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

*(dollars in thousands, except as noted)*

The following discussion reviews the combined financial condition and results of operations of *Ag***First** *Farm Credit Bank* (the Bank) and the District Associations (the District) for the nine months ended September 30, 1998. These comments should be read in conjunction with the accompanying financial statements and the 1997 Annual Report of *Ag***First** *Farm Credit Bank* and the District Associations.

Final net income for the nine months ending September 30, 1998 was $162,448, an increase of $3,180 compared to the nine months ending September 30, 1997. This 2.00 percent increase was primarily attributed to an improvement in net interest income that resulted from an increase in loan volume and a decrease in funding costs from the exercise of call options on higher-cost debt.

Total assets at September 30, 1998 increased 7.67 percent compared to December 31, 1997. The increase was primarily attributed to a seasonal increase in loan volume and an increase in investment securities.

Poor to extremely adverse weather conditions for many crops grown in the *Ag***First** associations' areas of lending and low farm product prices for many significant commodities produced in the region have resulted in lower farm income expectations for 1998. Current credit quality remains generally consistent with the same quarter last year but repayment shortfalls on 1998 operating loans are anticipated, particularly in the major row crop areas.

Nonearning loan assets within the associations at September 30, 1998 were .9 percent of total loan assets as compared to 1.1 percent at September 30, 1997.

Current conditions warrant close attention to the developing trends in both the domestic and the global economies as the significantly weaker ag export outlook has an adverse impact on returns to producers of commodities in the United States.

Key ratios and data reported below, and in the accompanying financial statements, address the financial performance of the District in more detail. The nine months' results of operations are not indicative of an entire year due to the seasonal nature of a portion of the district's assets.

## FINANCIAL CONDITION

*Loan Portfolio*

Gross loan volume at September 30, 1998 was $9,935,598, an increase of 4.31 percent compared to December 31, 1997 and 4.44 percent compared to September 30, 1997. The December-to-September increase is attributed primarily to a relatively healthy agricultural economy and significant business development activity that has resulted in an overall increase in market share for the district.

The allowance for loan losses at September 30, 1998 of $266,317 is considered by management to be adequate to absorb potential losses on existing loans. Refer to Note 2, "Allowance for Loan Losses" in the notes to the combined financial statements of this report for further information.

*Liquidity and Funding Sources*

As of September 30, 1998, the Bank exceeded all regulatory liquidity requirements. Cash and investment securities totaled $1,811,938, or just over 15 percent of total assets. Interest-bearing liabilities, consisting of bonds and notes, increased by $825,183 compared to bonds and notes outstanding at December 31, 1997. This increase was primarily attributed to the aforementioned increases in loans and investment securities.

## CAPITAL RESOURCES

Total members' equity increased $106,074 from December 31, 1997 to September 30, 1998. This net increase was primarily the result of a $154,891 increase in unallocated earnings from current year net income, partially offset by a $37,124 decrease in allocated retained earnings attributed to the revolvement of these earnings to members.

***Key financial condition comparisons:***

| | 9/30/98 | 12/31/97 |
|---|---|---|
| Members' Equity to Assets | 17.11% | 17.46% |
| Debt to Members' Equity | 4.85:1 | 4.73:1 |
| Allowance for Loan Losses to Loans | 2.68% | 2.72% |

## RESULTS OF OPERATIONS

Net interest income after provision for loan losses for the nine months ending September 30, 1998 was $308,494, an increase of $9,529 compared to the nine months ending September 30, 1997. The increase was primarily attributed to the increase in loan volume, discussed above, and a decrease in funding costs resulting from the exercise of call options on higher-cost debt.

Noninterest income decreased $371 compared to the nine months ended September 30, 1997. The net decrease was the result of a $3,449 decrease in gains on the sale of investments, substantially offset by increases in fee and financially related service income.

Noninterest expense increased $8,400 compared to the nine months ended September 30, 1997. This net increase was the result of the following offsetting factors:

- Intra-system financial assistance expenses increased $6,298, primarily the result of the expense related to the retirement of high-coupon debt. This is discussed in more detail below.

- Insurance fund premiums decreased $5,773 resulting from the Farm Credit System Insurance Corporation approaching a "secure base" and lowering premiums for all System entities.

