
# The Measure of Success

AgFirst Farm Credit Bank
2005 Annual Report

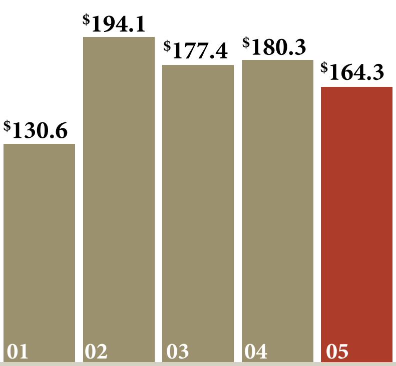
# AgFirst Farm Credit Bank
# 2005 Annual Report

# Five-Year Summary of Selected Consolidated Financial Data

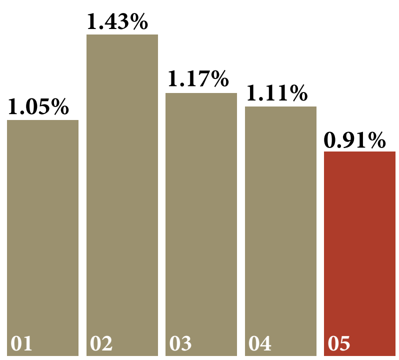
*(unaudited)*

| *(dollars in thousands)* | December 31, 2005 | 2004 | 2003 | 2002 | 2001 |
|---|---|---|---|---|---|
| **Consolidated Balance Sheet Data** | | | | | |
| Cash and cash equivalents | $ 557,882 | $ 470,258 | $ 469,945 | $ 359,819 | $ 265,254 |
| Investment securities | 5,255,745 | 3,278,414 | 2,832,716 | 2,153,118 | 1,663,323 |
| Loans | 14,411,050 | 12,908,249 | 12,375,351 | 12,008,041 | 11,128,810 |
| Less: allowance for loan losses | 10,114 | 14,800 | 34,168 | 31,155 | 25,616 |
| Net loans | 14,400,936 | 12,893,449 | 12,341,183 | 11,976,886 | 11,103,194 |
| Other assets | 268,468 | 245,402 | 235,704 | 211,367 | 201,634 |
| Total assets | $ 20,483,031 | $ 16,887,523 | $ 15,879,548 | $ 14,701,190 | $ 13,233,405 |
| Obligations with maturities of one year or less | $ 7,613,499 | $ 6,533,020 | $ 6,384,790 | $ 6,273,546 | $ 7,976,947 |
| Obligations with maturities greater than one year | 11,607,104 | 9,105,207 | 8,315,226 | 7,444,960 | 4,302,671 |
| Mandatorily redeemable preferred stock | 225,000 | 225,000 | 225,000 | — | — |
| Total liabilities | 19,445,603 | 15,863,227 | 14,925,016 | 13,718,506 | 12,279,618 |
| Mandatorily redeemable preferred stock | — | — | — | 225,839 | 225,839 |
| Perpetual preferred stock | 150,000 | 150,000 | 150,000 | — | — |
| Capital stock and participation certificates | 224,554 | 226,200 | 229,083 | 249,444 | 281,803 |
| Retained earnings | 665,445 | 644,366 | 601,699 | 527,673 | 439,104 |
| Accumulated other comprehensive income (loss) | (2,571) | 3,730 | (26,250) | (20,272) | 7,041 |
| Total shareholders' equity | 1,037,428 | 1,024,296 | 954,532 | 756,845 | 727,948 |
| Total liabilities and shareholders' equity | $ 20,483,031 | $ 16,887,523 | $ 15,879,548 | $ 14,701,190 | $ 13,233,405 |

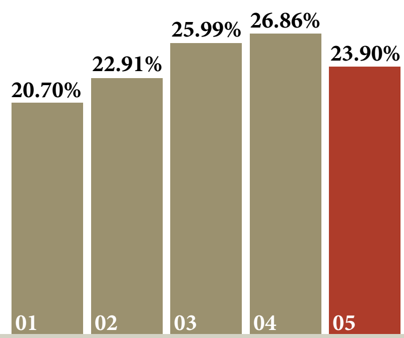
## Net Income
*(in millions)*




## Return on Assets

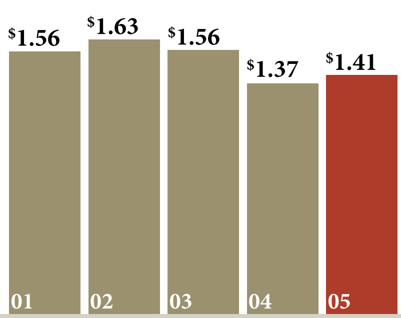



## Permanent Capital Ratio

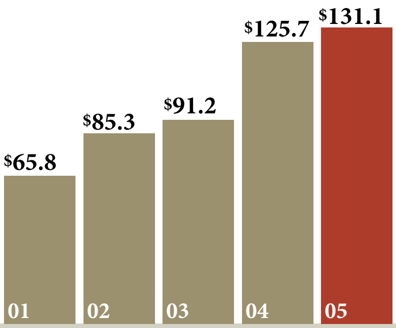


| (dollars in thousands) | December 31, 2005 | 2004 | 2003 | 2002 | 2001 |
|---|---|---|---|---|---|
| **Consolidated Statement of Income Data** | | | | | |
| Net interest income | $ 204,201 | $ 211,595 | $ 244,057 | $ 255,660 | $ 184,782 |
| Provision for (reversal of) loan losses | (4,995) | (15,292) | 2,500 | 8,000 | 4,500 |
| Noninterest income (expense), net | (44,937) | (46,581) | (64,108) | (53,527) | (49,676) |
| Net income | $ 164,259 | $ 180,306 | $ 177,449 | $ 194,133 | $ 130,606 |
| **Consolidated Key Financial Ratios** | | | | | |
| Rate of return on average: | | | | | |
| Total assets | 0.91% | 1.11% | 1.17% | 1.43% | 1.05% |
| Total shareholders' equity | 14.95% | 17.16% | 20.37% | 23.75% | 17.40% |
| Net interest income as a percentage of average earning assets | 1.14% | 1.32% | 1.62% | 1.91% | 1.50% |
| Net chargeoffs (recoveries) to average loans | (0.002%) | 0.033% | (0.004%) | 0.021% | 0.003% |
| Total shareholders' equity to total assets | 5.06% | 6.07% | 6.01% | 5.15% | 5.50% |
| Debt to shareholders' equity (:1) | 18.74 | 15.49 | 15.64 | 18.13 | 16.87 |
| Allowance for loan losses to loans | 0.07% | 0.11% | 0.28% | 0.26% | 0.23% |
| Permanent capital ratio | 23.90% | 26.86% | 25.99% | 22.91% | 20.70% |
| Total surplus ratio | 23.84% | 26.76% | 25.79% | 22.69% | 19.86% |
| Core surplus ratio | 14.15% | 15.60% | 14.45% | 13.20% | 10.39% |
| Collateral ratio | 105.70% | 106.88% | 106.94% | 105.94% | 106.38% |
| **Net Income Distribution** | | | | | |
| Cash distributions | $ 132,230 | $ 126,689 | $ 92,129 | $ 86,677 | $ 67,786 |
| Mandatorily redeemable preferred stock dividend | — | — | 10,282 | 18,887 | 10,912 |
| Perpetual preferred stock dividend | 10,950 | 10,950 | 1,851 | — | — |

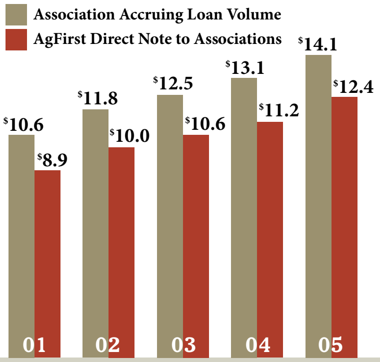
Participations/Syndications Year-End Volume
*(in billions)*




Distributions to Associations
*(in millions)*




Trends
*(in billions)*



AgFirst

# PROFILE

## 2005 Board of Directors

*Sitting, from the left:* Robert A. Carson, Thomas W. Kelly, Robert G. Sexton, Don W. Freeman.

