# SECOND QUARTER 2009

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**CERTIFICATION**

The undersigned certify that we have reviewed the June 30, 2009 quarterly report of AgFirst Farm Credit Bank, that the report has been prepared under the oversight of the Audit Committee of the Board of Directors and in accordance with all applicable statutory or regulatory requirements, and that the information contained herein is true, accurate, and complete to the best of our knowledge and belief.

Paul M. House
Chairman of the Board

F. A. Lowrey
Chief Executive Officer

Charl L. Butler
Chief Financial Officer

July 31, 2009

# Report on Internal Control Over Financial Reporting

The Bank's principal executives and principal financial officers, or persons performing similar functions, are responsible for establishing and maintaining adequate internal control over financial reporting for the Bank's 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 Bank's principal executives and principal financial officers, or persons performing similar functions, and effected by its Board of Directors, management and other personnel. This process provides reasonable assurance regarding the reliability of financial reporting information and the preparation of the Financial Statements for external purposes in accordance with accounting principles generally accepted in the United States of America.

Internal control over financial reporting 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 Bank, (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 Bank, and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the Bank's assets that could have a material effect on its Financial Statements.

The Bank's management has completed an assessment of the effectiveness of internal control over financial reporting as of June 30, 2009. 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 Bank concluded that as of June 30, 2009, the internal control over financial reporting was effective based upon the COSO criteria. Additionally, based on this assessment, the Bank determined that there were no material weaknesses in the internal control over financial reporting as of June 30, 2009.

F. A. Lowrey

F.A. Lowrey
Chief Executive Officer

Charl L. Butler

Charl L. Butler
Chief Financial Officer

July 31, 2009

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

The following discussion reviews the financial condition and results of operations of AgFirst Farm Credit Bank (AgFirst or Bank) as of and for the three and six month periods ended June 30, 2009. These comments should be read in conjunction with the accompanying financial statements, the Notes to the Financial Statements and the 2008 Annual Report of AgFirst Farm Credit Bank. AgFirst and its related associations (Associations or District Associations) are collectively referred to as the District. The accompanying financial statements were prepared under the oversight of the Audit Committee of the AgFirst Board of Directors.

Key ratios and data reported below, and in the accompanying financial statements, address the financial performance of AgFirst. However, neither the three months' nor the six months' results of operations may be indicative of an entire year due to the seasonal nature of a portion of AgFirst's business.

## FINANCIAL CONDITION

*Loan Portfolio*

AgFirst's loan portfolio primarily consists of direct loans to District Associations (Direct Notes), loan participations/syndications purchased, Correspondent Lending loans (primarily first lien residential mortgages), and loans to Other Financing Institutions (OFIs) as shown below:

**AgFirst Loan Portfolio**

| *(dollars in thousands)* | June 30, 2009 | | December 31, 2008 | | June 30, 2008 | |
|---|---|---|---|---|---|---|
| Direct Notes | $ 14,962,803 | 70.18% | $ 14,997,151 | 70.61% | $ 15,129,224 | 72.80% |
| Participations/Syndications purchased, net | 4,822,629 | 22.62 | 4,925,744 | 23.19 | 4,451,528 | 21.42 |
| Correspondent Lending | 1,518,452 | 7.12 | 1,309,285 | 6.16 | 1,187,747 | 5.72 |
| Loans to OFIs | 16,250 | 0.08 | 7,150 | 0.04 | 12,500 | 0.06 |
| Total | $ 21,320,134 | 100.00% | $ 21,239,330 | 100.00% | $ 20,780,999 | 100.00% |

Total loans outstanding were $21.320 billion at June 30, 2009, an increase of $80.8 million, or 0.38 percent, compared to total loans outstanding at December 31, 2008. For the last several years leading up to and including most of 2008, loan demand for the Bank was very strong. This trend changed in late 2008 and loan demand slowed dramatically. The marked decrease in loan demand continued into the first half of 2009, leading to no material change in total loans outstanding over that period.

The downturn in the general economy has served to weaken overall loan demand. Future loan demand is difficult to predict, although the growth rate of the loan portfolio is anticipated to remain at a very moderate level for at least the remainder of 2009.

Credit quality at June 30, 2009 reflected continued deterioration compared to prior reporting periods as shown in the table below. The increased volatility in the financial markets, farm commodity price levels, weaker demand for some agricultural products, and the generally weaker economy have affected the overall farm sector and some of AgFirst's customers. The pace of loans migrating to more adverse classifications continued in the first half of 2009 and some additional deterioration is expected.

The following table summarizes the credit quality classifications of the Bank's loan portfolio at June 30, 2009, and selected prior periods.

| AgFirst Total Loan Portfolio Credit Quality as of: | | | |
|---|---|---|---|
| **Classification** | **June 30, 2009** | **December 31, 2008** | **June 30, 2008** |
| Acceptable | 92.95% | 95.57% | 95.63% |
| OAEM * | 5.60% | 3.44% | 4.12% |
| Substandard | 1.45% | 0.99% | 0.25% |
| Doubtful | 0.00% | 0.00% | 0.00% |

* *Other Assets Especially Mentioned*

The recession in the general economy and resulting higher rate of unemployment could further compromise the credit quality of part-time farmers. Many borrowers who have historically had stable income from non-farm sources such as stock portfolios and capital gains income from traded assets have seen dramatic reductions in these income sources. AgFirst is routinely reevaluating the credit-worthiness of these borrowers. Continued weakness in the general economy could further affect credit quality during the remainder of 2009.

*Direct Notes*

AgFirst's primary line of business is to provide funds to the District Associations. AgFirst has a revolving line of credit, referred to as a direct note, in place with each of the Associations to support their loan growth and other operating needs. All the assets of the Associations secure the direct notes, and the capital and loan loss reserves of the Associations cushion the Bank from possible losses in their respective loan portfolios. Lending terms, including Association financial performance criteria, are specified in a separate General Financing Agreement (GFA) between AgFirst and each Association, including the subsidiaries of the Associations.

At June 30, 2009, total direct note volume outstanding was $14.963 billion, a decrease of $34.3 million, or 0.23 percent, compared to December 31, 2008. The volume decrease was primarily due to weak agricultural loan demand as discussed above, and an increase in the Bank's purchase of loan pools from certain Associations, which reduced those Associations' borrowing needs under their direct notes.

Credit quality statistics for the direct note portfolio are shown in the following chart:

| Direct Note Credit Quality as of: | | | |
|---|---|---|---|
| **Classification** | **June 30, 2009** | **December 31, 2008** | **June 30, 2008** |
| Acceptable | 94.40% | 96.99% | 95.56% |
| OAEM * | 5.60% | 3.01% | 4.44% |
| Substandard | 0.00% | 0.00% | 0.00% |
| Doubtful | 0.00% | 0.00% | 0.00% |

* *Other Assets Especially Mentioned*

As of June 30, 2009, twenty of the twenty-two District Associations' direct notes, representing 94.40 percent of the direct note portfolio, were classified acceptable. The remaining two direct notes, representing 5.60 percent of the total, were classified as Other Assets Especially Mentioned (OAEM). All twenty-two of the direct notes are performing. Twenty Associations met or exceeded the minimum GFA and regulatory requirements for liquidity, earnings, and capital as of June 30, 2009. Prior to 2009, one Association was operating under a special credit arrangement. At December 31, 2008, that Association was in violation of its liquidity requirement as measured under its Borrowing Base Formula as defined in the GFA. The same Association also failed to meet the standard earnings covenant at December 31, 2008. In early 2009, following a review of a business plan submitted by the Association to achieve compliance with the covenants during 2009, the Bank approved a temporary waiver of the defaults and allowed the Association to continue operating under a special credit arrangement pursuant to its GFA.

An additional Association also failed to meet its earnings covenant at December 31, 2008. Following review of a business plan submitted in early 2009 by that Association to achieve compliance with the covenant during 2009, the Bank approved a waiver of the default. All District Associations met all regulatory capital requirements.

*Participations/ Syndications*

AgFirst has a participations/syndications portfolio, which consists primarily of commercial agricultural and agribusiness loans. As of June 30, 2009, the participations/syndications portfolio totaled $4.823 billion. The size of this portfolio decreased $103.1 million, or 2.09 percent, from December 31, 2008 to June 30, 2009. As with the direct notes, the moderation of borrower demand in this portfolio is anticipated to continue into the near future.

The credit quality of the participations/syndications portfolio showed a decline during the past twelve months. AgFirst employs a number of risk management techniques to limit credit risk, including underwriting standards, individual borrower exposure limits based on risk ratings, commodity exposure limits, and limits on the amounts of loans purchased from a single originator. The portfolio is diversified both geographically and on a commodity basis. Concentration risk throughout the portfolio is mitigated through established maximum hold positions to a single borrower and to a single commodity. The participations/ syndications portfolio is comprised of a small number of relatively large loans.

Credit quality statistics for the participations/syndications portfolio are shown in the following chart:

| **Participations/Syndications Credit Quality as of:** | | | |
|---|---|---|---|
| **Classification** | **June 30, 2009** | **December 31, 2008** | **June 30, 2008** |
| Acceptable | 86.39% | 90.17% | 95.12% |
| OAEM * | 7.22% | 5.56% | 3.80% |
| Substandard | 6.39% | 4.27% | 1.08% |
| Doubtful | 0.00% | 0.00% | 0.00% |

* *Other Assets Especially Mentioned*

Credit quality deterioration has been caused by a number of different factors. Higher fuel costs in 2008 adversely impacted all producers. Higher feed costs were problematic for the livestock and poultry industries, which caused significant stress on some borrowers and contributed to the credit quality deterioration in the latter half of 2008. The overall level of stress being experienced by borrowers continued in the first half of 2009. Recently, certain commodity prices, including oil and grain, have declined significantly compared to the highest levels experienced during 2008 and early 2009, providing better opportunity for positive earnings in the meat production segments for the remainder of 2009. However, industries tied to housing, such as forestry, sawmills, sod, and landscape nurseries, continue to be impacted by the declining housing construction activity and weakness in the general economy. The global economic slowdown, as well as recent trade restrictions put in place by China, could create less demand for agricultural exports. Declining exports and the negative factors discussed above, could impact the profitability of production agriculture for the remainder of the year.

The ethanol industry has experienced stress due to rapidly changing commodity prices, especially corn, declining fuel consumption, and excess production capacity. This combination of factors has forced a number of ethanol producers into bankruptcy and is resulting in consolidation in the industry. The Bank had minimal exposure to the ethanol industry at June 30, 2009 with only 0.9 percent of total participation loans outstanding related to ethanol. Also, a significant portion of the Bank's other property owned consists of ownership interests in ethanol production facilities, as discussed in the *Nonaccrual Loans, Other Property Owned, and Allowance for Loan Losses* section below.