- Other noninterest expenses increased $7,875, or 6.56 percent.

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

| | Annualized for the nine months ended 9/30/98 | For the year ended 12/31/97 |
|---|---|---|
| Return on Average Assets | 1.90% | 1.94% |
| Return on Average Members' Equity | 11.02% | 11.02% |
| Net Interest Income as a Percentage of Average Earning Assets | 3.72% | 3.84% |
| Chargeoffs, Net of (Recoveries), to Average Loans | (.005)% | .001% |

## CALL OF FAC DEBT

In light of the current interest rate environment, the Bank entered into an agreement, effective July 31, 1998, with the other Farm Credit System Banks (Banks) and the Farm Credit System Financial Assistance Corporation (FAC) to call $240 million of 9.45 percent, November 2003 FAC bonds, first callable in November 1998, and, subject to certain conditions, $157 million of 9.50 percent, April 2004 FAC bonds, first callable in April 1999. The 9.45 percent, November 2003 FAC bonds were issued to fund the purchase of preferred stock from certain Banks by the FAC in order to provide financial assistance. Such Banks have since redeemed their preferred stock by placing in trust, funds that would grow to $240 million by November 2003. As provided for in the agreement, in August 1998 the Banks funded the difference between the amounts in the trusts and the amount needed to call the bonds. This difference was $39.5 million and was shared among the Banks, based upon the Bank's pro-rata share of the Banks' average District retail accruing loan volume since November 1988. The Bank's pro-rata share, which was recorded as a third quarter 1998 expense, was $5,950.

With respect to the $157 million of 9.50 percent, April 2004 FAC bonds, the Banks and the FAC agreed to call such debt conditioned upon interest rate levels near the date of the proposed call. This debt was issued to fund the payment by the FAC of certain Capital Preservation accruals, which had been assumed by the FAC, and is to be repaid by the Banks. Based upon a statutory repayment plan, the Banks have been funding their repayment obligations annually over the term of the debt. Accordingly, based on the presumption that such debt will be called in April 1999, $80 million in additional funds was funded in August 1998 based upon the Bank's pro-rata share of the Banks' average Bank-only accruing loan volume since April 1989. The Bank's pro-rata share, which will be recorded as a first quarter 1999 expense, if interest rates remain sufficiently below the coupon rate, was $11,424 and is currently included in other assets.

## YEAR 2000 COMPLIANCE

The District has assessed year 2000's impact on its business. This assessment resulted in the development of appropriate action plans and certification testing plans completed in the third quarter 1998. The District is implementing its plan to convert computer systems to be year 2000 compliant. The objective of this project is to ensure those computer systems and applications can properly process transactions relating to the year 2000 and beyond. The Bank and related Associations expect to be in full compliance by the end of June 1999 including year 2000 certification testing. The District has estimated the operating costs associated with becoming year 2000 compliant to be $2.1 million. To date, the District has already incurred $1.4 million of these costs. These estimates contain amounts already paid and projected expenses to third party vendors, including hardware and software expenses of approximately $800. They do not include the cost of upgrading existing software to new releases (which is considered a normal recurring cost) or internal overhead costs.

