# FIRST QUARTER 2003

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F. A. Lowrey
Chief Executive Officer

Paul Lemoine
Chairman of the Board

April 29, 2003

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

*(dollars in thousands, except as noted)*

The following discussion reviews the consolidated financial condition and results of operations of AgFirst Farm Credit Bank (AgFirst) and its subsidiary for the three months ended March 31, 2003. These comments should be read in conjunction with the accompanying financial statements and the 2002 Annual Report of AgFirst Farm Credit Bank and its subsidiary.

## FINANCIAL CONDITION

*Loan Portfolio*

Gross loan volume at March 31, 2003 was $11,848,477, a 1.33 percent decrease compared to the volume of $12,008,041 at December 31, 2002. The $159,564 decrease is attributed to several factors, which include bulk sales of rural home loans to Fannie Mae, a reduced level of usage of committed credit facilities, and increased sold participation loan volume. Fluctuations in credit facility usage around fiscal year-end are normal in the industry and are largely the result of borrower tax management activities. The significant growth rate experienced over the past several years moderated during the first quarter, with the slowdown attributed primarily to adverse weather conditions that have delayed agricultural activities in many areas.

The allowance for loan losses at March 31, 2003 of $33,655 is .28 percent of total gross loan volume and 2.22 percent of AgFirst's participation volume. Management considers this allowance to be adequate to absorb potential losses on existing loans.

Overall credit quality in the AgFirst portfolio at March 31, 2003 improved slightly as compared to December 31, 2002 while a decrease is evident compared to March 31st of the prior year. Nonaccrual loan assets in the AgFirst loan portfolio at March 31, 2003 decreased slightly to $20,325 compared to $20,545 at December 31, 2002, and increased from $7,054 at March 31, 2002. The increase in nonaccrual volume in the first quarter of 2003 compared to March 2002 is primarily related to two large loans put into nonaccrual status during the second and third quarters of 2002.

Although overall credit quality improved compared to December 31, 2002, adversity in certain discrete sectors of AgFirst's participation portfolio remains a concern. As a result, AgFirst added $2.5 million to its allowance during the first quarter.

*Liquidity and Funding Sources*

As of March 31, 2003, AgFirst exceeded the minimum permanent capital, core surplus, total surplus and net collateral ratio requirements under the Farm Credit Administration Regulations. At March 31, 2003, AgFirst's permanent capital ratio was 20.73 percent, core surplus was 11.88 percent, total surplus was 20.52 percent, and net collateral was 106.37 percent. Cash and investment securities totaled $2,588,670 or 17.73 percent of total assets compared to $2,512,937 or 17.09 percent of total assets at December 31, 2002. Interest-bearing liabilities, consisting of bonds and notes, decreased by $59,690, or .44 percent, compared to bonds and notes outstanding at December 31, 2002. Interest-bearing liabilities decreased primarily due to the decrease in loan volume previously mentioned.

*Capital Resources*

Total shareholders' equity increased $43,916 from December 31, 2002 to March 31, 2003. This 5.80 percent net increase is the result of an increase of $51,157 in retained earnings related to net income, which was partially offset by accrued dividends for preferred stock of $4,721 and $2,520 related to accumulated other comprehensive income.

***Key financial condition comparisons:***

| | **3/31/03** | **12/31/02** |
|---|---|---|
| Shareholders' Equity to Assets | 5.49% | 5.15% |
| Total Liabilities to Shareholders' Equity | 16.94:1 | 18.13:1 |
| Allowance for Loan Losses to Loans | .28% | .26% |

## RESULTS OF OPERATIONS

*Net Interest Income*

Net interest income for the three months ended March 31, 2003 was $66,320 compared to $61,108 in the same period of 2002. This increase in net interest income is a result of increased loan volume compared to the prior year combined with AgFirst's ability to call significant amounts of debt in a lower interest rate environment.

*Noninterest Income*

Noninterest income for the three months ended March 31, 2003 increased $4,476 compared to the same period in 2002. This increase is mostly attributed to the realized gain of $2,821 related to the sale of $221,317 of rural home loans to Fannie Mae during the quarter compared to $4 for the first quarter of 2002. Increases in upfront loan fees and prepayment penalty fees related to participation loans account for the additional increase.

*Noninterest Expense*

Noninterest expense for the three months ended March 31, 2003 was $20,313, an increase of $491 as compared to the corresponding period in 2002. This increase was primarily attributed to the increase of $3,569 in expenses related to called debt and an increase in salary and employee benefits, which includes $358 in retirement expense and $142 in postretirement healthcare benefits. These increases were offset by the $3,537 positive variance in net realized losses on investments recorded in 2002 compared to recoveries recorded in 2003. During the first quarter of 2002, $3,423 was recorded to write-off the remaining principal balance of an investment, compared to recoveries of $114 realized on the investment in the first quarter of 2003.