Loan portfolio credit quality was also adversely affected by deteriorating general economic conditions, including lower real estate values in certain geographic areas included in the Bank's and District's footprint, particularly Florida. The Florida economy slowed after an extended period of significant growth led by increasing real estate values and net population inflows. In 2008, real estate values declined, population growth slowed, and housing foreclosures increased. These conditions continued into the first half of 2009.

*Correspondent Lending*

AgFirst also has a correspondent lending portfolio, which consists primarily of first lien residential mortgages. As of June 30, 2009, the correspondent lending portfolio totaled $1.518 billion. From December 31, 2008 to June 30, 2009, this portfolio increased $209.2 million, or 15.98 percent. The increase in volume of this portfolio was primarily due to refinancing activity generated by the lower interest rate environment.

Essentially all loans in the correspondent lending portfolio are guaranteed by the Federal National Mortgage Association (Fannie Mae) and/or the Federal Agricultural Mortgage Corporation (Farmer Mac), thereby limiting credit risk to AgFirst. The guarantees are in the form of Long-Term Standby Commitments to Purchase, which give AgFirst the right to deliver delinquent loans to the "guarantor" at par. At June 30, 2009, 99.62 percent of the correspondent lending portfolio was classified as Acceptable, and 0.38 percent was classified as OAEM.

*Nonaccrual Loans, Other Property Owned, and Allowance for Loan Losses*

Nonaccrual loan assets for the Bank at June 30, 2009, were $188.5 million compared to $176.4 million at December 31, 2008. Nonaccrual loans increased $12.1 million, net of charge-offs and transfers to other property owned, for the six months ended June 30, 2009 primarily due to three borrower relationships in the forestry industry and one borrower relationship in the ethanol industry, which in total comprise 37.06 percent of the total nonaccrual loan balance at June 30, 2009. The six largest nonaccrual loan relationships accounted for 76.15 percent of the total. These six largest nonaccrual relationships were classified in the forestry (38.69 percent of the six largest total), poultry (30.92 percent), cattle (20.40 percent), and ethanol (9.99 percent) industries. Some of these loans were moved to nonaccrual as a result of transitional agricultural real estate having been negatively impacted by declining real estate values as discussed above. Transitional agricultural real estate is defined as agricultural land usually lying in the path of economic development which results in a land value that cannot be supported solely by agricultural activity. Nonaccrual loans were 0.88 percent of total loans outstanding at June 30, 2009. Management reviews, on an ongoing basis, the Bank's acceptable level of risk tolerance at the individual loan and portfolio levels. Management makes adjustments to credit policy and underwriting standards when appropriate as a part of the ongoing risk management process.

Other property owned (OPO) consists primarily of assets once held as loan collateral that were acquired through foreclosure or deeded to the Bank (or a lender group) in satisfaction of secured loans. Traditionally, OPO is primarily in the form of real estate. However, it can also include equipment and equity interests in companies or partnerships. OPO increased $34.8 million during the first half of 2009 and totaled $35.3 million at June 30, 2009. This increase is primarily due to nonaccrual loans that were transferred into OPO from two participation borrower relationships. Ethanol production facilities account for $32.7 million (92.66 percent) of the Bank's total OPO holdings at June 30, 2009. See discussion of OPO expense in the *Noninterest Income* section below.

The Bank maintains an allowance for loan losses at a level management considers adequate to provide for probable and estimable credit losses within the loan portfolio. The allowance for loan losses was $41.7 million at June 30, 2009, as compared with $44.6 million at December 31, 2008. The decrease during the first half of 2009 was primarily due to charge-offs of $37.8 million for loan amounts determined to be uncollectible. Charge-offs were primarily related to the ethanol (68.10 percent of total), forestry (17.28 percent), and citrus (11.56 percent) industries. The allowance at June 30, 2009 included specific reserves of $22.2 million primarily related to specific credits for three participation borrower relationships (78.81 percent of the total) and $19.5 million of general reserves attributed to participation loans. The total allowance at June 30, 2009 is primarily comprised of reserves for the cattle (29.29 percent of the total), forestry (28.47 percent), and ethanol (11.50 percent) industries. Declining transitional agricultural real estate values impacted charge-offs and reserves in several of the loan classification industries, including forestry, cattle, and citrus. See Note 3, *Allowance for Loan Losses and Impaired Loans,* in the Notes to the Financial Statements for further information. See *Provision for Loan Losses* section below for details regarding increases to the allowance from provision expense.

*Liquidity and Funding Sources*

One of the primary responsibilities of AgFirst is to maintain sufficient liquidity to fund the lending operations of the District Associations, in addition to its own needs. The primary source of funds for AgFirst is the issuance of

Systemwide Debt Securities through the Federal Farm Credit Banks Funding Corporation. At June 30, 2009, AgFirst had $28.100 billion in total debt outstanding compared to $28.053 billion at December 31, 2008. In addition, other interest-bearing liabilities for AgFirst included $225.0 million in Mandatorily Redeemable Preferred Stock in both periods. Total interest-bearing liabilities remained relatively constant primarily due to moderation in loan volumes as discussed in this report. Despite the recent adversity in the financial debt markets, the Bank continues to have adequate access to funding through the issuance of Farm Credit System debt.

AgFirst maintains a $150.0 million committed line of credit facility obtained from its primary commercial depository bank. The line of credit is tied to AgFirst's master cash management clearing account.

Cash and cash equivalents, which increased $77.8 million from December 31, 2008 to a total of $354.9 million at June 30, 2009, are primarily money market securities that are short term in nature (from overnight maturities to maturities that range up to 90 days) and are only purchased from financial institutions that carry sound credit ratings.

Investment securities totaled $7.953 billion, or 26.50 percent of total assets at June 30, 2009, compared to $7.993 billion, or 26.72 percent, as of December 31, 2008. Investment securities decreased $39.7 million (or 0.5 percent) compared to December 31, 2008 primarily due to the slowed growth of total loans as management maintained the investment securities portfolio size generally in line with that of the loan portfolio in order to maintain adequate liquidity.

As of June 30, 2009, AgFirst exceeded all applicable regulatory liquidity requirements. FCA regulations require a liquidity policy that establishes a minimum "coverage" level of 90 days. "Coverage" is defined as the number of days that maturing debt could be funded through the sale of eligible available-for-sale investments, cash, and other highly liquid assets maintained by the Bank. At June 30, 2009, AgFirst's coverage was 161 days. Cash provided by the Bank's operating activities, primarily generated from net interest income in excess of operating expenses and maturities in the loan portfolio, is an additional source of liquidity for the Bank that is not reflected in the coverage calculation of 161 days.

Investment securities classified as being held-to-maturity totaled $1.503 billion at June 30, 2009. These held-to-maturity investments were primarily Rural Housing Mortgage-Backed Securities purchased under a Mission-Related Investment pilot program approved by the FCA in 2005.

Investment securities classified as being available-for-sale totaled $6.451 billion at June 30, 2009. Available-for-sale investments at June 30, 2009 included $3.989 billion in Agency Collateralized Mortgage Obligations (CMOs), $2.009 billion in Agency Adjustable Rate Mortgages, $394.7 million in non-agency CMOs, and $58.2 million in asset-backed securities. Since the majority of the portfolio is invested in agency securities, the portfolio is highly liquid and potential credit loss exposure is limited.

Total net unrealized losses relating to the available-for-sale securities decreased $130.8 million during the first half of 2009 to a total of $225.0 million at June 30, 2009. These net unrealized losses are reflected in Accumulated Other Comprehensive Income (AOCI) in the Financial Statements. The net unrealized losses are primarily attributed to the market dislocation and illiquidity stemming from adversity in the subprime mortgage market. The Bank also recognized credit-related losses of $8.8 million for other-than-temporary impairment during the six months ended June 30, 2009 on three asset-backed securities and two non-agency CMO securities in its portfolio as discussed below, which reduced net income.

The Bank has low exposure to investments backed by subprime mortgages. Asset-backed securities with subprime exposure totaled $58.2 million, which represented 0.90 percent of the available-for-sale liquidity investment portfolio and 0.73 percent of the total investment security portfolio at June 30, 2009. The amortized cost of these investment securities totaled $96.8 million and the market value adjustment decrease for asset-backed securities of $38.7 million was included in the total $225.0 million of net unrealized losses reflected in AOCI at June 30, 2009. The Bank's asset-backed securities not rated in the highest category (AAA/Aaa) by at least one of the Nationally Recognized Statistical Rating Organizations (NRSROs) at June 30, 2009, totaled $46.0 million (amortized cost value of $82.9 million). Despite the uncertainty in the mortgage securities markets, which has adversely impacted the market value of all asset-backed securities, all but two of these securities, on which there was a $784 thousand payment shortfall during the second quarter of 2009, continue to perform.

Non-agency CMOs have also experienced significant market pricing volatility. Bank non-agency CMOs totaled $394.7 million, which represented 6.12 percent of the available-for-sale liquidity investment portfolio and 4.96 percent of the total investment security portfolio at June 30, 2009. The amortized cost of these investment securities totaled $511.7 million and the market value adjustment decrease for non-agency CMOs of $117.0 million was included in the total $225.0 million of net unrealized losses reflected in AOCI at June 30, 2009 as discussed above. The Bank's non-agency CMO securities not rated in the highest category (AAA/Aaa) by at least one of the NRSROs at June 30, 2009 had a total fair value of $42.6 million and an amortized cost of $58.2 million.

The Farm Credit Administration (FCA) considers asset-backed and mortgage-backed investment securities rated below AAA/Aaa by the NRSROs to be ineligible and requires System institutions to divest of such investments. However, System institutions may seek approval to continue to hold these investments. For each of the investment securities in the Bank's portfolio at June 30, 2009 rated below AAA/ Aaa (total fair value of $88.6 million and amortized cost of $141.1 million), the Bank has developed and submitted plans for approval by the FCA that provide that the securities may be held to maturity. The FCA has approved with conditions the Bank's plans for all but one, which the FCA is still in the process of reviewing. For purposes of the permanent capital, total surplus, and core surplus regulatory ratios, certain Bank ineligible securities at June 30, 2009 are risk weighted 100 percent instead of the standard 20 percent in calculating the risk adjusted assets amount. These ineligible securities had a fair value of $22.7 million and amortized cost of $30.2 million. Other ineligible securities which must be deducted completely from both capital and risk adjusted assets, based on the extent of its below investment grade rating from NRSROs, had a fair value of $65.9 million and amortized cost of $110.8 million at June 30, 2009. For purposes of the net collateral ratio, all ineligible investments are stated at lower of cost or market. See the *Capital Resources* section below for further discussion of the regulatory ratios. In addition, all ineligible investments are excluded from liquidity coverage as defined above.