F. A. Lowrey

F. A. Lowrey
Chief Executive Officer

Robert L. Holden

Robert L. Holden, Sr.
Chairman of the Board

October 27, 1998

# Combined Balance Sheets

| (dollars in thousands) | September 30, 1998 (unaudited) | December 31, 1997 |
|---|---|---|
| **Assets** | | |
| Cash and cash equivalents | $ 253,277 | $ 268,203 |
| Investment securities | 1,558,661 | 1,191,009 |
| Loans | 9,935,598 | 9,525,215 |
| Less: allowance for loan losses | 266,317 | 259,056 |
| Net loans | 9,669,281 | 9,266,159 |
| Accrued interest receivable | 219,938 | 155,419 |
| Investments in other Farm Credit System institutions | 9,407 | 9,310 |
| Premises and equipment, net | 66,387 | 65,079 |
| Other property owned | 6,377 | 4,691 |
| Other assets | 117,179 | 92,724 |
| Total assets | $11,900,507 | $11,052,594 |
| **Liabilities** | | |
| Bonds and notes | $ 9,635,939 | $ 8,810,756 |
| Accrued interest payable | 84,595 | 92,582 |
| Dividends and patronage refunds payable | 5,697 | 51,110 |
| Other liabilities | 138,615 | 168,559 |
| Total liabilities | 9,864,846 | 9,123,007 |
| Commitments and contingent liabilities | | |
| **Members' Equity** | | |
| Protected borrower equity | 35,559 | 42,946 |
| At-risk equity: | | |
| Capital stock and participation certificates | 165,098 | 167,351 |
| Retained earnings | | |
| Allocated | 519,337 | 556,461 |
| Unallocated | 1,313,548 | 1,158,657 |
| Accumulated other comprehensive income (loss) | 2,119 | 4,172 |
| Total members' equity | 2,035,661 | 1,929,587 |
| Total liabilities and members' equity | $11,900,507 | $11,052,594 |

# Combined Statements of Income

*(unaudited)*

| *(dollars in thousands)* | For the three months ended September 30, 1998 | For the three months ended September 30, 1997 | For the nine months ended September 30, 1998 | For the nine months ended September 30, 1997 |
|---|---|---|---|---|
| **Interest Income** | | | | |
| Investment securities and other | $ 23,973 | $20,923 | $ 67,652 | $ 63,922 |
| Loans | 222,909 | 218,640 | 654,570 | 627,364 |
| Total interest income | 246,882 | 239,563 | 722,222 | 691,286 |
| **Interest Expense** | 140,104 | 135,448 | 406,096 | 387,859 |
| Net interest income | 106,778 | 104,115 | 316,126 | 303,427 |
| Provision for loan losses | 4,227 | 2,325 | 7,632 | 4,462 |
| Net interest income after provision for loan losses | 102,551 | 101,790 | 308,494 | 298,965 |
| **Noninterest Income** | | | | |
| Loan fees | 2,550 | 1,519 | 8,435 | 6,089 |
| Fees for financially related services | 1,800 | 813 | 4,476 | 3,125 |
| Gains (losses) from other property owned, net | 122 | (137) | 378 | 69 |
| Realized gains (losses) on sales of investments, net | (1) | 3,137 | 10 | 3,459 |
| Miscellaneous | 1,068 | 1,216 | 3,356 | 4,284 |
| Total noninterest income | 5,539 | 6,548 | 16,655 | 17,026 |
| **Noninterest Expenses** | | | | |
| Salaries and employee benefits | 26,646 | 25,453 | 80,310 | 76,484 |
| Occupancy and equipment | 4,686 | 4,587 | 13,987 | 13,387 |
| Insurance Fund premium | 763 | 2,682 | 2,290 | 8,063 |
| Other operating expenses | 10,818 | 11,162 | 31,014 | 29,498 |
| Intra-System financial assistance expenses | 11,200 | 5,127 | 21,353 | 15,055 |
| Miscellaneous | 674 | 258 | 2,661 | 728 |
| Total noninterest expenses | 54,787 | 49,269 | 151,615 | 143,215 |
| Income before income taxes | 53,303 | 59,069 | 173,534 | 172,776 |
| Provision for income taxes | 3,226 | 4,700 | 11,086 | 13,508 |
| Net income | $ 50,077 | $54,369 | $162,448 | $159,268 |