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

| | Annualized for the three months ended 3/31/03 | For the year ended 12/31/02 |
|---|---|---|
| Return on Average Assets | 1.43% | 1.43% |
| Return on Average Shareholders' Equity | 26.45% | 23.75% |
| Net Interest Income as a Percentage of Average Earning Assets | 1.88% | 1.91% |

# Consolidated Balance Sheets

| (dollars in thousands) | March 31, 2003 | December 31, 2002 |
|---|---|---|
| | (unaudited) | |
| **Assets** | | |
| Cash and cash equivalents | $ 323,073 | $ 359,819 |
| Investment securities | 2,265,597 | 2,153,118 |
| Loans | 11,848,477 | 12,008,041 |
| Less: allowance for loan losses | 33,655 | 31,155 |
| Net loans | 11,814,822 | 11,976,886 |
| Accrued interest receivable | 48,863 | 50,470 |
| Investments in other Farm Credit System institutions | 78,142 | 78,251 |
| Premises and equipment, net | 18,838 | 18,722 |
| Other assets | 48,175 | 63,924 |
| Total assets | $ 14,597,510 | $ 14,701,190 |
| **Liabilities** | | |
| Bonds and notes | $ 13,478,846 | $ 13,538,536 |
| Accrued interest payable | 40,469 | 43,732 |
| Patronage distribution payable | — | 85,477 |
| Minimum pension liability | 11,351 | 10,449 |
| Other liabilities | 35,523 | 40,312 |
| Total liabilities | 13,566,189 | 13,718,506 |
| Commitments and contingencies | | |
| **Preferred Stock** | 230,560 | 225,839 |
| **Shareholders' Equity** | | |
| Capital stock and participation certificates | 249,444 | 249,444 |
| Retained earnings | 574,109 | 527,673 |
| Accumulated other comprehensive income (loss) | (22,792) | (20,272) |
| Total shareholders' equity | 800,761 | 756,845 |
| Total liabilities and equity | $ 14,597,510 | $ 14,701,190 |

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

# Consolidated Statements of Income

*(unaudited)*

| *(dollars in thousands)* | For the three months ended March 31, 2003 | 2002 |
|---|---|---|
| **Interest Income** | | |
| Investment securities and other | $ 16,077 | $ 16,699 |
| Loans | 121,291 | 139,115 |
| Total interest income | 137,368 | 155,814 |
| **Interest Expense** | 71,048 | 94,706 |
| Net interest income | 66,320 | 61,108 |
| Provision for loan losses | 2,500 | 1,000 |
| Net interest income after provision for loan losses | 63,820 | 60,108 |
| **Noninterest Income** | | |
| Loan fees | 3,845 | 2,825 |
| Gain on sale of rural home loans | 2,821 | 4 |
| Miscellaneous | 984 | 345 |
| Total noninterest income | 7,650 | 3,174 |
| **Noninterest Expenses** | | |
| Salaries and employee benefits | 5,723 | 5,148 |
| Occupancy and equipment | 2,041 | 1,821 |
| Other operating expenses | 2,914 | 3,618 |
| Intra-System financial assistance expenses | 3,851 | 3,896 |
| Realized losses (gains) on investments, net | (114) | 3,423 |
| Call debt expense | 4,963 | 1,394 |
| Miscellaneous | 935 | 522 |
| Total noninterest expenses | 20,313 | 19,822 |
| Net income | $ 51,157 | $ 43,460 |

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

# Consolidated Statements of Changes in Shareholders' Equity

*(unaudited)*

| *(dollars in thousands)* | Preferred Stock | Capital Stock and Participation Certificates | Retained Earnings | Accumulated Other Comprehensive Income | Total Shareholders' Equity |
|---|---|---|---|---|---|
| Balance at December 31, 2001 | $ 225,839 | $ 281,803 | $ 439,104 | $ 7,041 | $ 953,787 |
| Comprehensive income | | | | | |
| Net income | | | 43,460 | | 43,460 |
| Unrealized gains (losses) on investments available for sale | | | | (1,424) | (1,424) |
| Change in fair value of derivative instruments | | | | 1,412 | 1,412 |
| Total comprehensive income | | | | | 43,448 |
| At-risk equity: | | | | | |
| Capital stock/participation certificates issued/retired, net | | (2,638) | | | (2,638) |
| Preferred stock dividends accrued | 4,721 | | (4,721) | | — |
| Balance at March 31, 2002 | $ 230,560 | $ 279,165 | $ 477,843 | $ 7,029 | $ 994,597 |
| Balance at December 31, 2002 | $ 225,839 | $ 249,444 | $ 527,673 | $ (20,272) | $ 982,684 |
| Comprehensive income | | | | | |
| Net income | | | 51,157 | | 51,157 |
| Unrealized gains (losses) on investments available for sale | | | | (1,072) | (1,072) |
| Change in fair value of derivative instruments | | | | (1,448) | (1,448) |
| Total comprehensive income | | | | | 48,637 |
| Capital stock/participation certificates issued/retired, net | | — | | | — |
| Preferred stock dividends accrued | 4,721 | | (4,721) | | — |
| Balance at March 31, 2003 | $ 230,560 | $ 249,444 | $ 574,109 | $ (22,792) | $1,031,321 |