The Bank performs periodic credit reviews, including other-than-temporary impairment analysis, on its entire investment securities portfolio. Additional analysis for each security not rated in the top category by the NRSROs is performed using a cash flow model with key assumptions and performance factors which may include credit default rate, prepayment rate, and loss severity. The objective is to quantify any future possible loss of principal or interest due on each identified security. The credit enhancements specific to the individual security are considered as appropriate, and may include monoline credit insurance, subordination, over-collateralization and excess interest spread. Asset-backed securities covered by insurers are analyzed with insurance and without, to quantify the extent of reliance on their guarantee. Based on the results of all analyses, the Bank recognized other-than-temporary credit related impairment of $8.8 million on three asset-backed securities and two non-agency CMOs in its portfolio for the six months ended June 30, 2009, which was included in Net Impairment Losses on Investments in the Statements of Income. Credit loss is defined as the shortfall of the present value of the cash flows expected to be collected in relation to the amortized cost basis.

For all other investments, the Bank has not recognized any other-than-temporary impairment as it has determined that the decline in market value was caused primarily by reduced liquidity in the securities markets stemming from the general adversity in the financial and mortgage markets. The Bank has the ability and intent to hold these investments until a recovery of unrealized losses occurs, which may be at maturity, and at this time expects to collect the full principal amount and interest due on these securities.

For purposes of determining the fair values of the modeled securities and the resulting unrealized gain/ loss impact through AOCI, the Bank considers both a price or "mark" provided by a third party pricing service and also a value determined using the results of the modeling process. The Bank reviews and periodically discusses with the third party pricing service and valuation experts the assumptions used in their pricing models for the asset-backed and non-agency CMO securities impacted by inactive trading or distressed sales. This process ensures when relevant observable inputs are not available, that the fair value reported for each security fairly reflects the price expected to be received in an orderly transaction that is not a forced liquidation or distressed sale at the measurement date. The modeling process was factored into the pricing for the asset-backed security and the non-agency CMO security portfolios.

New accounting guidance issued by the Financial Accounting Standards Board (FASB) in April 2009 impacted the amount of security impairment exposure and the overall valuation of the Bank's security portfolio at June 30, 2009. See Note 1, *Organization, Significant Accounting Policies, and Recently Issued Accounting Pronouncements*, Note 2, *Investment Securities*, and Note 4, *Fair Value Measurement,* in the Notes to the Financial Statements for further information.

*Capital Resources*

Total shareholders' equity increased $242.0 million from December 31, 2008 to June 30, 2009. This 19.50 percent net increase is primarily attributed to an increase in unallocated retained earnings from net income of $116.4 million and a net increase in capital stock issued of $4.9 million, and a decrease of $130.8 million in unrealized losses on investments available-for-sale, a component of AOCI, offset by perpetual preferred stock dividends paid of $13.7 million. Total unrealized losses on investments available-for-sale were $225.0 million at June 30, 2009.

As of June 30, 2009, AgFirst exceeded the minimum permanent capital, core surplus, total surplus, and net collateral ratio requirements established by FCA Regulations. In conjunction with the issuance of the Mandatorily Redeemable Preferred Stock, FCA requires AgFirst to maintain a minimum net collateral ratio of 104.00 percent compared to the System regulatory minimum of 103.00 percent. AgFirst reported the following regulatory ratios:

| | **Regulatory** | **AgFirst Ratio as of** | |
|---|---|---|---|
| | **Minimum** | **6/30/09** | **12/31/08** |
| Permanent Capital Ratio | 7.00% | 15.97% | 17.15% |
| Total Surplus Ratio | 7.00% | 15.92% | 17.11% |
| Core Surplus Ratio | 3.50% | 9.03% | 10.43% |
| Net Collateral Ratio | 104.00% | 105.94% | 105.56% |

The Bank's permanent capital, total surplus, and core surplus ratios declined at June 30, 2009 as compared to December 31, 2008. These ratios are calculated using three month average daily balances for both capital and assets. Therefore, 2008 patronage paid affected the 2009 average capital levels. Also, deductions for ineligible investment securities were higher in the 2009 period. The impairment in AOCI, as discussed above, does not affect the reported capital ratios because the affect of AOCI is excluded entirely from the risk-based capital ratios.

## RESULTS OF OPERATIONS

Net income for the three months ended June 30, 2009 was $63.9 million, compared to $57.0 million at June 30, 2008, an increase of $6.9 million, or 12.06 percent. For the six months ended June 30, 2009, net income was $116.4 million, compared to $106.0 million at June 30, 2008, an increase of $10.4 million, or 9.81 percent. These overall increases are discussed below.

*Net Interest Income*

Net interest income for the three months ended June 30, 2009 was $117.7 million compared to $86.5 million for the same period of 2008, an increase of $31.1 million or 35.95 percent. For the six months ended June 30, 2009, net interest income was $225.2 million compared to $165.0 million for the same period of 2008, an increase of $60.2 million or 36.50 percent. Net interest margin was 1.59 percent and 1.55 percent in the current year three and six month periods respectively, an improvement of 36 basis points and 34 basis points over the same periods of 2008. Spreads improved as called debt was replaced by new debt issued at a lower rate of interest thereby increasing net interest income. Loan pricing compared to the underlying cost of funds also improved during the 2009 period. The increase in net interest income due to balance sheet volume was small due to very limited loan growth as previously discussed.

The following table illustrates the changes in net interest income:

| *(dollars in thousands)* | For the three months ended June 30, 2009 vs. June 30, 2008 — Increase (decrease) due to changes in: Volume | Rate | Total | For the six months ended June 30, 2009 vs. June 30, 2008 — Increase (decrease) due to changes in: Volume | Rate | Total |
|---|---|---|---|---|---|---|
| Interest Income: | | | | | | |
| Loans | $ 10,892 | $ (51,812) | $ (40,920) | $ 34,713 | $ (124,732) | $ (90,019) |
| Investments & Cash Equivalents | 4,673 | (26,472) | (21,799) | 13,274 | (64,476) | (51,202) |
| Total Interest Income | $ 15,565 | $ (78,284) | $ (62,719) | $ 47,987 | $ (189,208) | $ (141,221) |
| Interest Expense: | | | | | | |
| Interest-Bearing Liabilities | $ 14,553 | $ (108,380) | $ (93,827) | $ 43,434 | $ (244,870) | $ (201,436) |
| Changes in Net Interest Income | $ 1,012 | $ 30,096 | $ 31,108 | $ 4,553 | $ 55,662 | $ 60,215 |

*Provision for Loan Losses*

The provision for loan losses was $18.2 million and $34.9 million for the three and six month periods ended June 30, 2009, compared to $6.1 million and $6.7 million for the same periods in 2008. Provision expense for the three month period ended June 30, 2009 was primarily specific reserve increases for four participation borrower relationships, a reversal of a specific reserve for one participation borrower relationship, and general reserve increases for the forestry and swine industries. The net provision expense of $18.2 million was primarily due to loans classified in the forestry (28.54 percent of the total), cattle (24.65 percent), ethanol (23.74 percent), citrus (12.09 percent) and swine (10.45 percent) industries.

Provision expense for the six months ended June 30, 2009 was primarily specific reserve increases for eight participation borrower relationships, a reversal of a specific reserve for one participation borrower relationship, and general reserve increases for the forestry and swine industries. The net provision expense of $34.9 million was primarily due to loans classified in the ethanol (36.73 percent of the total), forestry (27.94 percent), cattle (16.50 percent), swine (5.41 percent) and citrus (4.95 percent) industries.

As mentioned previously, declining transitional agricultural real estate values were, in part, the reason for some of the provision expense recognized by the Bank.

See Note 3, *Allowance for Loan Losses and Impaired Loans,* in the Notes to the Financial Statements for further information.

*Noninterest Income*

The following table illustrates the changes in noninterest income:

| **Change in Noninterest Income** *(dollars in thousands)* | For the three months ended June 30, 2009 | 2008 | Increase/ (Decrease) | For the six months ended June 30, 2009 | 2008 | Increase/ (Decrease) |
|---|---|---|---|---|---|---|
| Loan fees | $ 3,095 | $ 2,326 | $ 769 | $ 5,345 | $ 4,701 | $ 644 |
| Gains (losses) from other property owned, net | (2,286) | - | (2,286) | (2,286) | (9) | (2,277) |
| Gains (losses) on investments, net | - | - | - | - | (71) | 71 |
| Net impairment losses on investments | (3,378) | - | (3,378) | (8,831) | - | (8,831) |
| Gains (losses) on derivatives | (266) | - | (266) | 305 | - | 305 |
| Gains (losses) on sale of rural home loans, net | - | (5) | 5 | - | 35 | (35) |
| Patronage refunds from other Farm Credit Institutions | 375 | (210) | 585 | 1,133 | 226 | 907 |
| Other noninterest income | 1,607 | 1,189 | 418 | 3,174 | 1,822 | 1,352 |
| Total noninterest income | $ (853) | $ 3,300 | $ (4,153) | $ (1,160) | $ 6,704 | $ (7,864) |

Noninterest income, net of certain gains and losses as detailed in the table above for the three months ended June 30, 2009, was ($853 thousand), which reflected a decrease of $4.2 million compared to the same period in 2008. For the six months ended June 30, 2009, noninterest income was ($1.2 million), which reflected a decrease of $7.9 million compared to the same period in 2008. The decrease for the three and six month periods was primarily due to the recognition of credit related other-than-temporary impairment on several of the Bank's investment securities of $3.4 million and $8.8 million respectively, as discussed above. Also, expenses, including legal and appraisal fees, associated with OPO have increased significantly during the second quarter of 2009 due to the acquisition of such properties by the Bank as discussed above. The gains (losses) on derivatives in 2009 are from hedging ineffectiveness related to swap derivatives. Noninterest income benefitted by increases in loan fees and patronage refunds from other Farm Credit Institutions. Also adding to total noninterest income in the 2009 periods was other noninterest income primarily from outside sources for services to Associations and other Farm Credit System entities and a 2008 captive insurance premium rebate received and recorded in the first quarter of 2009.