# Combined Statements of Changes in Members' Equity

*(unaudited)*

| *(dollars in thousands)* | Protected Borrower Equity | At-Risk Equity: Capital Stock and Participation Certificates | At-Risk Equity: Retained Earnings: Allocated | At-Risk Equity: Retained Earnings: Unallocated | At-Risk Equity: Accumulated Other Comprehensive Income | Total Members' Equity |
|---|---|---|---|---|---|---|
| Balance at December 31, 1996 | $ 51,901 | $166,808 | $ 484,507 | $1,109,292 | $ 895 | $ 1,813,403 |
| Comprehensive income | | | | | | |
| Net income | | | | 159,268 | | 159,268 |
| Unrealized gains (losses) on investments available for sale, net of reclassification adjustments | | | | | 1,757 | 1,757 |
| Total comprehensive income | | | | | | 161,025 |
| Protected borrower equity retired | (7,311) | | | | | (7,311) |
| At-risk equity: | | | | | | |
| Capital stock/participation certificates issued/retired, net | | (1,664) | | | | (1,664) |
| Dividends declared/paid | | 79 | | (541) | | (462) |
| Patronage distribution | | | | | | |
| Cash | | | | (4,428) | | (4,428) |
| Retained earnings retired | | | (22,640) | | | (22,640) |
| Patronage distribution adjustment | | | (1,310) | 2,707 | | 1,397 |
| Balance at September 30, 1997 | $ 44,590 | $165,223 | $ 460,557 | $1,266,298 | $ 2,652 | $ 1,939,320 |
| Balance at December 31, 1997 | $ 42,946 | $167,351 | $ 556,461 | $1,158,657 | $ 4,172 | $ 1,929,587 |
| Comprehensive income | | | | | | |
| Net income | | | | 162,448 | | 162,448 |
| Unrealized gains (losses) on investments available for sale, net of reclassification adjustments | | | | | (2,053) | (2,053) |
| Total comprehensive income | | | | | | 160,395 |
| Protected borrower equity retired | (7,387) | | | | | (7,387) |
| At-risk equity: | | | | | | |
| Capital stock/participation certificates issued/retired, net | | (2,363) | | | | (2,363) |
| Dividends declared/paid | | 110 | | (525) | | (415) |
| Patronage distribution | | | | | | |
| Cash | | | | (5,651) | | (5,651) |
| Allocated retained earnings | | | 1,818 | (1,818) | | — |
| Retained earnings retired | | | (38,599) | | | (38,599) |
| Patronage distribution adjustment | | | (343) | 437 | | 94 |
| Balance at September 30, 1998 | $ 35,559 | $165,098 | $ 519,337 | $1,313,548 | $ 2,119 | $ 2,035,661 |

# Combined Statements of Cash Flows

*(unaudited)*

| *(dollars in thousands)* | For the nine months ended September 30, 1998 | 1997 |
|---|---|---|
| **Cash flows from operating activities:** | | |
| Net income | $ 162,448 | $ 159,268 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation on premises and equipment | 7,333 | 6,697 |
| Provision for loan losses | 7,632 | 4,462 |
| (Gains) losses on other property owned, net | (378) | (69) |
| Realized gains on sales of investments, net | (10) | (3,459) |
| Changes in operating assets and liabilities: | | |
| (Increase) decrease in accrued interest receivable | (64,519) | (65,148) |
| (Increase) decrease in investments in other Farm Credit System institutions | (97) | 428 |
| (Increase) decrease in other assets | (24,455) | (14,306) |
| Increase (decrease) in accrued interest payable | (7,987) | 6,548 |
| Increase (decrease) in other liabilities | (29,895) | (25,955) |
| Total adjustments | (112,376) | (90,802) |
| Net cash provided by operating activities | 50,072 | 68,466 |
| **Cash flows from investing activities:** | | |
| Investment securities purchased | (9,894,180) | (1,089,125) |
| Investment securities sold or matured | 9,524,485 | 1,133,663 |
| Net increase in loans | (414,856) | (535,607) |
| Purchase of premises and equipment, net | (8,641) | (8,611) |
| Proceeds from sale of other property owned | 2,745 | 5,302 |
| Net cash used in investing activities | (790,447) | (494,378) |
| **Cash flows from financing activities:** | | |
| Bonds and notes issued | 32,320,685 | 26,796,544 |
| Bonds and notes retired | (31,495,502) | (26,344,221) |
| Protected borrower equity retired | (7,387) | (7,311) |
| At-risk equity: | | |
| Capital stock and participation certificates issued/retired, net | (2,363) | (1,664) |
| Patronage refunds and dividends paid | (51,385) | (44,492) |
| Retained earnings retired | (38,599) | (22,640) |
| Net cash provided by financing activities | 725,449 | 376,216 |
| Net decrease in cash and cash equivalents | (14,926) | (49,696) |
| Cash and cash equivalents, beginning of period | 268,203 | 287,764 |
| Cash and cash equivalents, end of period | $ 253,277 | $ 238,068 |
| **Supplemental schedule of non-cash investing and financing activities:** | | |
| Financed sales of other property owned | $ 886 | $ 1,475 |
| Loans transferred to other property owned | 4,988 | 5,683 |
| Patronage refund and dividends payable | 6,066 | 4,890 |
| Change in unrealized gains (losses) on investments, net | (2,053) | 1,757 |
| **Supplemental information:** | | |
| Interest paid | $ 414,083 | $ 381,311 |
| Taxes paid, net | 10,987 | 13,566 |