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

# Consolidated Statements of Cash Flows

*(unaudited)*

| *(dollars in thousands)* | For the three months ended March 31, 2003 | 2002 |
|---|---|---|
| **Cash flows from operating activities:** | | |
| Net income | $ 51,157 | $ 43,460 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation on premises and equipment | 1,273 | 987 |
| Provision for loan losses | 2,500 | 1,000 |
| Realized (gains) losses on investments, net | (114) | 3,423 |
| Changes in operating assets and liabilities: | | |
| (Increase) decrease in accrued interest receivable | 1,607 | (1,448) |
| (Increase) decrease in investments in other Farm Credit System institutions | 109 | 159 |
| (Increase) decrease in other assets | 15,749 | (4,562) |
| Increase (decrease) in accrued interest payable | (3,263) | 14,467 |
| Increase (decrease) in other liabilities | (3,887) | 279 |
| Total adjustments | 13,974 | 14,305 |
| Net cash provided by operating activities | 65,131 | 57,765 |
| **Cash flows from investing activities:** | | |
| Investment securities purchased | (931,831) | (600,266) |
| Investment securities sold or matured | 818,394 | 643,369 |
| Net (increase) decrease in loans | 159,564 | (287,152) |
| Purchase of premises and equipment, net | (1,389) | (2,412) |
| Net cash used in investing activities | 44,738 | (246,461) |
| **Cash flows from financing activities:** | | |
| Bonds and notes issued | 15,774,112 | 10,338,336 |
| Bonds and notes retired | (15,835,250) | (10,062,400) |
| Capital stock and participation certificates issued/retired, net | — | (2,638) |
| Patronage refunds and dividends paid | (85,477) | (67,786) |
| Net cash provided by (used in) financing activities | (146,615) | 205,512 |
| Net increase (decrease) in cash and cash equivalents | (36,746) | 16,816 |
| Cash and cash equivalents, beginning of period | 359,819 | 265,254 |
| Cash and cash equivalents, end of period | $ 323,073 | $ 282,070 |
| **Non-cash changes related to hedging activities:** | | |
| Decrease (increase) in loans | $ (1,366) | $ (373) |
| Increase (decrease) in bonds and notes | 384 | (817) |
| Decrease (increase) in other assets | (736) | 193 |
| Increase (decrease) in other liabilities | (418) | (788) |
| **Supplemental information:** | | |
| Interest paid | $ 74,311 | $ 80,239 |

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

# Notes to the Consolidated Financial Statements

*(dollars in thousands, except as noted)*
*(unaudited)*

## NOTE 1 — ORGANIZATION AND SIGNIFICANT ACCOUNTING POLICIES

The accompanying consolidated financial statements include the accounts of AgFirst Farm Credit Bank (AgFirst) and the accounts of the Farm Credit Finance Corporation of Puerto Rico (the Finance Corporation), a wholly owned subsidiary (collectively referred to as the Bank). All significant transactions and balances among the Bank and the Finance Corporation have been eliminated in consolidation.

The significant accounting policies followed and the financial condition and results of operations of the Bank as of and for the year ended December 31, 2002, are contained in the 2002 Annual Report. These unaudited first quarter financial statements should be read in conjunction with the 2002 Annual Report.

The accompanying consolidated financial statements contain all adjustments necessary for a fair presentation of the interim financial condition and results of operations and conform with accounting principles generally accepted in the United States of America (GAAP). The results for the three months ended March 31, 2003 are not necessarily indicative of the results to be expected for the year ending December 31, 2003.

The Bank maintains an allowance for loan losses in accordance with GAAP. The loan portfolio is reviewed quarterly to determine the adequacy of the allowance for losses. As of March 31, 2003, the allowance for losses was adequate in management's opinion to provide for possible losses on existing loans.

## NOTE 2 — ALLOWANCE FOR LOAN LOSSES

An analysis of the allowance for loan losses follows:

| | |
|---|---|
| Balance at 12-31-01 | $ 25,616 |
| Provision for loan losses | 1,000 |
| Loans (charged off), net of recoveries | (231) |
| Balance at 3-31-02 | $ 26,385 |
| | |
| Balance at 12-31-02 | $ 31,155 |
| Provision for loan losses | 2,500 |
| Loans (charged off), net of recoveries | — |
| Balance at 3-31-03 | $ 33,655 |

**NOTE 3 — COMMITMENTS AND CONTINGENT LIABILITIES**

Under the Farm Credit Act of 1971, each System bank is primarily liable for its portion of Systemwide bond and discount note obligations. Additionally, the banks are contingently liable for the Systemwide obligations of the System banks. The total consolidated Systemwide debt securities of the System were $89.8 billion at March 31, 2003.

There are no actions pending against the Bank in which claims for money damages are asserted.