*Noninterest Expense*

The following table illustrates the changes in noninterest expense:

| **Change in Noninterest Expense** | **For the three months ended June 30,** | | | **For the six months ended June 30,** | | |
|---|---|---|---|---|---|---|
| *(dollars in thousands)* | **2009** | **2008** | **Increase/ (Decrease)** | **2009** | **2008** | **Increase/ (Decrease)** |
| Salaries and employee benefits | $ 9,496 | $ 6,954 | $ 2,542 | $ 18,611 | $ 14,116 | $ 4,495 |
| Occupancy and equipment | 3,457 | 3,575 | (118) | 6,669 | 7,336 | (667) |
| Insurance Fund premiums | 5,337 | 2,047 | 3,290 | 10,329 | 3,901 | 6,428 |
| Other operating expenses | 4,946 | 5,060 | (114) | 10,163 | 10,167 | (4) |
| Called debt expense | 9,495 | 8,265 | 1,230 | 23,296 | 21,873 | 1,423 |
| Correspondent lending servicing expense | 1,878 | 762 | 1,116 | 3,496 | 1,394 | 2,102 |
| Other noninterest expense | 69 | 69 | - | 139 | 139 | - |
| Total noninterest expense | $ 34,678 | $ 26,732 | $ 7,946 | $ 72,703 | $ 58,926 | $ 13,777 |

Noninterest expense for the three months ended June 30, 2009 was $34.7 million, which reflected an increase of $7.9 million compared to the corresponding period in 2008. For the six months ended June 30, 2009, noninterest expense was $72.7 million, which reflected an increase of $13.8 million compared to the corresponding period in 2008.

Salaries and employee benefits increased $2.5 million (36.55 percent) and $4.5 million (31.84 percent) for the three and six month periods primarily due to increased pension expense resulting from a decrease in the expected return on plan assets and an increase in the amount of actuarial losses amortized for 2009 for the districtwide plan in which the Bank participates. See Note 7, *Employee Benefit Plans*, in the Notes to the Financial Statements, for further information.

The Insurance Fund premiums increased $3.3 million (160.72 percent) and $6.4 million (164.78 percent) for the three and six month periods primarily due to a change in assessment of Insurance Fund premiums. Effective July 1, 2008, the base on which Insurance Fund premiums are assessed was expanded from total loans to total System debt. Also, the annual premium rate, which was 15 basis points for the first six months of 2008, was increased to 20 basis points for 2009.

Called debt expense increased $1.2 million (14.88 percent) for the three month period as call options were exercised on bonds totaling $6.4 billion during the second quarter of 2009 and the remaining $9.5 million of concession (debt issuance costs) for these bonds were expensed. The called debt expense is more than offset by interest expense savings realized as called debt is replaced by new debt issued at a lower rate of interest. Called debt activity is expected to be less significant for the remainder of the year.

The increase in correspondent lending servicing expense of $1.1 million (146.46 percent) and $2.1 million (150.79 percent) for the three and six month periods, respectively, was primarily due to higher guarantee fees from increased volume in the correspondent lending portfolio.

Other noninterest expense consists of amortization of mandatorily redeemable preferred stock issuance costs.

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

| | Annualized for the six months ended June 30, 2009 | For the year ended December 31, 2008 | Annualized for the six months ended June 30, 2008 |
|---|---|---|---|
| Return on average assets | 0.79% | 0.76% | 0.77% |
| Return on average shareholders' equity | 17.40% | 14.59% | 14.46% |
| Net interest income as a percentage of average earning assets | 1.55% | 1.29% | 1.21% |
| Net (charge-offs) recoveries to average loans | (0.36)% | (0.01)% | 0.02% |

## RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS

Please refer to Note 1, *Organization, Significant Accounting Policies, and Recently Issued Accounting Pronouncements*, in the Notes to the Financial Statements, and the 2008 Annual Report of AgFirst Farm Credit Bank for recently issued accounting pronouncements.

**NOTE:** Shareholder investment in a District Association is materially affected by the financial condition and results of operations of AgFirst Farm Credit Bank. Copies of AgFirst's annual and quarterly reports are available upon request free of charge by calling 1-800-845-1745, ext. 378, or writing Stephen Gilbert, Director of Financial Reporting, AgFirst Farm Credit Bank, P.O. Box 1499, Columbia, SC 29202. Combined information concerning AgFirst Farm Credit Bank and District Associations can also be obtained at the Bank's website, *www.agfirst.com*. AgFirst prepares a quarterly report within 40 days after the end of each fiscal quarter, except that no quarterly report need be prepared for the fiscal quarter that coincides with the end of the fiscal year of the institution.

# Balance Sheets

| (dollars in thousands) | June 30, 2009 (unaudited) | December 31, 2008 (audited) |
|---|---|---|
| **Assets** | | |
| Cash and cash equivalents | $ 354,894 | $ 277,003 |
| Investment securities: | | |
| Available for sale (amortized cost of $6,675,598 and $6,619,348 respectively) | 6,450,638 | 6,263,557 |
| Held to maturity (fair value of $1,530,890 and $1,763,185 respectively) | 1,502,861 | 1,729,600 |
| Total investment securities | 7,953,499 | 7,993,157 |
| Loans | 21,320,134 | 21,239,330 |
| Less: allowance for loan losses | 41,728 | 44,565 |
| Net loans | 21,278,406 | 21,194,765 |
| Accrued interest receivable | 95,859 | 106,593 |
| Investments in other Farm Credit System institutions | 74,671 | 75,055 |
| Premises and equipment, net | 16,156 | 18,061 |
| Other property owned | 35,326 | 540 |
| Due from associations | 21,418 | 40,671 |
| Other assets | 182,799 | 205,206 |
| Total assets | $ 30,013,028 | $ 29,911,051 |
| **Liabilities** | | |
| Bonds and notes | $ 28,099,601 | $ 28,053,023 |
| Mandatorily redeemable preferred stock | 225,000 | 225,000 |
| Accrued interest and dividends payable | 105,006 | 154,143 |
| Patronage distribution payable | — | 157,017 |
| Other liabilities | 100,360 | 80,776 |
| Total liabilities | 28,529,967 | 28,669,959 |
| Commitments and contingencies (Note 6) | — | — |
| **Shareholders' Equity** | | |
| Perpetual preferred stock | 400,000 | 400,000 |
| Capital stock and participation certificates | 439,843 | 434,929 |
| Retained earnings | | |
| Allocated | 848 | 805 |
| Unallocated | 868,629 | 762,550 |
| Accumulated other comprehensive income (loss) | (226,259) | (357,192) |
| Total shareholders' equity | 1,483,061 | 1,241,092 |
| Total liabilities and equity | $ 30,013,028 | $ 29,911,051 |

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

# Statements of Income

*(unaudited)*

| *(dollars in thousands)* | For the three months ended June 30, 2009 | For the three months ended June 30, 2008 | For the six months ended June 30, 2009 | For the six months ended June 30, 2008 |
|---|---|---|---|---|
| **Interest Income** | | | | |
| Investment securities and other | $ 51,471 | $ 73,270 | $ 102,880 | $ 154,082 |
| Loans | 207,788 | 248,708 | 424,247 | 514,266 |
| Total interest income | 259,259 | 321,978 | 527,127 | 668,348 |
| **Interest Expense** | 141,605 | 235,432 | 301,926 | 503,362 |
| Net interest income | 117,654 | 86,546 | 225,201 | 164,986 |
| Provision for (reversal of) loan losses | 18,194 | 6,065 | 34,895 | 6,725 |
| Net interest income after provision for (reversal of) loan losses | 99,460 | 80,481 | 190,306 | 158,261 |
| **Noninterest Income** | | | | |
| Loan fees | 3,095 | 2,326 | 5,345 | 4,701 |
| Gains (losses) from other property owned, net | (2,286) | — | (2,286) | (9) |
| Gains (losses) on investments, net | — | — | — | (71) |
| Impairment losses on investments (Note 2) | (3,500) | — | (22,134) | — |
| Noncredit-related losses on investments not expected to be sold (recognized in other comprehensive income) (Note 2) | 122 | — | 13,303 | — |
| Net impairment losses on investments | (3,378) | — | (8,831) | — |
| Gains (losses) on derivatives, net | (266) | — | 305 | — |
| Gain (loss) on sale of rural home loans, net | — | (5) | — | 35 |
| Patronage refunds from other Farm Credit institutions | 375 | (210) | 1,133 | 226 |
| Other noninterest income | 1,607 | 1,189 | 3,174 | 1,822 |
| Total noninterest income | (853) | 3,300 | (1,160) | 6,704 |
| **Noninterest Expenses** | | | | |
| Salaries and employee benefits | 9,496 | 6,954 | 18,611 | 14,116 |
| Occupancy and equipment | 3,457 | 3,575 | 6,669 | 7,336 |
| Insurance Fund premiums | 5,337 | 2,047 | 10,329 | 3,901 |
| Other operating expenses | 4,946 | 5,060 | 10,163 | 10,167 |
| Called debt expense | 9,495 | 8,265 | 23,296 | 21,873 |
| Correspondent lending servicing expense | 1,878 | 762 | 3,496 | 1,394 |
| Other noninterest expense | 69 | 69 | 139 | 139 |
| Total noninterest expenses | 34,678 | 26,732 | 72,703 | 58,926 |
| Net income | $ 63,929 | $ 57,049 | $ 116,443 | $ 106,039 |

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

# Statements of Changes in Shareholders' Equity

*(unaudited)*

| *(dollars in thousands)* | Perpetual Preferred Stock | Capital Stock and Participation Certificates | Retained Earnings Allocated | Retained Earnings Unallocated | Accumulated Other Comprehensive Income | Total Shareholders' Equity |
|---|---|---|---|---|---|---|
| Balance at December 31, 2007 | $ 400,000 | $ 364,759 | $705 | $ 730,724 | $ (38,707) | $ 1,457,481 |
| Comprehensive income | | | | | | |
| Net income | | | | 106,039 | | 106,039 |
| Unrealized gains (losses) on investments available for sale | | | | | (138,869) | (138,869) |
| Employee benefit plans adjustments | | | | (138) | 86 | (52) |
| Total comprehensive loss | | | | | | (32,882) |
| Capital stock/participation certificates issued/(retired), net | | 33,808 | | | | 33,808 |
| Perpetual preferred stock dividends paid | | | | (13,706) | | (13,706) |
| Cash patronage | | | | (261) | | (261) |
| Patronage distribution adjustment | | | (89) | 200 | | 111 |
| Balance at June 30, 2008 | $ 400,000 | $ 398,567 | $ 616 | $ 822,858 | $ (177,490) | $ 1,444,551 |
| | | | | | | |
| Balance at December 31, 2008 | $ 400,000 | $ 434,929 | $ 805 | $ 762,550 | $ (357,192) | $ 1,241,092 |
| Comprehensive income (loss) | | | | | | |
| Net income | | | | 116,443 | | 116,443 |
| Unrealized gains (losses) on investments available for sale: | | | | | | |
| Other-than-temporarily impaired (Note 2) | | | | | (13,303) | |
| Temporarily impaired (Note 2) | | | | | 147,608 | |
| Total unrealized gains (losses) on investments available for sale | | | | | | 134,305 |
| Employee benefit plans adjustments | | | | | 102 | 102 |
| Total comprehensive income | | | | | | 250,850 |
| Capital stock/participation certificates issued/(retired), net | | 4,914 | | | | 4,914 |
| Perpetual preferred stock dividends paid | | | | (13,706) | | (13,706) |
| Nonqualified allocated retained earnings | | | 43 | (43) | | — |
| Cash patronage | | | | (25) | | (25) |
| Cumulative-effect adjustment for investment impairment accounting change (Note 2) | | | | 3,474 | (3,474) | — |
| Patronage distribution adjustment | | | | (64) | | (64) |
| Balance at June 30, 2009 | $ 400,000 | $ 439,843 | $ 848 | $ 868,629 | $ (226,259) | $ 1,483,061 |

