and management are committed to providing programs that facilitate meeting the needs of this group of customers. These programs also address other issues, including the aging of agricultural landowners and customers, the need to transfer assets to another generation of potential landowners and a recognition that many young, beginning and small operators will need to supplement their farm income by seeking off-farm employment. Additionally, demographic trends indicate that agricultural landowners make decisions regarding land or agricultural endeavors based on lifestyle choices, recreational utility or as an alternative investment in a major financial asset.

### **Definitions for YBS Farmers and Ranchers**

**Young Farmer or Rancher**- a farmer, rancher or producer/harvester of aquatic products who was age 35 or younger as of the date when the loan was originally made.

**Beginning Farmer or Rancher**- a farmer, rancher or producer/harvester of aquatic products who had ten years or less of experience at farming or ranching, or producing or harvesting aquatic products as of the date the loan was originally made.

**Small Farmer or Rancher**- a farmer, rancher or producer/harvester of aquatic products who normally generates less than \$250,000 in annual gross sales of agricultural or aquatic products at the date the loan was originally made.

(A loan to a borrower may meet the definition of a YBS borrower if any one of the categories is achieved.)

In order to address the specific needs of these customers, and to be responsive to the credit needs of young, beginning and small farmers, the association utilizes all existing loan programs to the maximum benefit of young, beginning and small farmers. The

association has also developed specific loan programs to meet the credit needs of this group. Qualifying young, beginning and small farmers who are involved or becoming more involved in agriculture may be eligible for loans with more flexible rates and fees. The association's YBS loans as a percentage of total loans outstanding for years ending 2016, 2015 and 2014, respectively, are reflected in the table below:

|           | <u>2016</u>    |                 | <u>2015</u>    |                 | <u>2014</u>    |                 |
|-----------|----------------|-----------------|----------------|-----------------|----------------|-----------------|
|           | <u>% Loans</u> | <u>% Volume</u> | <u>% Loans</u> | <u>% Volume</u> | <u>% Loans</u> | <u>% Volume</u> |
| Young     | 17.72%         | 9.52%           | 17.83%         | 10.11%          | 18.30%         | 10.97%          |
| Beginning | 59.26%         | 47.17%          | 58.39%         | 47.76%          | 58.11%         | 49.65%          |
| Small     | 82.98%         | 60.94%          | 81.17%         | 58.37%          | 80.78%         | 61.10%          |

The association's YBS loans, as a percentage of all loans closed each year, are reflected in the table below for the past three years:

|           | <u>2016</u>    |                 | <u>2015</u>    |                 | <u>2014</u>    |                 |
|-----------|----------------|-----------------|----------------|-----------------|----------------|-----------------|
|           | <u>% Loans</u> | <u>% Volume</u> | <u>% Loans</u> | <u>% Volume</u> | <u>% Loans</u> | <u>% Volume</u> |
| Young     | 17.98%         | 9.17%           | 16.17%         | 8.24%           | 17.31%         | 9.97%           |
| Beginning | 57.49%         | 43.76%          | 52.63%         | 36.91%          | 52.31%         | 41.85%          |
| Small     | 79.32%         | 59.04%          | 73.68%         | 43.20%          | 73.96%         | 45.07%          |

The board established quantitative targets within the 2016 operational and strategic business plan to measure and evaluate progress toward serving young, beginning and small customers. These volume-based targets for performance included new credit to young farmers at 10.0 percent, to beginning farmers at 47.0 percent and to small farmers at 48.0 percent. While new credit to young and beginning farmers did not meet expectations in 2016, small farmer activity exceeded objectives. The percentage goals established for young and beginning customers was not achieved primarily due to the level of other loan activity being greater than projected. Goals were also established by the board for loans outstanding to young, beginning and small farmers. Volume based performance goals for outstanding loans included young borrowers at 10.5 percent, beginning borrowers at 48.0 percent and small borrowers at 58.5 percent of all loans outstanding. Performance mirrored that of new business, with the volume outstanding percentages for young and beginning farmers being below expectations due to overall new loan activity being greater than projected.

The United States Department of Agriculture's NASS 2012 Census of Agriculture provides data regarding the actual market for YBS farmers and ranchers within the 48-county area served by Lone Star. This census data indicated 8.0 percent of farm operators are "young," 30.4 percent of operators are "beginning" and 97.5 percent of farm units are categorized as "small." There are differences in the method by which association YBS data and demographic census data is described. Census data is based on the number of farms, and association data is based on the number of customers. Additionally, census dates do not coincide with an annual analysis of association data, and calculations for young and beginning farmers are slightly different. Annual performance data and goals established also include lending activity outside the association's territory. However, a comparison does offer a quantitative measure of the association's performance in fulfilling its mission of service to young, beginning and small farmers.

The association coordinates its young, beginning and small farmer loan program activities with other lenders. This includes the purchase and sale of loan participations, loan guarantees and joint lending. Related services including appraisal, credit life insurance, life and disability products and leasing programs are available to assist YBS borrowers in their credit and related service needs.

Important components of the association's YBS efforts include the emphasis placed on outreach programs. The association has held a long-standing belief that an investment in agricultural students and youth activities is important to the long-term success of the cooperative. The association develops a comprehensive array of marketing efforts to include youth activities and events including livestock shows, 4-H and FFA events, young professional groups and agricultural leadership opportunities.

The association offers a scholarship program for area seniors and four scholarships are awarded in the lending area. The association also sponsors youth activities in the local area and at the state level through support of 4-H and FFA activities.

A YBS advisory board was formed to generate ideas and methods on how Lone Star, ACA can better serve the YBS demographic in our area. The advisory board minutes are reported to the board of directors.

In summary, the association fulfills its mission of providing agricultural credit, and meeting the specific credit and related service needs of young, beginning and small farmers, ranchers and producers/harvesters of aquatic products through specific lending programs, quantitative performance measures and broad-based objectives.