# Notes to Combined Financial Statements

*(dollars in thousands, except as noted)*

*(unaudited)*

## NOTE 1 — ORGANIZATION AND SIGNIFICANT ACCOUNTING POLICIES

The accompanying combined financial statements include the accounts of *Ag***First** *Farm Credit Bank* (the Bank or *Ag***First**) and the accounts of the district Agricultural Credit Associations (ACAs) and Production Credit Association (PCA), collectively referred to as Associations, and reflect the investments in and allocated earnings of the service organizations in which *Ag***First** has a partial ownership interest. All significant transactions and balances among the Bank and the Associations have been eliminated in combination.

The significant accounting policies followed and the financial condition and results of operations of the combined Bank as of and for the year ended December 31, 1997, are contained in the 1997 Annual Report to Stockholders. These unaudited third quarter 1998 financial statements should be read in conjunction with the 1997 Annual Report to Stockholders.

On January 1, 1998, the combined Bank adopted Statement of Financial Accounting Standards (SFAS) No. 130, "Reporting Comprehensive Income." This Standard establishes requirements for reporting and displaying comprehensive income and its components in the financial statements. Under this Standard, the Bank classified items of other comprehensive income by their nature in the Combined Statements of Changes in Members' Equity and displayed the accumulated balance of other comprehensive income separately from retained earnings in the Members' Equity section of the Combined Balance Sheets.

In June 1998, the Financial Accounting Standards Board issued SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activity," which is effective for fiscal years beginning after June 15, 1999. This Standard requires derivatives to be recorded on the balance sheet as assets or liabilities, measured at fair value. Changes in the values of those derivatives would be accounted for as gains or losses or as a component of other comprehensive income depending on the use of the derivative and whether it qualifies for hedge accounting. The impact of adoption of this Standard has not yet been determined.

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. The results for the nine months ended September 30, 1998 are not necessarily indicative of the results to be expected for the year ending December 31, 1998.

Master note investments are currently shown as cash equivalents (along with federal funds) to more accurately reflect the cash management activities for which these investments are used. Certain amounts in the prior period financial statements have been reclassified to conform to current financial statement presentation. All such reclassifications had no effect on the prior period net income or total members' equity as previously reported.

The District maintains allowances for loan losses in accordance with generally accepted accounting principles. The loan portfolios are reviewed quarterly to determine the adequacy of the allowances for losses. As of September 30, 1998, the allowances for losses are adequate in management's opinion to provide for possible losses on existing loans.

## NOTE 2 — ALLOWANCE FOR LOAN LOSSES

An analysis of the allowance for loan losses included in the accompanying financial statements follows:

| | |
|---|---|
| Balance at 12-31-96 | $ 253,405 |
| Provision for loan losses | 4,462 |
| Loans (charged off), net of recoveries | (224) |
| Balance at 9-30-97 | $ 257,643 |
| Balance at 12-31-97 | $ 259,056 |
| Provision for loan losses | 7,632 |
| Recoveries, net of loans (charged off) | (371) |
| Balance at 9-30-98 | $ 266,317 |

## NOTE 3 — OTHER COMPREHENSIVE INCOME

The following represents the reclassification amount:

| | For the nine months ended September 30, 1998 | 1997 |
|---|---|---|
| Unrealized holding gains (losses) arising during the period | $(2,043) | $5,216 |
| Less: reclassification adjustment for gains (losses) included in net income | 10 | 3,459 |
| Net unrealized gains (losses) on investments | $(2,053) | $1,757 |

## NOTE 4 — COMMITMENTS AND CONTINGENT LIABILITIES

Under the Farm Credit Act of 1971, each System bank is primarily liable for its portion of systemwide bond and discount note obligations. Additionally, the banks are contingently liable for the systemwide obligations of the System banks.