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

# Statements of Cash Flows

*(unaudited)*

| *(dollars in thousands)* | For the six months ended June 30, 2009 | 2008 |
|---|---|---|
| **Cash flows from operating activities:** | | |
| Net income | $ 116,443 | $ 106,039 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation on premises and equipment | 4,191 | 4,682 |
| Premium amortization/discount accretion on investment securities | 5,428 | 2,835 |
| Premium amortization/discount accretion on bonds and notes | 26,942 | 7,576 |
| Provision for (reversal of) loan losses | 34,895 | 6,725 |
| (Gains) losses on other property owned, net | 2,286 | 9 |
| Net impairment losses on investments | 8,831 | — |
| (Gains) losses on investments, net | — | 71 |
| (Gains) losses on derivatives, net | (305) | — |
| (Gains) losses on sales of rural home loans, net | — | (35) |
| Net change in loans held for sale | — | 16,275 |
| (Increase) decrease in accrued interest receivable | 10,734 | 3,001 |
| (Increase) decrease in due from associations | 19,253 | 17,360 |
| (Increase) decrease in other assets | (20,136) | (6,054) |
| Increase (decrease) in accrued interest payable | (49,137) | 9,015 |
| Increase (decrease) in other liabilities | 14,536 | (6,322) |
| Total adjustments | 57,518 | 55,138 |
| Net cash provided by (used in) operating activities | 173,961 | 161,177 |
| **Cash flows from investing activities:** | | |
| Investment securities purchased | (1,077,876) | (2,220,748) |
| Investment securities sold or matured | 1,151,584 | 1,051,059 |
| Net (increase) decrease in loans | (64,434) | (1,684,543) |
| (Increase) decrease in investments in other Farm Credit System institutions | 384 | 472 |
| Purchase of premises and equipment, net | (2,286) | (4,104) |
| Proceeds from sale of other property owned | 179 | — |
| Net cash provided by (used in) investing activities | 7,551 | (2,857,864) |
| **Cash flows from financing activities:** | | |
| Bonds and notes issued | 56,695,369 | 62,800,203 |
| Bonds and notes retired | (56,633,092) | (60,119,030) |
| Capital stock and participation certificates issued/retired, net | 4,914 | 33,808 |
| Cash distribution to shareholders | (157,106) | (153,253) |
| Dividends paid on perpetual preferred stock | (13,706) | (13,706) |
| Net cash provided by (used in) financing activities | (103,621) | 2,548,022 |
| Net increase (decrease) in cash and cash equivalents | 77,891 | (148,665) |
| Cash and cash equivalents, beginning of period | 277,003 | 558,770 |
| Cash and cash equivalents, end of period | $ 354,894 | $ 410,105 |
| **Supplemental schedule of non-cash investing and financing activities:** | | |
| Loans transferred to other property owned | $ 34,965 | $ 540 |
| Investments transferred to loans (Note 1) | 91,353 | — |
| Change in unrealized gains (losses) on investments and derivative instruments, net | 134,305 | (138,869) |
| Employee benefit plans adjustments | 102 | (52) |
| Cumulative-effect adjustment for investment impairment accounting change (Note 2) | (3,474) | — |
| **Non-cash changes related to hedging activities:** | | |
| Increase (decrease) in bonds and notes | $ (42,641) | $ 4,442 |
| Decrease (increase) in other assets | 42,543 | (4,568) |
| Increase (decrease) in other liabilities | (305) | 126 |
| **Supplemental information:** | | |
| Interest paid | $ 324,121 | $ 486,771 |

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

# Notes to the Financial Statements

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

**NOTE 1 — ORGANIZATION, SIGNIFICANT ACCOUNTING POLICIES, AND RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS**

The accompanying financial statements include the accounts of AgFirst Farm Credit Bank (AgFirst or Bank). AgFirst and its related associations (Associations or District Associations) are collectively referred to as the District. A description of the organization and operations, 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, 2008 are contained in the 2008 Annual Report to Shareholders. These unaudited second quarter 2009 financial statements should be read in conjunction with the 2008 Annual Report to Shareholders.

The accompanying financial statements contain all adjustments necessary for a fair presentation of the interim financial condition and results of operations and conform with generally accepted accounting principles (GAAP) and prevailing practices within the banking industry. The results for the six months ended June 30, 2009 are not necessarily indicative of the results to be expected for the year ending December 31, 2009.

There were no reclassifications of amounts in the prior period's financial statements to conform to the current period's financial statement presentation. During the second quarter of 2009, the Bank reclassified certain financial instruments which totaled $91.4 million from investments to loans. These instruments were secondary market acquisitions of either private placement or senior secured notes transacted under the scope of the Bank's lending authority. The reclassification better reflects the nature of these notes and provides for consistent presentation across the Farm Credit System. This reclassification of $91.4 million is reflected as a non-cash item in the Statements of Cash Flows and did not have a significant impact on the Financial Statements or the regulatory ratios.

The Bank maintains an allowance for loan losses at a level considered adequate by management to provide for probable and estimable losses inherent in the loan portfolio. The allowance for loan losses is increased through provisions for loan losses and loan recoveries and is decreased through allowance for loan losses reversals and loan charge-offs. A review of individual loans in each respective portfolio is performed periodically to determine the appropriateness of risk ratings and to assure loss exposure to the Bank has been identified. Certain loan pools acquired from several of the District Associations are analyzed in accordance with the selling Association's allowance methodologies for assigning general and specific allowances. The allowance for loan losses is a valuation account used to reasonably estimate loan losses as of the financial statement date. Determining the appropriate allowance for loan losses balance involves significant judgment about when a loss has been incurred and the amount of that loss. The Bank considers factors such as credit risk classifications, collateral values, risk concentrations, economic and weather related conditions, among others, when determining the allowance for loan losses.

A specific allowance may be established for impaired loans under Statement of Financial Accounting Standards (SFAS) No. 114, "Accounting by Creditors for Impairment of a Loan." Impairment of these loans is measured based on the present value of expected future cash flows discounted at the loan's effective interest rate or at the loan's observable market price or fair value of the collateral if the loan is collateral dependent.

A general allowance may also be established under SFAS No. 5, "Accounting for Contingencies," to reflect estimated probable credit losses inherent in the remainder of the loan portfolio which excludes impaired loans considered under the specific allowance discussed above. A general allowance can be evaluated on a pool basis for those loans with similar characteristics. The level of the general allowance may be based on management's best estimate of the likelihood of default adjusted for other relevant factors reflecting the current environment.

Effective January 1, 2009, the Bank adopted SFAS No. 161, "Disclosures about Derivative Instruments and Hedging Activities," which amends and expands the disclosure requirements for derivative instruments and for hedging activities previously required by SFAS No. 133, “Accounting for Derivative Instruments and Hedging Activities.” It states that an entity with derivative instruments shall disclose information to enable users of the financial statements to understand:

a. How and why an entity uses derivative instruments
b. How derivative instruments and related hedged items are accounted for under this Statement and related interpretations
c. How derivative instruments and related hedged items affect an entity’s financial position, financial performance, and cash flows.

The adoption of this Standard did not have an impact on the financial statements; however, the derivative instruments disclosures have been expanded in accordance with SFAS No. 161 (see Note 8).

Effective January 1, 2009, the Bank adopted Financial Accounting Standards Board (FASB) Statement of Position (FSP) No. 157-2, “Effective Date of FASB Statement No. 157.” This FSP delayed the effective date of Statement No. 157 for nonfinancial assets and nonfinancial liabilities until fiscal years beginning after November 15, 2008. The impact of adoption resulted in additional fair value disclosures (see Note 4), primarily regarding other property owned, but does not have an impact on the Bank’s financial condition or results of operations.

In April 2009, the FASB issued FSP No. 157-4, “Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly” (FSP 157-4). FSP 157-4 emphasizes that even if there has been a significant decrease in the volume and level of activity for the asset or liability and regardless of the valuation technique and inputs used, the objective for the fair value measurement is unchanged from what it would be if markets were operating at normal activity levels or transactions were orderly; that is, to determine the current exit price. It sets forth additional factors that should be considered to determine whether there has been a significant decrease in volume and level of activity when compared with normal market activity. The reporting entity shall evaluate the significance and relevance of the factors to determine whether, based on the weight of evidence, there has been a significant decrease in activity and volume. FSP 157-4 indicates that if an entity determines that either the volume or level of activity for an asset or liability has significantly decreased (from normal conditions for that asset or liability) or price quotations or observable inputs are not associated with orderly transactions, increased analysis and management judgment will be required to estimate fair value. It is further noted that a fair value measurement should include a risk adjustment to reflect the amount market participants would demand because of the risk (uncertainty) in the cash flows.

FSP 157-4 also requires a reporting entity to make additional disclosures in interim and annual periods. Revisions resulting from a change in valuation techniques or their application are accounted for as a change in accounting estimate. The Bank adopted this FSP effective March 31, 2009 (see Note 2 and Note 4).

In April 2009, the FASB issued FSP No. 115-2, “Recognition and Presentation of Other-Than-Temporary Impairments” (FSP 115-2), which amends the other-than-temporary impairment guidance for debt securities to make the guidance more operational and to improve the presentation and disclosure of other-than-temporary impairments on debt securities in the financial statements. It does not change existing recognition and measurement guidance related to other-than-temporary impairments of equity securities.

FSP 115-2 changes existing impairment guidance under FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities (FAS 115) by eliminating the “ability and intent to hold” provision. In addition, impairment is now considered to be other than temporary if an entity 1) intends to sell the security, 2) more likely than not will be required to sell the security before recovering its cost, or 3) does not expect to recover the security’s entire amortized cost basis (even if the entity does not intend to sell). The “probability” standard relating to the collectability of cash flows is also eliminated, and impairment is now considered to be other-than-temporary if the present value of cash flows expected to be collected from the debt security is less than the amortized cost basis of the security (any such shortfall is referred to in FSP 115-2 as a “credit loss”). If an entity intends to sell an impaired debt security or more likely than not will be required to sell the security before recovery of its amortized cost basis less any current-period credit loss, the impairment is other-than-temporary and should be recognized currently in earnings in an amount equal to the entire difference between fair value and amortized cost. If a credit loss exists, but an entity does not intend to sell the impaired debt security and is not more likely than not to be required to sell before recovery, the impairment is other-than-temporary and should be separated into 1) the estimated amount relating to credit loss, and 2) the amount relating to all other factors. Only the estimated credit loss amount is recognized currently in earnings, with the remainder of the loss amount recognized in other comprehensive income. For held-to-maturity securities, the portion of the other-than-temporary impairment not related to a credit loss will be recognized in a new category of other comprehensive income and amortized over the remaining life of the debt security as an increase in the security's carrying amount. Disclosure requirements for impaired debt and equity securities are expanded and will now be required quarterly (see Note 2), as well as annually.