*Standing, from the left:* Eugene W. Merritt, Jr., Paul Lemoine, Walter L. Schmidlen, Jr., Richard Kriebel, Henry M. Frazee, J. Dan Raines, Jr., Robert L. Holden, Sr., Lyle Ray King, Paul M. House, Dale W. Player, Dr. Chester D. Black, William C. Bess, Jr., M. Wayne Lambertson, F. Merrel Lust.

*Not pictured:* E. McDonald Berryman

## What we deliver

Through their affiliation with AgFirst, the ACAs have access to a broad range of financial tools that allows them to compete in today's global economy. These tools include:

- Lines of credit that enable borrowers to take advances at their choice of Prime, LIBOR or fixed rate.
- Credit Delivery, a loan origination system developed by AgFirst and used by all 23 of our member-associations.
- AgScore, a secure, web-based credit scoring product developed by AgFirst and used by 21 associations and 33 other financial institutions.
- AgriLine®, an automated system that enables borrowers to write their own loan advances by check.
- *FastCash*, a product that enables associations to send loan advances to their borrowers' checking accounts overnight through the Automated Clearing House system.
- AutoDraft, a service that automatically drafts borrowers' loan payments.
- AccountAccess, an online service that enables borrowers to make payments, transfer funds and obtain loans via a secure Internet site.
- LoanLine, a service that provides loan and payment information by telephone.
- AutoBorrow, a cash management product for commercial borrowers developed by AgFirst in partnership with Bank of America.
- AgSweep, a cash management product for borrowers developed by AgFirst in partnership with Wachovia.

These products and services have helped our associations grow and gain market share throughout their chartered territories.

# TO OUR SHAREHOLDERS

**Robert G. Sexton**
**Chairman of the Board**

**F. A. Lowrey**
**Chief Executive Officer**

There are several ways to measure the success of a financial institution. Earnings and growth. Credit quality and customer satisfaction. The achievement of goals that support strategic objectives. And, the ability to maximize new business opportunities. By all of these measurements, AgFirst had an exceptionally successful year in 2005.

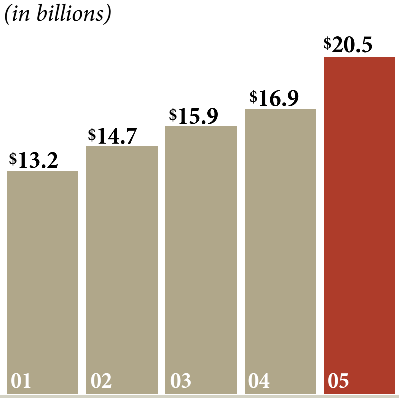
Our success is closely tied to that of the 23 Farm Credit and Ag Credit associations we serve, our customer-stockholders. Their strong marketing efforts resulted in a higher-than-expected rate of growth in 2005 and helped push AgFirst over the $20 billion asset mark by year-end. Our strong earnings made possible another record distribution to stockholders in 2005.

## Earnings

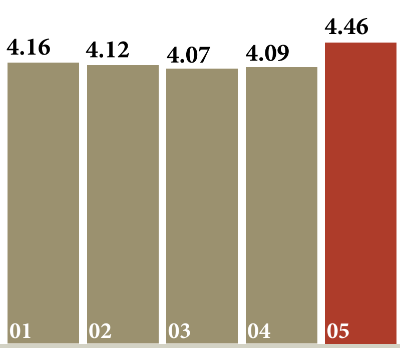
Maintaining strong and stable earnings has always been our goal; our record over the last several years is evidence that we are meeting that goal. Although final net income in 2005 was lower than the past several years, those years were positively impacted by extraordinary events, such as the temporary benefit of calling debt in a declining interest rate environment and the one-time reversal of loan loss provision in 2004.

The earnings level achieved in 2005 is consistent with our asset structure, which predominately consists of loans to the 23 associations. Our 2005 earnings level enabled us to distribute a record $131 million to the associations, bringing association net borrowing cost to a level equal to the underlying marginal cost of Farm Credit debt.

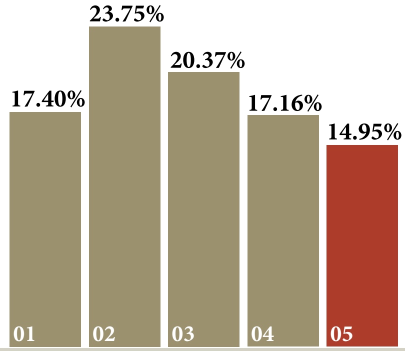
Total Assets
*(in billions)*




Customer Satisfaction
*(1 to 5 Scale)*




Return on Shareholders' Equity



## Growth

Agricultural economists have indicated that 2005's net farm income will be a near-record $72.6 billion, a level exceeded only by the previous year's $82.5 billion. While high levels of farm income have reduced loan demand in some agricultural sectors, our affiliated associations continued to grow and maintain their strong market share positions in 2005. Their growth, along with the achievements of our Capital Markets and Correspondent Lending operations—and the success of several new initiatives—helped AgFirst grow by 21%, or $3.6 billion, in 2005, ending the year at $20.5 billion in assets. Over the last five years, we have grown by 55%, an average of 11% a year.

## Credit Quality

Hurricanes Katrina, Rita and Wilma swept across the South and Southeast in late 2005, causing severe flooding and destruction throughout Louisiana, Mississippi, Alabama, and Florida. Although these storms caused substantial damage to crops, livestock and homes, we have not seen a significant impact on credit quality in the affected areas.

Our credit quality remains high. Associations reported 95.58% acceptable loans at year-end, up from 94.50% the previous year. Delinquencies were only 0.45% of associations' total loans at the close of the year, down from 0.59% at 2004 year-end and the lowest level reported in four years.

Because poultry operations represent 14% of associations' credit portfolios, we have closely followed the reports of avian influenza in other parts of the world and have conducted research to assess the probability of the disease spreading to the U.S. We are optimistic at this point that the trade restrictions and other steps taken by the USDA will adequately protect the people and poultry industry of the United States. We will continue to monitor this situation and will take appropriate actions, if necessary.

## Customer Satisfaction

One of the important measures—and predictors—of success is customer satisfaction. That's why, once a year, every year, we ask our customers to tell us how we're meeting their expectations. We ask them to rate the performance of our staff and our services.

We are proud to report that, in 2005, AgFirst received its highest overall rating ever, a score 4.46 on a scale of 1 to 5, with "5" representing excellent performance. We are proud of this achievement and of the AgFirst employees who made this rating possible.