There is currently pending in the United States District Court for the Central District of California, Southern Division, a lawsuit filed by Orange County, California against all eight Banks. Similar lawsuits were also filed against other government-sponsored enterprises (GSEs), Merrill Lynch & Co., Inc. (Merrill Lynch) and others. The lawsuits arose out of the December 1994 municipal bankruptcy of Orange County. Among other things, the complaint against the Banks alleges that offering documents delivered in connection with certain unspecified Systemwide Debt Securities purchased by Orange County contain misrepresentations and omissions that contributed to the County's losses and subsequent bankruptcy. The complaint also alleges that the Banks (acting with or through certain broker/dealers) engaged in fraudulent conduct in connection with the sale of Systemwide Debt Securities purchased by Orange County and that this led to the County's bankruptcy. Orange County and Merrill Lynch have announced a settlement of their lawsuit and have signed a settlement agreement. As part of its settlement with Merrill Lynch, Orange County will also agree to dismiss with prejudice its lawsuits against the GSE defendants, including the Banks, upon receipt of final payment of the settlement amount by Merrill Lynch. No money will be paid by the Banks in consideration of the settlement and it is anticipated that the GSEs, including the Banks, will enter into mutual releases with Orange County in connection with the settlement. In anticipation of the dismissal of the lawsuit against the Banks, the Banks have entered into a stipulation with Orange County suspending the July 15, 1998 discovery cut-off date and staying all discovery, pending finalization of the settlement between Orange County and Merrill Lynch. The District Court approved this stipulation by order dated July 1, 1998. The stipulation further provides that if the settlement between Orange County and Merrill Lynch is rendered null and void because of a failure of conditions, the parties shall have an additional reasonable period of time to conclude discovery. A hearing for a good faith determination of the settlement is currently scheduled for November 23, 1998, in the United States District Court for the Central District of California. The previous hearing date was continued upon the application of certain defendants in other similar cases brought by Orange County. These defendants have sought additional time in which to review (and possibly conduct) discovery regarding liability, damages and the circumstances of the proposed settlements.

Other actions are pending against the Bank and certain District Associations in which claims for money damages are asserted. On the basis of information presently available, management and legal counsel are of the opinion that the ultimate liability, if any, from these other actions, would not be material in relation to the combined financial position of the Bank and Associations.

## NOTE 5 — BANK ONLY FINANCIAL DATA

Condensed financial information of *Ag***First** follows:

**Balance Sheet Data**

| | **9/30/98** | **12/31/97** *(Audited)* |
|---|---|---|
| Cash and investment securities | $ 1,780,234 | $ 1,390,453 |
| Loans | 8,487,971 | 8,084,566 |
| Less: allowance for loan losses | 11,867 | 10,267 |
| Net loans | 8,476,104 | 8,074,299 |
| Other assets | 181,440 | 167,522 |
| Total assets | $10,437,778 | $ 9,632,274 |
| Bonds and notes | $ 9,635,939 | $ 8,810,732 |
| Other liabilities | 127,437 | 195,976 |
| Total liabilities | 9,763,376 | 9,006,708 |
| Capital stock and participation certificates | 308,630 | 307,181 |
| Retained earnings | 363,653 | 314,213 |
| Accumulated other comprehensive income (loss) | 2,119 | 4,172 |
| Total members' equity | 674,402 | 625,566 |
| Total liabilities and members' equity | $10,437,778 | $ 9,632,274 |

**Statement of Income Data**

| | **For the three months ended September 30,** | | **For the nine months ended September 30,** | |
|---|---|---|---|---|
| | **1998** | **1997** | **1998** | **1997** |
| Interest income | $172,503 | $164,936 | $498,503 | $474,582 |
| Interest expense | 140,054 | 135,424 | 406,022 | 387,820 |
| Net interest income | 32,449 | 29,512 | 92,481 | 86,762 |
| Provision for loan losses | 600 | 1,500 | 1,600 | 1,800 |
| Net interest income after provision for loan losses | 31,849 | 28,012 | 90,881 | 84,962 |
| Noninterest income (expense), net | (17,076) | (9,175) | (41,441) | (30,271) |
| Net income | $ 14,773 | $ 18,837 | $ 49,440 | $ 54,691 |