The Bank adopted this FSP effective March 31, 2009. For securities held at the beginning of the interim period of adoption for which an other-than-temporary impairment was previously recognized, if an entity does not intend to sell and it is not more likely than not that it will be required to sell before recovery of its amortized cost basis, the entity shall recognize the cumulative effect of initially applying this FSP adjustment to the opening balance of retained earnings with a corresponding adjustment to accumulated other comprehensive income. The Bank recognized an adjustment to beginning retained earnings in the amount of $3.5 million, and a corresponding adjustment to accumulated other comprehensive income of $3.5 million in the first quarter of 2009.

In addition, in April 2009, the FASB issued FSP No. 107-1 and Accounting Principles Board (APB) No. 28-1, "Interim Disclosures about Fair Value of Financial Instruments." This FSP requires disclosures about fair value of financial instruments for interim reporting periods of publicly traded companies as well as in annual financial statements. The Bank adopted this FSP effective March 31, 2009 (see Note 5).

In May 2009, the FASB issued SFAS No. 165, "Subsequent Events," which sets forth general standards of accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued or are available to be issued. Recognized subsequent events should be included in the financial statements since the conditions existed at the date of the balance sheet. Nonrecognized subsequent events are not included in the financial statements since the conditions arose after the balance sheet date but before the financial statements are issued or are available to be issued. This Standard, which includes a required disclosure of the date through which an entity has evaluated subsequent events, is effective for interim or annual periods ending after June 15, 2009 (see Note 9).

## NOTE 2 — INVESTMENT SECURITIES

### Available-for-sale

A summary of the amortized cost and fair value of debt securities held as available-for-sale investments at June 30, 2009 follows:

| *(dollars in thousands)* | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value | Weighted Average Yield |
|---|---|---|---|---|---|
| U.S. Govt. GNMA MBS/CMOs | $3,001,863 | $17,600 | $(26,873) | $2,992,590 | 1.91 % |
| U.S. Govt. Agency MBS | 3,065,233 | 19,342 | (79,421) | 3,005,154 | 1.90 |
| Non-Agency CMOs | 511,664 | - | (116,952) | 394,712 | 0.73 |
| Asset-Backed Securities | 96,838 | - | (38,656) | 58,182 | 0.53 |
| Total | $6,675,598 | $36,942 | $(261,902) | $6,450,638 | 1.79 % |

### Held-to-maturity

A summary of the amortized cost and fair value of debt securities held as held-to-maturity investments at June 30, 2009 follows:

| *(dollars in thousands)* | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value | Weighted Average Yield |
|---|---|---|---|---|---|
| U.S. Govt. Agency MBS | $1,373,189 | $41,233 | $(305) | $1,414,117 | 5.23 % |
| Other | 129,672 | 1,391 | (14,290) | 116,773 | 6.11 |
| Total | $1,502,861 | $42,624 | $(14,595) | $1,530,890 | 5.30 % |

AgFirst's investments include primarily mortgage-backed securities (MBSs) and asset backed securities (ABSs). MBSs are collateralized by U.S. government or U.S. agency guaranteed residential mortgages and all were rated in the top category (AAA/Aaa) by the Nationally Recognized Statistical Rating Organizations (NRSROs) at June 30, 2009. Non-agency CMO securities not rated in the top category by at least one of the NRSROs at June 30, 2009 had a fair value of $42.6 million. ABSs not rated in the top category by at least one of the NRSROs at June 30, 2009 had a fair value of $46.0 million. All ABSs have credit enhancement features including senior/subordinate structure and/or are backed by a bond insurer.

The fair value of all investments at June 30, 2009 split rated AAA/Aaa or lower by the NRSROs totaled $254.5 million (amortized cost of $370.8 million), which represents approximately 3.2 percent (and 4.5 percent) of total fair value (and amortized cost) of the Bank's total investment portfolio at June 30, 2009.

An investment is considered impaired if its fair value is less than its cost. A continuous unrealized loss position for an investment is based on the date the impairment was first identified. This also applies to those securities other-than-temporarily impaired for which a credit loss has been recognized but noncredit-related losses continue to remain unrealized. The following table shows the fair value and gross unrealized losses for investments that have been in a continuous unrealized loss position aggregated by investment category at June 30, 2009.

| | Less than 12 Months | | Greater than 12 Months | | Total | |
|---|---|---|---|---|---|---|
| *(dollars in thousands)* | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| U.S. Govt. GNMA MBS/CMOs | $ 910,006 | $ 10,630 | $ 1,081,461 | $ 16,243 | $ 1,991,467 | $ 26,873 |
| U.S. Govt. Agency MBS | 501,675 | 25,290 | 1,461,664 | 54,436 | 1,963,339 | 79,726 |
| Non-Agency CMOs | 21,768 | 5,975 | 372,944 | 110,978 | 394,712 | 116,953 |
| Asset-Backed Securities | - | - | 58,182 | 38,655 | 58,182 | 38,655 |
| Other | 22,271 | 1,750 | 58,697 | 12,540 | 80,968 | 14,290 |
| Total | $ 1,455,720 | $ 43,645 | $ 3,032,948 | $ 232,852 | $ 4,488,668 | $ 276,497 |

On June 30, 2009, the Bank held certain investments having continuous unrealized loss positions for more than 12 months with a fair value totaling $3.033 billion and an unrealized loss position totaling $232.9 million. The Bank performs periodic credit reviews, including other-than-temporary impairment analyses, on its investment securities portfolio. The objective is to quantify any future possible loss of principal or interest due on each security identified for additional analysis. Factors considered in determining whether an impairment is other-than-temporary include among others: 1) the length of time and the extent to which the fair value is less than cost, 2) the financial condition and near-term prospects of the issuer, 3) the estimated cash flow projections compared to contractual cash flows, 4) significant rating agency changes on the issuer, and 5) the Bank's ability and intent to hold these investments for a period of time sufficient to collect all amounts due according to the contractual terms of the investments. Based on the results of all analyses, the Bank has recognized total other-than-temporary impairment during the first six months of 2009 of $22.1 million in connection with three ABS securities and two non-agency CMO securities in its portfolio, which is included in Impairment Losses on Investments in the Statements of Income.

Since the Bank does not intend to sell these five impaired debt securities and is not more likely than not to be required to sell before recovery, the other-than temporary impairment of $22.1 million is separated into: 1) the estimated amount relating to credit loss ($8.8 million reflected in Net Income in the Statements of Income), and 2) the amount relating to all other factors ($13.3 million reflected in other comprehensive income in the Statement of Changes in Shareholders' Equity). Credit loss is defined as the shortfall of the present value of the cash flows expected to be collected in relation to the amortized cost basis. In determining the amount of credit loss, the Bank uses the expected present value technique as its best estimate of the present value of cash flows expected to be collected from the debt security. Significant inputs used in this technique to measure the amount related to the credit loss include, but are not limited to, performance indicators of the underlying assets in the security (including default rates, delinquency rates, and percentage of nonperforming assets), loan to collateral value ratios, third-party guarantees, current levels of subordination, vintage, geographic concentration, and credit ratings.

Due to the adoption of FSP 115-2, the Bank recognized the cumulative effect of initially applying this FSP in 2009 as an adjustment to the opening balance of unallocated retained earnings of $3.5 million with the corresponding adjustment amount to AOCI. The $3.5 million represents the noncredit-related amount of the previous other-than-temporary impairment recognized by the Bank in 2008 of $10.5 million on one ABS security.

For all investments other than the five securities discussed above, the Bank has not recognized any other-than-temporary impairment as the unrealized losses resulted primarily from reduced liquidity in the securities markets stemming from general adversity in the financial markets. Full payment of principal and interest is expected. The Bank has the ability and intent to hold these investments until a recovery of unrealized losses occurs, which may be at maturity, and at this time expects to collect the full principal amount and interest due on these securities, especially after considering credit enhancements. All securities, except two that have been determined to be other-than-temporarily impaired, continue to perform. Substantially all of these investments were in U. S. government agency securities and the Bank expects these securities would not be settled at a price less than their amortized cost. For the first half of 2009, net unrealized gains of $147.6 million were recognized in other comprehensive income for temporarily impaired available for sale investments.

A summary of the expected maturity, estimated fair value and amortized cost of investment securities at June 30, 2009 follows:

### Available-for-sale

| | Due in 1 year or less | | Due after 1 year through 5 years | | Due after 5 years through 10 years | | Due after 10 years | | Total | |
|---|---|---|---|---|---|---|---|---|---|---|
| *(dollars in thousands)* | Amount | Weighted Average Yield | Amount | Weighted Average Yield | Amount | Weighted Average Yield | Amount | Weighted Average Yield | Amount | Weighted Average Yield |
| U.S. Govt. GNMA MBS/CMOs | $ - | -% | $ - | -% | $ 1,797 | 0.75% | $ 2,990,793 | 1.91% | $ 2,992,590 | 1.91% |
| U.S. Govt. Agency MBS | - | - | 717 | 0.97 | 176,305 | 1.66 | 2,828,132 | 1.96 | 3,005,154 | 1.94 |
| Non-Agency CMOs | - | - | - | - | - | - | 394,712 | 0.95 | 394,712 | 0.95 |
| Asset-Backed Securities | - | - | - | - | - | - | 58,182 | 0.88 | 58,182 | 0.88 |
| Total fair value | $ - | -% | $ 717 | 0.97% | $ 178,102 | 1.65% | $ 6,271,819 | 1.86% | $ 6,450,638 | 1.86% |
| Total amortized cost | $ - | - | $ 720 | | $ 177,768 | | $ 6,497,110 | | $ 6,675,598 | |

### Held-to-maturity

| | Due in 1 year or less | | Due after 1 year through 5 years | | Due after 5 years through 10 years | | Due after 10 years | | Total | |
|---|---|---|---|---|---|---|---|---|---|---|
| *(dollars in thousands)* | Amount | Weighted Average Yield | Amount | Weighted Average Yield | Amount | Weighted Average Yield | Amount | Weighted Average Yield | Amount | Weighted Average Yield |
| U.S. Govt. Agency MBS | $ - | - | $ - | -% | $ 3,040 | 4.12 | $ 1,370,149 | 5.23 | $ 1,373,189 | 5.23 |
| Other | - | - | 16,206 | 4.89 | 28,567 | 6.30 | 84,899 | 6.28 | 129,672 | 6.11 |
| Total amortized cost | $ - | - | $ 16,206 | 4.89% | $ 31,607 | 6.09 | $ 1,455,048 | 5.29 | $ 1,502,861 | 5.30 |
| Total fair value | $ - | | $ 16,524 | | $ 31,021 | | $ 1,483,345 | | $ 1,530,890 | |