## Strategic Initiatives

As we reported to you last year, AgFirst is focused on several strategic initiatives designed to improve the bank's performance and create efficiencies in association operations. In 2005, we:

- Moved forward with our several "Business Integration Projects," including CRM (Customer Relationship Management) and AgriGate (Workflow Management). We also introduced upgrades to our FrontEnd, Credit Delivery and E-Commerce products. These projects and products will help associations serve their borrowers more efficiently and effectively.
- Expanded and enhanced Farm Credit University (FCU), an AgFirst-based training program for new loan officers and credit analysts. Since 2004, more than 200 students have enrolled in FCU's "Lifestyle Lending" curriculum, including employees outside the AgFirst family of associations, and we have trained more than 100 association mentors/coaches to work with these new lenders. In 2006, we will introduce a new curriculum, called "Commercial Agricultural Lending."
- Sponsored district-wide advertising aimed at the growing "lifestyle farmer" market. Our ads in *Southern Farm and Ranch* and *Hobby Farms* and our sponsorship of the *Progressive Farmer* Idea House and Farmstead have helped build awareness of our associations' "Country Mortgages" brand.
- Expanded our Risk Management department to include responsibility for assessing our controls around financial disclosure and insuring the integrity of our data, as well as assessing portfolio risk.
- Restructured our Secondary Mortgage Market Unit to eliminate its direct servicing activities. This unit, renamed "Correspondent Lending," now focuses its efforts on underwriting and purchasing rural home and part-time farm loans from Farm Credit associations and other originators throughout the United States.

## Serving Rural America

In late 2004, the Farm Credit System launched HORIZONS, a forward-looking planning initiative focused on meeting the future financial needs of the next generation of farmers, ranchers and rural residents and a changing Rural America. The goal of HORIZONS is to help Farm Credit prepare for the future so that we may fully meet the evolving needs of our customers.

Throughout 2005, many AgFirst and association directors and employees participated in the marketplace assessments, research and analysis that became the foundation of HORIZONS. Working together with others across the nation, we learned that U.S. agriculture and rural communities must have access to capital, financial services and expertise to sustain a strong economic future.

Over the last 90 years, AgFirst and its affiliated associations have been dedicated to the mission of improving the quality of life on the farm and in rural areas throughout our part of America. By any measure, we have succeeded. And, by any measure, we will succeed for the next 90 years and beyond.

Robert G. Sexton
Chairman of the Board

F. A. Lowrey
Chief Executive Officer

# 2005

# Financial Results

# Report of Management

The accompanying consolidated financial statements and related financial information appearing throughout this annual report have been prepared by management of AgFirst Farm Credit Bank (the Bank) in accordance with generally accepted accounting principles appropriate in the circumstances. Amounts which must be based on estimates represent the best estimates and judgments of management. Management is responsible for the integrity, objectivity, consistency, and fair presentation of the consolidated financial statements and financial information contained in this report.

Management maintains and depends upon an internal accounting control system designed to provide reasonable assurance that transactions are properly authorized and recorded, that the financial records are reliable as the basis for the preparation of all consolidated financial statements, and that the assets of the Bank are safeguarded. The design and implementation of all systems of internal control are based on judgments required to evaluate the costs of controls in relation to the expected benefits and to determine the appropriate balance between these costs and benefits. The Bank maintains an internal audit program to monitor compliance with the systems of internal accounting control. Audits of the accounting records, accounting systems and internal controls are performed and internal audit reports, including appropriate recommendations for improvement, are submitted to the Audit Committee of the Board of Directors and to the Chief Executive Officer.

In 2004, AgFirst adopted a Code of Ethics for its Chief Executive Officer and Senior Financial Officers who are involved with preparation and distribution of financial statements and maintenance of the records supporting the financial statements. A copy of the AgFirst Code of Ethics may be viewed on the Bank's website at www.agfirst.com.

The consolidated financial statements have been examined by independent public auditors, whose report appears elsewhere in this annual report. The Bank is also subject to examination by the Farm Credit Administration.

The consolidated financial statements, in the opinion of management, fairly present the financial condition of the Bank. The undersigned certify that the 2005 Annual Report has been prepared 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.

Robert G. Sexton
Chairman of the Board

F. A. Lowrey
Chief Executive Officer

Leon T. Amerson
Chief Financial Officer

March 1, 2006

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

as of December 31, 2005

AgFirst Farm Credit Bank (the Bank or AgFirst) is one of the banks of the Farm Credit System (the System), a nationwide system of cooperatively owned banks (the banks) and associations. Banks and associations are collectively referred to as a district (district). The System was established by Acts of Congress and is subject to the provisions of the Farm Credit Act of 1971, as amended (the Farm Credit Act).

The nation is currently served by four Farm Credit Banks (FCBs) and one Agricultural Credit Bank (ACB), each of which has specific lending authorities within its chartered territory. The ACB also has certain additional specific nationwide lending authorities. AgFirst is chartered to service the states of Pennsylvania, Delaware, Maryland, Virginia, West Virginia, North Carolina, South Carolina, Georgia, Florida, Alabama, Mississippi, the Commonwealth of Puerto Rico and portions of the states of Ohio, Tennessee, Kentucky and Louisiana.

Each FCB and the ACB serves one or more Production Credit Associations (PCAs) that originate and service short- and intermediate-term loans, Federal Land Credit Associations (FLCAs) that originate and service long-term real estate mortgage loans and/or Agricultural Credit Associations (ACAs) that originate both long-term and short- and intermediate-term loans. PCAs, FLCAs and ACAs are collectively referred to as associations. AgFirst and its related associations (Associations or District Associations) are collectively referred to as the District. The District Associations jointly own all of AgFirst's voting stock. As of December 31, 2005, the District consisted of the Bank and twenty-three District ACAs. All twenty-three are structured as holding companies, which include FLCA and PCA subsidiaries.

The following commentary reviews the consolidated financial condition and results of operations of AgFirst and its subsidiary (the Farm Credit Finance Corporation of Puerto Rico) for the years ended December 31, 2005, 2004 and 2003. This information should be read in conjunction with the accompanying consolidated financial statements, the Notes to the Consolidated Financial Statements and other sections of this annual report. See Note 1, *Organization and Operations,* in the Notes to the Consolidated Financial Statements for a discussion of the operations of AgFirst.

The operations of the Farm Credit Finance Corporation of Puerto Rico (the Finance Corporation) were suspended effective December 31, 2005. The Board of Directors of the Finance Corporation determined there was insufficient financial benefit resulting from island-based tax treatment of the corporation to justify continuing the operations of the corporation at this time. All outstanding capital of the Finance Corporation was transferred to AgFirst on December 31, 2005. This will not have a material effect on the financial condition of AgFirst.

**FINANCIAL OVERVIEW**

The following information provides an overview, in capsule form, of AgFirst's financial results for 2005 as compared to 2004 and 2003:

- The aggregate principal amount of loans outstanding at December 31, 2005 was $14.41 billion compared to $12.91 billion at December 31, 2004, and $12.38 billion at December 31, 2003, reflecting increases of 11.62 percent and 16.40 percent compared to 2004 and 2003, respectively.

- Net income totaled $164.3 million for the twelve months ended December 31, 2005, reflecting an 8.87 percent decrease and a 7.38 percent decrease compared to the years ended December 31, 2004 and 2003, respectively.

- The 2004 net income includes a $15.3 million reversal of the allowance for loan losses. This reversal, which positively affected income, was the result of the completion of previously announced studies to refine AgFirst's methodology for determining the allowance for loan losses.

- AgFirst's ratio of total shareholders' equity to total assets decreased from 6.07 percent at December 31, 2004 and 6.01 percent at December 31, 2003 to 5.06 percent at December 31, 2005.