The following schedule details the activity related to cumulative credit losses on investments recognized in earnings as of June 30, 2009:

| *(dollars in thousands)* | **For the six months ended June 30, 2009** |
|---|---|
| **Beginning balance at January 1, 2009** | $ - |
| Adjustment to beginning balance due to application of investment impairment accounting change | 6,991 |
| **Adjusted beginning balance at January 1, 2009** | 6,991 |
| Additions for the amount related to credit loss for which other-than-temporary impairment was not previously recognized | 6,749 |
| Increases to the amount related to credit loss for which other-than-temporary impairment was previously recognized when the Bank does not intend to sell and it is not more likely than not that it will be required to sell before recovery of its amortized cost basis | 2,082 |
| **Ending balance at June 30, 2009** | $ 15,822 |

**NOTE 3 — ALLOWANCE FOR LOAN LOSSES AND IMPAIRED LOANS**

An analysis of the allowance for loan losses follows:

| | **For the six months ended June 30,** | |
|---|---|---|
| *(dollars in thousands)* | **2009** | **2008** |
| Balance at beginning of period | $ 44,565 | $ 2,816 |
| Provision for (reversal of) loan losses | 34,895 | 6,724 |
| Charge-offs | (37,765) | (1,429) |
| Recoveries | 33 | 158 |
| Balance at end of period | $ 41,728 | $ 8,269 |

Impaired loans are loans for which it is probable that all principal and interest will not be collected according to the contractual terms of the loan.

The following table presents information concerning impaired loans as of June 30,

| *(dollars in thousands)* | **2009** | **2008** |
|---|---|---|
| Impaired loans with related allowance | $ 22,456 | $ 6,163 |
| Impaired loans with no related allowance | 170,560 | 33,779 |
| Total impaired loans | $ 193,016 | $ 39,942 |
| Allowance on impaired loans | $ 22,232 | $ 6,131 |

The following table summarizes impaired loan information for the six months ended June 30,

| *(dollars in thousands)* | **2009** | **2008** |
|---|---|---|
| Average impaired loans | $ 192,214 | $ 5,692 |
| Interest income recognized on impaired loans | 420 | 62 |

**NOTE 4 — FAIR VALUE MEASUREMENT**

Effective January 1, 2008, the Bank adopted SFAS No. 157 "Fair Value Measurements." This Statement defines fair value, establishes a framework for measuring fair value and expands the Bank's fair value disclosure for certain assets and liabilities measured at fair value on a recurring and non-recurring basis. These assets and liabilities primarily consist of investments available-for-sale, highly-liquid funds, derivative assets and liabilities, assets held in trust funds, standby letters of credit, impaired loans, and other property owned.

SFAS No. 157 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.

SFAS No. 157 establishes a fair value hierarchy for disclosure of fair value measurements to maximize the use of observable inputs, that is, inputs that reflect the assumptions market participants would use in pricing an asset or liability based on market data obtained from sources independent of the reporting entity. The valuation hierarchy is based upon the transparency of inputs to the valuation of an asset or liability as of the measurement date. A financial instrument's categorization within the valuation hierarchy is based upon the lowest level of input that is significant to the fair value measurement.

The three levels of inputs and the classification of the Bank's financial instruments within the fair value hierarchy are as follows:

**Level 1**

Level 1 inputs to the valuation methodology are unadjusted quoted prices for identical assets or liabilities in active markets. Level 1 assets and liabilities could include investment securities and derivative contracts that are traded in an active exchange market, in addition to certain U.S. Treasury securities that are highly-liquid and are actively traded in over-the-counter markets.

The Bank's Level 1 assets at June 30, 2009 consist of assets held in trust funds related to deferred compensation and supplemental retirement plans. The trust funds include investments in securities that are actively traded and have quoted net asset value prices that are directly observable in the marketplace.

**Level 2**

Level 2 inputs to the valuation methodology include quoted prices for similar assets and liabilities in active markets; quoted prices in markets that are not active; and inputs that are observable, or can be corroborated, for substantially the full term of the asset or liability. Level 2 assets and liabilities could include investment securities that are traded in active, non-exchange markets and derivative contracts that are traded in active, over-the-counter markets.

The fair value of substantially all of the Bank's investment securities is determined from third-party valuation services that estimate current market prices. Inputs and assumptions related to third-party market valuation services are typically observable in the marketplace. Such services incorporate prepayment assumptions and underlying mortgage- or asset-backed collateral information to generate cash flows that are discounted using appropriate benchmark interest rate curves and volatilities. Third-party valuations also incorporate information regarding broker/dealer quotes, available trade information, historical cash flows, credit ratings, and other market information. Such valuations represent an estimated exit price, or price to be received by a seller in active markets to sell the investment securities to a willing participant.

The fair value of the Bank's derivative financial instruments is the estimated amount to be received to sell a derivative asset or paid to transfer a derivative liability in active markets among willing participants at the reporting date. Estimated fair values are determined through internal market valuation models. These models incorporate benchmark interest rate curves, volatilities, and other inputs which are observable directly or indirectly in the marketplace. The Bank compares internally calculated derivative valuations to broker/dealer quotes to substantiate the results.

The Bank's Level 2 assets and liabilities at June 30, 2009 include derivative contracts and investment securities in U.S. government and agency mortgage-backed securities, non-agency mortgage-backed securities, and U.S. agency debt securities, all of which have unadjusted values from third-party or internal pricing models. Level 2 assets also include federal funds sold, securities purchased under resale agreements and other highly-liquid funds, all of which are non-exchange-traded instruments. The market value of these federal funds sold and other instruments is generally their face value, plus accrued interest, as these instruments are highly-liquid, readily convertible to cash, and short-term in nature.

**Level 3**

Level 3 inputs to the valuation methodology are unobservable and supported by little or no market activity. Level 3 assets and liabilities could include investments and derivative contracts whose value is determined using pricing models, discounted cash flow methodologies, or similar techniques, and other instruments for which the determination of fair value requires significant management judgment or estimation. Level 3 assets and liabilities also could include investments and derivative contracts whose price has been adjusted based on dealer quoted pricing that is different than the third-party valuation or internal model pricing.

Level 3 assets at June 30, 2009 include impaired loans which represent the fair value of certain loans that were evaluated for impairment under SFAS No. 114. The fair value was based upon the underlying collateral since these were collateral-dependent loans. 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 collateral, less estimated costs to sell, is less than the principle balance of the loan, a specific reserve is established.

Level 3 assets at June 30, 2009 also include the Bank's mortgage-related asset-backed investment portfolio and non-agency CMO investment portfolio. Based on the currently illiquid marketplace for non-agency mortgage-backed investments and the lack of marketplace information available as inputs and assumptions to the valuation process, the Bank classified the mortgage-related asset-backed investment portfolio and non-agency CMO investment portfolio as Level 3 assets. The fair value measurement of these assets involved management's judgment and was based on multiple factors including information obtained from third-party valuation services using both level 2 and level 3 inputs.

Other property owned is classified as a level 3 asset at June 30, 2009. The fair value for other property owned is based upon the collateral less estimated costs to sell.

Level 3 liabilities at June 30, 2009 include standby letters of credit whose market value is internally calculated based on information that is not observable either directly or indirectly in the marketplace.

**Assets and Liabilities Measured at Fair Value on a Recurring Basis**

The following table presents the assets and liabilities that are measured at fair value on a recurring basis at June 30, 2009 for each of the fair value hierarchy levels:

| *(dollars in thousands)* | Level 1 | Level 2 | Level 3 | Total Fair Value |
|---|---|---|---|---|
| **Assets:** | | | | |
| Investments available-for-sale | $ - | $ 5,997,744 | $ 452,894 | $ 6,450,638 |
| Federal funds sold, securities purchased under resale agreements, and other | - | 265,508 | - | 265,508 |
| Interest rate swaps and other financial instruments | - | 82,439 | - | 82,439 |
| Assets held in trust funds | 2,623 | - | - | 2,623 |
| Total Assets | $ 2,623 | $ 6,345,691 | $ 452,894 | $ 6,801,208 |
| **Liabilities:** | | | | |
| Interest rate swaps and other financial instruments | $ - | $ 164 | $ - | $ 164 |
| Standby letters of credit | - | - | 2,866 | 2,866 |
| Total Liabilities | $ - | $ 164 | $ 2,866 | $ 3,030 |

The following table presents the changes in Level 3 assets and liabilities measured at fair value on a recurring basis. Non-agency CMO securities were transferred from level 2 to level 3 assets effective March 31, 2009 as the Bank began adjusting the valuation obtained from a third party pricing service for this portfolio to reflect, in part, the valuation obtained from a cash flow modeling process. Total credit losses of $1.4 million were included in earnings for the first quarter of 2009 for two non-agency CMOs determined to be other-than-temporarily impaired.

| *(dollars in thousands)* | Asset-Backed Investment Securities | Non-Agency CMOs | Standby Letters Of Credit |
|---|---|---|---|
| Balance at January 1, 2009 | $ 79,961 | $ - | $ 2,301 |
| Total gains or (losses) realized/unrealized: | | | |
| Included in earnings | (6,092) | (1,297) | - |
| Included in other comprehensive loss | 8,995 | 29,995 | - |
| Purchases, sales, issuances and settlements, net | (24,682) | (31,306) | 565 |
| Transfers in and/or out of level 3 | - | 397,320 | - |
| Balance at June 30, 2009 | $ 58,182 | $ 394,712 | $ 2,866 |

**Assets and Liabilities Measured at Fair Value on a Non-recurring Basis**

Assets and liabilities measured at fair value on a non-recurring basis at June 30, 2009 for each of the fair value hierarchy values are summarized below:

| *(dollars in thousands)* | Level 1 | Level 2 | Level 3 | Total Fair Value | YTD Total Gains (Losses) |
|---|---|---|---|---|---|
| **Assets:** | | | | | |
| Impaired loans | $ - | $ - | $ 224 | $ 224 | $ (27,554) |
| Other Property Owned | $ - | $ - | $ 35,326 | $ 35,326 | $ - |

**NOTE 5 — DISCLOSURES ABOUT FAIR VALUE OF FINANCIAL INSTRUMENTS**

The following table presents the carrying amounts and fair values of the Bank's financial instruments at June 30, 2009.