- AgFirst's return on average total assets and return on average shareholders' equity for the year ended December 31, 2005 were 0.91 percent and 14.95 percent, respectively, compared to 1.11 percent and 17.16 percent for the year ended December 31, 2004, and 1.17 percent and 20.37 percent for the year ended December 31, 2003.

**CRITICAL ACCOUNTING POLICIES**

The financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America. AgFirst considers significant accounting policies to be critical to the understanding of AgFirst's results of operations and financial position because some accounting policies require complex or subjective judgments and estimates that may affect the value of certain assets or liabilities. For a complete discussion of significant accounting policies, see Note 2, *Summary of Significant Accounting Policies*, of the Notes to the Consolidated Financial Statements. The following is a summary of certain critical policies.

- *Allowance for loan losses* – The allowance for loan losses is management's best estimate of the amount of probable losses inherent in its loan portfolio. The allowance for loan losses is increased through provisions for loan losses and loan recoveries and is decreased through allowance reversals and loan charge-offs. The allowance for loan losses is determined based on a periodic evaluation of the loan portfolio, which generally considers types of loans, credit quality, specific industry conditions, general economic and political conditions, and changes in the character, composition, and performance of the portfolio, among other factors.

  Significant individual loans are evaluated based on the borrower's overall financial condition, resources, and payment record, the prospects for support from any financially responsible guarantor, and, if appropriate, the estimated net realizable value of any collateral. The allowance for loan losses attributable to these loans is established by a process that estimates the probable loss inherent in the loans, taking into account various historical and projected factors, internal risk ratings, regulatory oversight, geographic, industry and other factors.

  Changes in the factors considered by management in the evaluation of losses in the loan portfolios could result in a change in the allowance for loan losses and could have a direct impact on the provision for loan losses and the results of operations.

- *Valuation methodologies* – Management applies various valuation methodologies to assets and liabilities that often involve a significant degree of judgment, particularly when liquid markets do not exist for the particular items being valued. Quoted market prices are referred to when estimating fair values for certain assets for which an observable liquid market exists, such as most investment securities. Management utilizes significant estimates and assumptions to value items for which an observable liquid market does not exist. Examples of these items include impaired loans, pension and other postretirement benefit obligations, and certain derivative and other financial instruments. These valuations require the use of various assumptions, including, among others, discount rates, rates of return on assets, repayment rates, cash flows, default rates, costs of servicing and liquidation values. The use of different assumptions could produce significantly different results, which could have material positive or negative effects on AgFirst's results of operations.

**MISSION-RELATED INVESTMENTS**

During 2005, the Farm Credit Administration (FCA) initiated a program to stimulate economic growth and development in rural areas. Recognizing that different investment strategies are needed for agricultural and rural communities, the FCA outlined a program to allow System institutions to hold investments, subject to approval by the FCA on a case-by-case basis. FCA has approved the Rural Housing Mortgage-Backed Securities pilot program, the Rural America Bond pilot and the Tobacco Buyout programs under the mission-related investments umbrella, as described below.

*Rural Housing Mortgage-Backed Securities*

In May 2005, AgFirst received approval from the FCA to purchase and hold Rural Housing Mortgage-Backed Securities (RHMBS) under its Mission-Related Investments Pilot Program. The RHMBS must be fully guaranteed by a government agency or government-sponsored enterprise (GSE). The rural housing loans backing the RHMBS must be conforming first-lien residential mortgage loans originated by non-System lenders in "rural areas" as defined by the Farm Security and Rural Investment Act of 2002 (2002 Farm Bill), or eligible rural housing loans originated by System lenders under FCA Regulation section 613.3030. This program should increase liquidity for rural housing loans resulting in more cost-effective credit to homeowners in rural America by providing an incentive to lenders to create RHMBS for sale in the secondary market. Investment securities at December 31, 2005 included $1.35 billion in RHMBS classified as held-to-maturity.

*Rural America Bonds*

In October 2005, FCA approved this investment program for AgFirst and the Associations. In recognition of the economic interdependence between agricultural and rural communities, AgFirst institutions seek to safely and soundly invest in debt obligations that support farmers, ranchers, agribusinesses, and their rural communities and businesses. In doing so, AgFirst institutions hope to increase the well-being and prosperity of American farmers, ranchers, and rural areas and residents. The FCA approved the Rural America Bonds investment program for a three-year pilot period. As of December 31, 2005, the AgFirst District Associations had $1.5 million in the Rural America Bond program. AgFirst and the Associations are actively planning to evaluate more opportunities in 2006.

*Tobacco Buyout Program*

On October 22, 2004, Congress enacted the "Fair and Equitable Tobacco Reform Act of 2004" (Tobacco Act) as part of the "American Jobs Creation Act of 2004." The Tobacco Act repealed the Federal tobacco price support and quota programs, provides for payments to tobacco "quota owners" and producers for the elimination of the quota, and provides an assessment mechanism for tobacco manufacturers and importers to pay for the buyout. Tobacco quota holders and producers will receive equal annual payments under a contract with the Secretary of Agriculture. The Tobacco Act also includes a provision that allows the quota holders and producers to assign to a "financial institution" the right to receive the contract payments so that they may obtain a lump sum or other payment. On April 4, 2005, the United States Department of Agriculture (USDA) issued a Final Rule implementing the "Tobacco Transition Payment Program" (Tobacco Buyout).

The FCA determined that System institutions are "financial institutions" within the meaning of the Tobacco Act and are therefore eligible to participate in the Tobacco Buyout. The FCA recognized that the Tobacco Buyout has significant implications for some System institutions and the tobacco quota holders and producers they serve. The FCA's goal is to provide System institution borrowers with the option to immediately receive Tobacco Buyout contract payments and reinvest them in future business opportunities.

For the year ended December 31, 2005, thirteen District Associations held loan assignments for Tobacco Buyout borrowers and/or Successor-in-Interest Contracts (SIIC). As of December 31, 2005, the District Associations held Tobacco Buyout loan assignments of $84.8 million and SIIC of $237.2 million. In addition, the District Associations also had commitments to purchase SIIC of $112.7 million.

**LOAN PORTFOLIO**

AgFirst's loan portfolio primarily consists of direct loans to affiliated Associations (Direct Notes), loan participations/syndications purchased, loans purchased through AgFirst's Correspondent Lending activities, and loans to Other Financing Institutions (OFIs) as shown below.

| **AgFirst Loan Portfolio** *(dollars in thousands)* | | 2005 | | | 2004 | | | 2003 | |
|---|---|---|---|---|---|---|---|---|---|
| Direct Notes | $ | 12,441,170 | 86.33% | $ | 11,229,197 | 86.99% | $ | 10,592,325 | 85.59% |
| Participations/syndications purchased, net | | 1,411,802 | 9.80 | | 1,374,863 | 10.65 | | 1,554,762 | 12.57 |
| Correspondent Lending | | 555,421 | 3.85 | | 302,226 | 2.34 | | 228,046 | 1.84 |
| SFAS No. 133 adjustment | | 7 | – | | 63 | – | | (282) | – |
| Loans to OFIs | | 2,650 | 0.02 | | 1,900 | 0.02 | | 500 | – |
| Total | $ | 14,411,050 | 100.00% | $ | 12,908,249 | 100.00% | $ | 12,375,351 | 100.00% |

The diversification of AgFirst loan volume by type is shown below.

| *(dollars in thousands)* | | 2005 | | | 2004 | | | 2003* | |
|---|---|---|---|---|---|---|---|---|---|
| Production agriculture: | | | | | | | | | |
| Real estate mortgage | $ | 411,707 | 2.86% | $ | 441,113 | 3.42% | $ | – | –% |
| Production and intermediate-term | | 490,057 | 3.40 | | 412,240 | 3.19 | | – | – |
| Agribusiness: | | | | | | | | | |
| Loans to cooperatives | | 142,947 | 0.99 | | 91,638 | 0.71 | | 396,000 | 3.20 |
| Processing and marketing | | 280,932 | 1.95 | | 282,359 | 2.19 | | – | – |
| Farm-related business | | 7,278 | 0.05 | | 23,654 | 0.18 | | – | – |
| Communication | | 27,717 | 0.19 | | 68,291 | 0.53 | | – | – |
| Energy | | 142,593 | 0.99 | | 160,926 | 1.25 | | – | – |
| Rural residential real estate | | 442,692 | 3.07 | | 183,206 | 1.42 | | – | – |
| Lease receivables | | 21,307 | 0.15 | | 13,725 | 0.10 | | – | – |
| Direct Loans to Associations | | 12,441,170 | 86.33 | | 11,229,197 | 86.99 | | 10,592,325 | 85.59 |
| Discounted Loans to OFIs | | 2,650 | 0.02 | | 1,900 | 0.02 | | 500 | .01 |
| Other | | – | – | | – | – | | 1,386,526 | 11.20 |
| Total | $ | 14,411,050 | 100.00% | $ | 12,908,249 | 100.00% | $ | 12,375,351 | 100.00% |

* *Beginning with year-end 2004, loan type categories have been expanded to provide additional information on the types of loans made. As a result, three years of comparable data is not available.*

Loan growth came primarily through the direct notes that fund Association lending activity. Association growth was the result of their purchasing participations in addition to originations within their chartered territories. Association growth in originations is attributable to a seasoned lending staff, the value inherent to patronage paid under their cooperative structure, the direct and indirect payments on Program Crops under the current Farm Bill, an improving world economy coupled with a weaker dollar that helped boost agricultural exports, and borrowers seizing low interest rate opportunities.

Credit quality at year-end 2005 reflected improvement over previous years. Each loan is classified according to the Uniform Classification System, which is used by all System institutions. Below are the classification definitions.

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

The following table presents selected statistics related to the credit quality of AgFirst loans including accrued interest at December 31.

| AgFirst Loans Credit Quality | 2005 | 2004 | 2003 |
|---|---|---|---|
| Acceptable | 98.55% | 98.06% | 96.44% |
| OAEM | 1.21 | 1.54 | 3.10 |
| Adverse* | 0.24 | 0.40 | 0.46 |
| Total | 100.00% | 100.00% | 100.00% |

* *Adverse loans include substandard, doubtful, and loss loans.*

*Direct Notes*

AgFirst's primary line of business is to provide funds to affiliated Associations. Each Association is a Federally chartered instrumentality of the United States and is regulated by the FCA. AgFirst has in place with each of the Associations, a revolving line of credit, referred to as a *direct note*. Each of the Associations funds most of its lending and general corporate activities by borrowing under its direct note. All assets of the Associations secure the direct notes and lending terms are specified in a separate General Financing Agreement (GFA) between AgFirst and each Association, including the subsidiaries of the Associations. (See Note 1, *Organization and Operations,* in the Notes to the Consolidated Financial Statements for further discussion.) Each GFA contains minimum liquidity, capital, and earnings requirements that must be maintained by the Association.

Although AgFirst's loans to the Associations are evidenced by direct notes that are with full recourse to the borrowing Associations, the Associations' ability to repay is significantly dependent upon repayment of loans made to their borrowers. Accordingly, AgFirst's direct and indirect credit exposure depends upon the creditworthiness of both the Associations that are direct borrowers and the underlying borrowers of the Associations as indirect borrowers of AgFirst.

AgFirst continually monitors the risk-bearing capacity of each Association through a variety of mechanisms, including testing of the reliability of the Association's risk ratings, periodic meetings with Association Managements and Boards, semi-annual formalized risk assessments, and prior-approval of transactions that exceed the Association's delegated authority (which is determined by AgFirst). In addition, Associations are subject to an annual audit by independent auditors and periodic examination by the FCA.

All Associations exceeded the minimum GFA and regulatory requirements for liquidity, earnings, and capital as of December 31, 2005. No Association is operating under a supervisory action and the litigation in which Associations are involved is typically loan related and poses no material threat to their viability.

Associations employ a number of risk management techniques to limit credit exposures. Each Association has adopted underwriting standards, individual borrower exposure limits, commodity exposure limits, and other risk management techniques. AgFirst and the Associations actively purchase and sell participations to achieve diversified portfolios and the Associations utilize guarantees from U.S. government agencies/departments, including the Federal Agricultural Mortgage Corporation (Farmer Mac), the Farm Service Agency, and the Small Business Administration to further limit credit exposures. At December 31, 2005, Associations collectively had $1.15 billion under such government or GSE guarantee programs.

Credit quality within the combined Associations' portfolios improved during the twelve months ended December 31, 2005. At year-end, the combined Associations' loans including accrued interest were classified as follows:

| District Associations Credit Quality | 2005 | 2004 | 2003 |
|---|---|---|---|
| Acceptable | 95.58% | 94.50% | 92.72% |
| OAEM | 2.86 | 3.43 | 4.96 |
| Adverse* | 1.56 | 2.07 | 2.32 |
| Total | 100.00% | 100.00% | 100.00% |

* *Adverse loans include substandard, doubtful, and loss loans.*

Delinquencies were 0.45 percent of Association total loan assets at year-end 2005 compared to 0.59 percent and 0.73 percent at year-end 2004 and 2003, respectively. Nonperforming assets for the combined ACAs represented 0.50 percent of total loan assets or $72.1 million, compared to 0.63 percent or $84.1 million for 2004, and 0.78 percent or $98.4 million for 2003. Nonperforming assets consist of nonaccrual loans, accruing restructured loans, accruing loans 90 days or more past due, and other property owned.

Association net charge-offs of $1.7 million, $3.9 million and $3.1 million were recorded in 2005, 2004, and 2003, respectively. As a percentage of total loan assets, net charge-offs for the combined Associations were 0.01 percent for 2005 compared to 0.03 percent and 0.02 percent in 2004 and 2003, respectively.