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

| | June 30, 2009 | |
|---|---|---|
| *(dollars in thousands)* | Carrying Amount | Estimated Fair Value |
| **Financial assets:** | | |
| Loans, net of allowance | $ 21,278,406 | $ 21,543,801 |
| Derivative assets | $ 82,439 | $ 82,439 |
| Cash and cash equivalents | $ 354,894 | $ 354,894 |
| Investment securities | $ 7,953,499 | $ 7,981,528 |
| Assets held in trust funds | $ 2,623 | $ 2,623 |
| **Financial liabilities:** | | |
| Systemwide Debt Securities | $ 28,099,601 | $ 28,088,699 |
| Derivative liabilities | $ 164 | $ 164 |

A description of the methods and assumptions used to estimate the fair value of each class of the Bank's financial instruments for which it is practicable to estimate that value follows:

A. **Loans:** Because no active market exists for the Bank's loans, fair value is estimated by discounting the expected future cash flows using the Bank's current interest rates at which similar loans would be made to borrowers with similar credit risk.

   For purposes of determining fair value of accruing loans, the loan portfolio is segregated into pools of loans with homogeneous characteristics based upon repricing and credit risk. Expected future cash flows and interest rates reflecting appropriate credit risk are separately determined for each individual pool. Fair values of loans in a nonaccrual status are estimated to be the carrying amount of the loan less specific reserves. The carrying value of accrued interest approximates its fair value.

B. **Cash and Cash Equivalents:** The carrying value is primarily a reasonable estimate of fair value.

C. **Investment Securities:** Fair value is primarily based upon prices obtained from a third party valuation service. See additional information in Note 4.

D. **Systemwide Debt Securities:** Bonds and notes are not regularly traded; thus, quoted market prices are not available. Fair value of these instruments is estimated by discounting expected future cash flows based on the quoted market price of similar maturity Treasury notes, assuming a constant estimated current spread relationship between Systemwide bonds and notes and comparable Treasury notes.

E. **Derivative Instruments:** The fair value of derivatives is the estimated amount to be received or paid to replace the instruments at the reporting date, considering current and projected interest rates. Where actively quoted market prices do not exist, estimated fair values are determined through dealer quotes. See additional information in Note 4.

F. **Assets Held In Trust Funds:** See Note 4 for discussion of estimation of fair value for this instrument.

## NOTE 6 — COMMITMENTS AND CONTINGENT LIABILITIES

Under the Farm Credit Act of 1971, each Farm Credit System bank is primarily liable for its portion of Systemwide bond and discount note obligations. Additionally, the banks are jointly and severally liable for the bonds and notes of the other Farm Credit System banks. The total bonds and notes of the System were $180.397 billion at June 30, 2009.

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

## NOTE 7 — EMPLOYEE BENEFIT PLANS

The following is a table of retirement and other postretirement benefit expenses for the Bank:

| | **For the six months ended June 30,** | |
|---|---|---|
| *(dollars in thousands)* | **2009** | **2008** |
| Pension | $ 4,242 | $ 1,115 |
| 401k | 440 | 397 |
| Other postretirement benefits | 442 | 431 |
| Total | $ 5,124 | $ 1,943 |

The following table includes only non-qualified retirement and other postretirement benefit contributions for the Bank. Projections are based upon actuarially determined amounts as of the most recent measurement date of December 31, 2008.

| *(dollars in thousands)* | **Actual YTD Through 6/30/09** | **Projected Contributions for Remainder Of 2009** | **Projected Total Contributions 2009** |
|---|---|---|---|
| Pensions | $ 126 | $ 130 | $ 256 |
| Other postretirement benefits | 460 | 463 | 923 |
| Total | $ 586 | $ 593 | $ 1,179 |

As of June 30, 2009, no contributions have been made for 2009 by the Bank to the qualified District pension plan in which the Bank participates. Actuarial calculations as of the last plan measurement date (December 31, 2008) projected total contributions of $52.0 million to the qualified District pension plan for all participating institutions for 2009. The funding policy for this plan is to fund the service cost with a seven year amortization schedule using the discount rate determined as of December 31st of the preceding year. This aggregate contribution will be allocated to the participating District institutions, including the Bank, based upon each institution's pro rata share of service cost. Market conditions could impact discount rates and return on plan assets which could make additional contributions necessary before the next plan measurement date of December 31, 2009.

Further details regarding employee benefit plans are contained in the 2008 Annual Report to Shareholders.

## NOTE 8 – DERIVATIVE FINANCIAL INSTRUMENTS AND HEDGING ACTIVITIES

Effective January 1, 2009, the Bank adopted SFAS No. 161, "Disclosures about Derivative Instruments and Hedging Activities," which amends and expands the disclosure requirements for derivative instruments and for hedging activities previously required by SFAS No. 133.

The Bank maintains an overall interest rate risk management strategy that may incorporate the use of derivative instruments to lower cost of funding or to reduce interest rate risk. The Bank's goal is to manage interest rate sensitivity by modifying the repricing characteristics of certain balance sheet assets and liabilities so that the net interest margin is not adversely affected by movements in interest rates. As a result of interest rate fluctuations, hedged fixed-rate assets and liabilities will appreciate or depreciate in market value. The effect of this unrealized appreciation or depreciation is expected to be substantially offset by the Bank's gains or losses on the derivative instruments that are linked to these hedged assets and liabilities. Another result of interest rate fluctuations is that the interest income and interest expense of hedged variable-rate assets and liabilities, respectively, will increase or decrease. The effect of this variability in earnings is expected to be substantially offset by the Bank's gains and losses on the derivative instruments that are linked to these hedged assets and liabilities. The Bank considers its strategic use of derivatives to be a prudent method of managing interest rate sensitivity, as it prevents earnings from being exposed to undue risk posed by changes in interest rates.

The Bank enters into derivatives, particularly interest rate swaps, to lower funding costs, allow it to diversify sources of funding, or alter interest rate exposures arising from mismatches between assets and liabilities. Interest rate swaps allow the Bank to raise long-term borrowings at fixed rates and swap them into floating rates that are lower than those available to the Bank if floating rate borrowings were made directly. Under interest rate swap arrangements, the Bank agrees with other parties to exchange, at specified intervals, payment streams calculated on a specified notional principal amount, with at least one stream based on a specified floating rate index. The Bank may also purchase interest rate derivatives such as caps in order to reduce the impact of rising interest rates on its floating-rate debt and floors in order to reduce the impact of falling interest rates on its floating-rate assets.

The primary type of derivative instrument used and the amount of activity for the six months ended June 30, 2009 is summarized in the following table:

| *(dollars in millions)* | **Receive-Fixed Swaps** |
|---|---|
| Balance at beginning of period | $2,223 |
| Additions | - |
| Maturities/amortization | (450) |
| Terminations | (50) |
| Balance at end of period | $1,723 |

By using derivative instruments, the Bank exposes itself to credit and market risk. If a counterparty fails to fulfill its performance obligations under a derivative contract, the Bank's credit risk will equal the fair value gain in the derivative. Generally, when the fair value of a derivative contract is positive, this indicates that the counterparty owes the Bank, thus creating a repayment risk for the Bank. When the fair value of the derivative contract is negative, the Bank owes the counterparty and, therefore, assumes no repayment risk.

To minimize the risk of credit losses, the Bank deals with counterparties that have an investment grade credit rating from a major rating agency and also monitors the credit standing of and levels of exposure to individual counterparties. The estimated credit risk exposure at June 30, 2009 of $65.3 million, net of $17.1 million interest-bearing cash collateral posted by two counterparties, was with eight counterparties and represents approximately 3.79 percent of the total notional amount of interest rate swaps. The Bank does not anticipate nonperformance by any of these counterparties. The Bank typically enters into master agreements that contain netting provisions. These provisions allow the Bank to require the net settlement of covered contracts with the same counterparty in the event of default by the counterparty on one or more contracts. A number of swaps are supported by collateral arrangements with counterparties. At June 30, 2009, the Bank had not posted collateral with respect to these arrangements.

The Bank's derivative activities are monitored by its Asset-Liability Management Committee (ALCO) as part of the Committee's oversight of the Bank's asset/liability and treasury functions. The Bank's ALCO is responsible for approving hedging strategies that are developed within parameters established by the Bank's board of directors through the Bank's analysis of data derived from financial simulation models and other internal and industry sources. The resulting hedging strategies are then incorporated into the Bank's overall interest rate risk-management strategies.

**Fair-Value Hedges**

For derivative instruments that are designated and qualify as a fair value hedge, the gain or loss on the derivative as well as the offsetting loss or gain on the hedged item attributable to the hedged risk are recognized in current earnings. The Bank includes the gain or loss on the hedged items in the same line item (interest expense) as the offsetting loss or gain on the related interest rate swaps. The amount of the gain on interest rate swaps recognized in interest expense for the six months ended June 30, 2009 was $42.5 million, while the amount of the loss on the Systemwide Debt Securities was ($42.5) million. Gains and losses on the derivative representing either hedge ineffectiveness or hedge components excluded from the assessment of effectiveness are recognized in current earnings.

| *(dollars in thousands)* | **Balance Sheet Classification – Assets** | **6/30/09 Fair Value** | **Balance Sheet Classification - Liabilities** | **6/30/09 Fair Value** |
|---|---|---|---|---|
| **Derivatives designated as hedging instruments under SFAS No. 133:** | | | | |
| Receive-fixed swaps | Other Assets | $ 82,439 | Other Liabilities | $ 164 |
| Total | | $ 82,439 | | $ 164 |

The following table sets forth the effect of derivative instruments on the Statement of Income for the six month period ended June 30, 2009:

| *(dollars in thousands)* | **Location of Gain or (Loss) Recognized in the Statement of Income** | **Amount of Gain or (Loss) Recognized in the Statement of Income** |
|---|---|---|
| **Derivatives – Fair Value Hedging Relationships:** | | |
| Receive-fixed swaps | Other Income | $ 305 |
| Total | | $ 305 |

**NOTE 9 – SUBSEQUENT EVENTS**

The Bank has evaluated subsequent events through July 31, 2009, which is the date the financial statements were available to be issued.

Certain of the Bank's asset-backed securities are protected by guarantees from monoline insurance providers. These insurance providers, like financial institutions in general, have been negatively impacted by the continued general adversity in the financial and mortgage markets. Subsequent to June 30, 2009, one of the insurance providers for four of the asset-backed securities was significantly downgraded by the NRSROs. The Bank considers the ratings by the NRSROs in its assessment of other-than-temporary impairment recoverability of the asset-back securities protected by guarantees of the insurance providers. This may thus potentially result in the recognition of other-than-temporary impairment in the third quarter of 2009 and future periods if the Bank concludes the creditworthiness of this insurance provider is not adequate to support credit losses related to the underlying related securities.