Each Association maintains an allowance for loan losses determined by its management and is capitalized based upon its unique situation. The minimum regulatory capital ratios for System banks and associations are 7.00 percent for the permanent capital ratio and 3.50 percent for core surplus ratio. The following table illustrates the risk bearing capacity of the Associations.

| Association | Regulatory Permanent Capital Ratio | Regulatory Core Surplus Ratio | Allowance/ Loans |
|---|---|---|---|
| AgChoice | 14.39% | 11.57% | 0.31% |
| Ag Credit | 18.73% | 14.74% | 0.47% |
| AgGeorgia | 14.64% | 9.60% | 1.36% |
| AgSouth | 16.81% | 12.71% | 0.33% |
| Cape Fear | 16.95% | 13.24% | 0.66% |
| Carolina | 16.39% | 12.24% | 0.24% |
| Central Florida | 15.36% | 12.70% | 0.53% |
| Central Kentucky | 14.72% | 12.33% | 0.94% |
| Chattanooga | 14.32% | 10.89% | 0.49% |
| Colonial | 17.48% | 15.64% | 0.47% |
| East Carolina | 16.88% | 13.29% | 1.72% |
| Farm Credit of the Virginias | 15.08% | 12.00% | 0.23% |
| First South | 13.63% | 10.40% | 0.55% |
| Jackson Purchase | 15.17% | 13.37% | 0.48% |
| MidAtlantic | 15.31% | 12.42% | 0.63% |
| North Florida | 13.81% | 11.53% | 0.39% |
| Northwest Florida | 12.54% | 11.55% | 0.34% |
| Pee Dee | 14.59% | 11.94% | 0.35% |
| Puerto Rico | 24.02% | 23.59% | 0.09% |
| South Florida | 16.76% | 14.44% | 1.09% |
| Southwest Florida | 18.07% | 12.63% | 0.07% |
| Southwest Georgia | 13.04% | 10.54% | 0.19% |
| Valley | 14.10% | 10.09% | 0.44% |

Affiliated Associations serve all or a portion of fifteen states and Puerto Rico. This wide geographic dispersion is a natural risk-reducing factor for AgFirst. The following table illustrates the geographic distribution of the loan volume originated by the Associations.

| District Associations | | | |
|---|---|---|---|
| State | 2005 | 2004 | 2003 |
| North Carolina | 16 % | 16 % | 16% |
| Florida | 15 | 14 | 16 |
| Georgia | 13 | 13 | 12 |
| Virginia | 11 | 11 | 11 |
| Pennsylvania | 11 | 11 | 11 |
| Maryland | 7 | 7 | 7 |
| South Carolina | 6 | 6 | 7 |
| Ohio | 5 | 5 | 5 |
| Alabama | 3 | 3 | 3 |
| Kentucky | 3 | 3 | 3 |
| Mississippi | 2 | 2 | 2 |
| West Virginia | 2 | 2 | 2 |
| Delaware | 2 | 2 | 2 |
| Louisiana | 2 | 2 | 1 |
| Puerto Rico | 1 | 2 | 1 |
| Tennessee | 1 | 1 | 1 |
| Total | 100 % | 100% | 100% |

Only five states have loan volume representing more than 10.00 percent of the total. Commodity diversification, guarantees, and borrowers with relatively high levels of non-farm income mitigate the geographic concentration risk in these states.

During the third quarter of 2005, hurricane activity caused damage across a significant portion of the AgFirst District. Louisiana, Mississippi, Alabama, and southern Florida were the areas most impacted. Crop and commodity damage in certain areas was severe, but the impact on repayment of loans and risk of loss appears to be mitigated by insurance proceeds, disaster relief, and the overall financial health of the borrowers' balance sheets.

Earnings for the combined Associations totaled $343.8 million, $478.4 million, and $231.6 million, producing an average return on assets of 2.40 percent, 3.65 percent, and 1.85 percent, and an average return on equity of 14.68 percent, 24.35 percent, and 12.26 percent for 2005, 2004, and 2003, respectively. Association earnings decreased $134.6 million for the period ended December 31, 2005 compared to 2004. Included in the 2004 results was a one-time reversal of the allowance for loan losses of $188.9 million, net of $11.2 million tax impact, in connection with completion of previously announced studies to refine the System institutions' methodologies for determining the allowance for loan losses. Excluding the impact of the one-time reversal of the allowance for loan losses, net income for the combined Associations would have been $289.5 million for 2004. The portion of net income resulting from the reversal of the allowance for loan losses was retained in capital and has minimal impact on the combined Associations' overall risk funds (total capital plus allowance for loan losses). During 2005, the combined Associations' risk funds, a measure of risk-bearing capacity, increased $129.9 million to $2.46 billion, which represents 17.32 percent of combined Association loans.

AgFirst provides each Association with core operating systems and support, including a loan origination system, loan accounting and servicing systems, general ledger and related financial accounting systems, and a human resources/payroll system. With AgFirst providing such systems, the Associations are able to achieve efficiencies ordinarily afforded only to much larger organizations. In addition, having common systems supported by AgFirst provides an opportunity to automate the AgFirst/Association lending process. One of the most significant advantages of this is a match-funding mechanism that automatically creates direct note advances that match the repricing and maturity characteristics of each underlying loan. By employing this system, interest rate risk is significantly reduced at the Associations.

The diversity of income sources supporting Association loan repayment mitigates credit risk to AgFirst. The Associations' credit portfolios are comprised of a number of segments having varying agricultural characteristics. Commodity and industry categories are based on the Standard Industrial Classification system published by the federal government. This system is used to assign commodity or industry categories based on the largest agricultural commodity of the customer. The following table/chart illustrates the aggregate credit portfolio of the Associations by major commodity segments.

| District Associations | | | |
|---|---|---|---|
| | Percent of Portfolio | | |
| Commodity Group | 2005 | 2004 | 2003 |
| Poultry | 14% | 13% | 13% |
| Forestry | 13 | 12 | 12 |
| Fruits/Vegetables | 10 | 9 | 5 |
| Cattle | 9 | 9 | 9 |
| Grain | 7 | 8 | 10 |
| Dairy | 7 | 8 | 8 |
| Nursery/Greenhouse | 5 | 5 | 5 |
| Rural Home | 4 | 4 | 4 |
| Processing | 3 | 4 | 4 |
| Tobacco | 3 | 4 | 4 |
| Swine | 3 | 3 | 3 |
| Cotton | 3 | 3 | 3 |
| Citrus | 2 | 2 | 3 |
| Other | 17 | 16 | 17 |
| Total | 100% | 100% | 100% |

The table illustrates that 2005 commodity concentrations were 5.00 percent or more in only seven segments. The concentration in these segments is mitigated by a prevalence of non-farm income among the borrowers as demonstrated by the following table, which segregates part-time farm loans into a unique segment.

| District Associations | | | |
|---|---|---|---|
| | Percent of Portfolio | | |
| Commodity Group | 2005 | 2004 | 2003 |
| Part-time Farmers | 41% | 40% | 39% |
| Poultry and Eggs | 11 | 11 | 11 |
| Dairy | 7 | 8 | 8 |
| Forestry | 6 | 6 | 7 |
| Nursery/Greenhouse | 4 | 4 | 4 |
| Cotton | 3 | 3 | 3 |
| Swine | 3 | 3 | 3 |
| Tobacco | 3 | 3 | 3 |
| Cattle | 3 | 3 | 3 |
| Corn | 2 | 2 | 1 |
| Other | 17 | 17 | 18 |
| Total | 100% | 100% | 100% |

Associations have concentrations of full-time farmers greater than 5.00 percent in only three commodities - poultry, dairy, and forestry. All three commodities have a large geographic dispersion with production over the entire AgFirst footprint. Concentrations within the Associations are further dispersed through the number of farm units producing poultry or dairy products. Poultry production is almost exclusively done through a network of contract growers whose income remains stable because the variable costs are absorbed by the contracting integrators. Poultry concentration is further disbursed as production is segregated between chicken, turkey, and egg production. Dairy herds range in size from less than 100 cows to approximately 10 thousand. Associations also manage credit and concentration risk through participations, guarantees, and direct payment assignments from the poultry integrators and milk processing facilities. Forestry is divided principally into hardwood and softwood production and value added processing. The timber from hardwood production is further processed into furniture, flooring, and high-grade paper and is generally located at the more northern latitudes and higher elevations. Softwood timber production is typically located in the coastal plains of the AgFirst footprint and is utilized for building material for the housing market and pulp to make paper and hygiene products. Forestry production, at the Associations, ranges from less than fifty acres to thousands of acres; value added processing is conducted at sawmills and planer mills. Also, many poultry, dairy, and forestry producers have significant secondary income from off-farm employment by a family member.

| Gross Loans Per Borrower | |
|---|---|
| **$ Range** | **% of Total** |
| $1-$50,000 | 5% |
| $50,001 to $100,000 | 7 |
| $100,001 to $250,000 | 18 |
| $250,001 to $500,000 | 18 |
| $500,001 to $1,000,000 | 18 |
| $1,000,001 to $3,000,000 | 19 |
| $3,000,00, to $5,000,000 | 7 |
| $5,000,000 and above | 8 |
| Total | 100% |

Individual loan exposures totaling $5.0 million or greater, which represent the commercial and corporate side of agribusiness, comprise approximately 7.70 percent of Association loan volume. As mentioned above, loans exceeding an Association's delegated lending authority must be pre-approved by AgFirst. As a result, larger agribusiness loans are typically analyzed by AgFirst's commercial lending staff as well as the Associations' own lending staff prior to an Association committing to such loans.

Approximately 47.66 percent of outstanding loan volume is comprised of loans under $500 thousand, and loans less than $100 thousand make up 11.85 percent of loan volume. This diversification among borrowers is another key component of the Associations' stable credit quality and solid financial performance over time.

Typically short and long term loans to the same borrower are cross-collateralized and cross-defaulted. By law, all long-term loans must be secured by a first lien on real estate with an initial loan to appraised value not exceeding 85.00 percent. As of December 31, 2005, 52.86 percent of the Association loans were identified as real estate loans. Exposure to losses is reduced through collateralization.

*Participations/Syndications*

AgFirst has an active Capital Markets Unit that purchases and sells large loan participations and syndications. The Capital Markets Unit works with the Associations to originate loans within the District's territory, providing commercial loan expertise to augment the Associations' staffs, as needed, as well as providing an outlet for loans that exceed an Association's exposure limits. Additionally, the Capital Markets Unit actively pursues the purchase of participations and syndications originated outside of the District's territory. These loans may be held as earning assets of AgFirst or sub-participated to the Associations. The Capital Markets Unit also sells participations outside of the District to manage its own concentrations. See the *Recent Regulatory Matters* discussion at the end of this Management's Discussion and Analysis for additional information regarding participations/syndications.

The AgFirst participation/syndication portfolio average outstanding volume for the twelve months ended December 31, 2005 totaled $1.24 billion, which reflects a decrease of $64.2 million or 4.92 percent, compared to 2004.

The following table shows portfolio credit exposures as of December 31.

| | AgFirst Participations | | |
|---|---|---|---|
| *(dollars in thousands)* | **2005** | **2004** | **2003** |
| Participations Purchased | $ 1,906,665 | $ 1,676,940 | $ 1,898,309 |
| Less: Participations Sold | 494,863 | 302,077 | 343,547 |
| Net Outstanding | 1,411,802 | 1,374,863 | 1,554,762 |
| Available Commitment | 1,486,601 | 1,086,958 | 855,727 |
| Letters of Credit and Guarantees | 127,662 | 146,579 | 239,211 |
| Total Exposure | $ 3,026,065 | $ 2,608,400 | $ 2,649,700 |

Like the Associations, AgFirst employs a number of risk management techniques to limit credit exposures, such as the adoption of underwriting standards, individual borrower exposure limits based on risk ratings and commodity exposure limits.

The following table illustrates AgFirst's participation/syndication portfolio by geographic distribution and major commodity segments:

| | AgFirst Participations | | | | | |
|---|---|---|---|---|---|---|
| *(dollars in thousands)* | **2005** | | **2004** | | **2003** | |
| Florida | $ 325,528 | 23% | $ 291,437 | 21% | $ 278,446 | 18% |
| South Carolina | 154,780 | 11 | 108,621 | 8 | 129,686 | 8 |
| North Carolina | 85,543 | 6 | 149,917 | 11 | 192,324 | 12 |
| Texas | 81,992 | 6 | 72,553 | 5 | 76,494 | 5 |
| Georgia | 80,432 | 6 | 84,864 | 6 | 79,333 | 5 |
| Pennsylvania | 80,147 | 6 | 64,792 | 5 | 80,997 | 5 |
| Delaware | 78,453 | 5 | 47,854 | 4 | 36,506 | 2 |
| Virginia | 64,895 | 5 | 70,733 | 5 | 75,480 | 5 |
| Missouri | 61,637 | 4 | 65,944 | 5 | 78,580 | 5 |
| Colorado | 57,431 | 4 | 23,076 | 2 | 17,880 | 1 |
| New York | 43,705 | 3 | 60,450 | 4 | 85,467 | 6 |
| Minnesota | 40,716 | 3 | 59,544 | 4 | 94,138 | 6 |
| Ohio | 35,151 | 3 | 27,146 | 2 | 30,603 | 2 |
| California | 34,280 | 2 | 30,608 | 2 | 35,677 | 2 |
| Illinois | 24,842 | 2 | 24,759 | 2 | 24,515 | 2 |
| Other | 162,270 | 11 | 192,565 | 14 | 238,636 | 16 |
| Total | $ 1,411,802 | 100% | $ 1,374,863 | 100% | $ 1,554,762 | 100% |

The higher geographic concentrations in Florida and South Carolina are attributed to large commodity concentrations in the sugar and citrus industries in Florida and in the poultry and timber industries in South Carolina. Concentration risk is mitigated through established hold positions to a single borrower and to a single commodity/industry. The decline in volume in North Carolina is attributed to lower usage of committed lines of credit than previous years to companies in the swine industry due to highly profitable operating results of those borrowers.

Volume outstanding in AgFirst's participation/syndication portfolio increased by 2.69 percent from 2004 year-end to 2005 year-end, despite a 17.17 percent increase in the number of borrowers and a 16.61 percent increase in credit exposure extended from December 31, 2004 to December 31, 2005. The volume growth was moderated by the continued trend of lower usage on committed lines of credits, as excellent profitability of many commodity sectors producing robust cash flow and continued restraint in capital spending has contributed to reduced usage of credit facilities.

Most of the commodities/industries within the portfolio are performing well, which should produce some internal volume growth over time as these borrowers find need to call on their committed lines of credit. AgFirst's calling program is continuing to generate opportunities to purchase new credits as well as maintain our allocations in existing credits. The portfolio is well diversified with volume spread out into many different commodity groups.

The largest major commodity concentration is food and kindred products, which represents a widely diverse group of food and food processing companies. The following shows the various major commodity groups in the portfolio and their percentage of the portfolio's outstanding volume.

| AgFirst Participations | Percent of Portfolio | | |
|---|---|---|---|
| **Commodity Group** | **2005** | **2004** | **2003** |
| Food and Kindred Products | 24% | 22% | 23% |
| Electric Utilities | 10 | 11 | 13 |
| Agribusiness | 10 | 7 | 10 |
| Lumber/Paper | 8 | 7 | 5 |
| Forestry | 7 | 9 | 6 |
| Sugar Cane/Sugar Beets | 7 | 9 | 9 |
| Citrus | 7 | 6 | 7 |
| Horticulture | 6 | 5 | 3 |
| Poultry & Eggs | 5 | 7 | 6 |
| Swine | 3 | 5 | 6 |
| Telephone Utilities | 2 | 5 | 8 |
| Other | 11 | 7 | 4 |
| Total | 100% | 100% | 100% |

The following table represents the Participation/Syndication credit quality as of December 31.

| | Participation/Syndication | | |
|---|---|---|---|
| Credit Quality | 2005 | 2004 | 2003 |
| Acceptable | 96.01% | 93.82% | 92.94% |
| OAEM | 1.65 | 2.75 | 3.66 |
| Substandard | 1.67 | 2.66 | 2.78 |
| Doubtful | 0.67 | 0.77 | 0.62 |
| Total | 100.00% | 100.00% | 100.00% |

*Correspondent Lending*

AgFirst operates Correspondent Lending, formerly referred to as a Secondary Mortgage Market Unit (SMMU) to facilitate the purchase of loans in the secondary market. Loans purchased by Correspondent Lending to be "held to maturity" are generally guaranteed by Fannie Mae and/or Farmer Mac, thereby exposing AgFirst to limited credit risk. Technically, 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.

The table below illustrates the Correspondent Lending gross unpaid principal balance of loans outstanding at December 31, 2005, 2004 and 2003.

| | AgFirst Correspondent Lending | | | | | |
|---|---|---|---|---|---|---|
| *(dollars in millions)* | 2005 | | 2004 | | 2003 | |
| Rural Home Loans - Guaranteed | $ 411.6 | 74% | $ 145.3 | 48% | $ 18.2 | 8% |
| Part-time Farm Loans - Guaranteed | 110.0 | 20 | 115.7 | 38 | 110.6 | 48 |
| Agricultural Loans - Guaranteed | 3.2 | 1 | 3.5 | 1 | 4.4 | 2 |
| Non-guaranteed Loans | 30.6 | 5 | 37.7 | 13 | 94.8 | 42 |
| Total | $ 555.4 | 100% | $ 302.2 | 100% | $ 228.0 | 100% |

*Rural home loans* are loans that conform to Fannie Mae underwriting standards and are guaranteed by Fannie Mae and Farmer Mac. These loans are classified by AgFirst as "held to maturity." During 2005, AgFirst purchased $312.4 million of rural home and part-time farm loans. Purchases of rural home and part-time farm loans averaged $26.0 million per month for 2005.

The $110.0 million in *part-time farm loans* represent first lien mortgages on homes with property characteristics (such as acreage or agricultural improvements) that conform to Farmer Mac standards. These loans are guaranteed by Farmer Mac and are accounted for as "held-to-maturity."

AgFirst owns $3.2 million of *agricultural loans* that are guaranteed by Farmer Mac. This segment is small, due primarily to the Associations' propensity to hold agricultural loans in-portfolio. Through AgFirst, a number of Associations obtain Farmer Mac guarantees for qualifying segments of their agricultural portfolios, thereby eliminating the need to sell those loans to AgFirst.

The $30.6 million of *non-guaranteed loans* generally consists of loans that are being held for eventual delivery to, or guarantee by, Fannie Mae or Farmer Mac. Such loans are secured by first-lien mortgages and are considered high quality assets at time of purchase.

The total volume being serviced as of December 31, 2005 was $21.2 million, with the servicing asset valued at $22 thousand. At December 31, 2004, AgFirst serviced $1.62 billion in loan volume with the servicing asset valued at $9.9 million. During 2005, AgFirst sold most of the servicing assets and intends to sell the remainder in 2006.

**RISK MANAGEMENT**

***Overview***

The System is in the business of making agricultural and other loans that requires taking certain risks in exchange for compensation for the risks undertaken. Management of risks inherent in AgFirst business is essential for current and long-term financial performance. The goal is to identify and assess risk, and to properly and effectively mitigate, measure, price, monitor and report risks in the business activities.

The major types of risks are:

- *structural risk* — risk inherent in the business and related to the District structure (an interdependent network of lending institutions),
- *credit risk* — risk of loss arising from an obligor's failure to meet the terms of its contract or failure to perform as agreed,
- *interest rate risk* — risk that changes in interest rates may adversely affect the operating results and financial condition,
- *liquidity risk* — risk of loss arising from the inability to meet obligations when they come due without incurring unacceptable losses,
- *operational risk* — risk of loss resulting from inadequate or failed internal processes or systems, errors by employees or external events, and
- *political risk* — risk of loss of support for the System and agriculture by the U.S. government.

***Structural Risk Management***

Structural risk results from the fact that AgFirst, along with the Associations, is part of the System, which is comprised of banks and associations that are cooperatively owned, directly or indirectly, by their borrowers. While System institutions are financially and operationally interdependent, this structure at times requires action by consensus or contractual agreement. The Federal Farm Credit Banks Funding Corporation (Funding Corporation) provides for the issuance, marketing and processing of Systemwide Debt Securities using a network of investment dealers and dealer banks. The System banks fund association loans, with Systemwide debt. (See Note 8, *Bonds and Notes*, in the Notes to the Consolidated Financial Statements for further discussion.) The banks are jointly and severally liable for the payments of Systemwide Debt Securities, exposing each bank to the risk of default of the others.

In order to mitigate this risk, the System banks, including AgFirst, utilize two integrated contractual agreements — the Amended and Restated Contractual Interbank Performance Agreement, or CIPA, and the Amended and Restated Market Access Agreement, or MAA. Under provisions of the CIPA, a score is calculated that measures the financial condition and performance of each district using various ratios that take into account the district and bank capital, asset quality, earnings, interest-rate risk and liquidity. Based on these measures, the CIPA establishes an agreed-upon standard of financial condition and performance that each district must achieve and maintain. The CIPA also establishes economic incentives whereby monetary penalties are applied if the performance standard is not met. These penalties will occur at the same point at which a bank would be required to provide additional monitoring information under the MAA.

The MAA establishes criteria and procedures for the banks to provide certain additional information and, under specified circumstances, for restricting or prohibiting an individual bank's participation in issuances of Systemwide Debt Securities. The MAA promotes the identification and resolution of individual bank financial problems in a timely manner and discharges the Funding Corporation's statutory responsibility for determining conditions of participation for each bank's participation in each issuance of Systemwide Debt Securities.

During the three years ended and as of December 31, 2005, all banks met the agreed-upon standard of financial condition and performance required by the CIPA and MAA.

***Credit Risk Management***

Credit risk arises from the potential inability of an obligor to meet its repayment obligation and exists in our outstanding loans, letters of credit, unfunded loan commitments, investment portfolio and derivative counterparty credit exposures. The Bank manages credit risk associated with lending activities through an assessment of the credit risk profile of an individual borrower. The Bank sets its own underwriting standards and lending policies that provide direction to loan officers and are approved by the board of directors.

The credit risk management process begins with an analysis of the borrower's credit history, repayment capacity and financial position. Repayment capacity focuses on the borrower's ability to repay the loan based on cash flows from operations or other sources of income, including non-farm income. Long-term real estate loans must be secured by first liens on the real estate (collateral). As required by regulation, each institution that makes loans on a secured basis must have collateral evaluation policies and procedures. In addition, each loan is assigned a credit risk rating based on the underwriting standards. This credit risk rating process incorporates objective and subjective criteria to identify inherent strengths and weaknesses and risks in a particular relationship. In addition, borrower and commodity concentration lending limits have been established to manage credit exposure.

A two-dimensional loan risk rating structure, incorporating a 14-point risk-rating scale to identify and track the probability of borrower default and a separate scale addressing loss-given-default is used. The loan rating structure supports estimates of loss through two components: borrower risk and transaction risk. Borrower risk is the risk of loss driven by factors intrinsic to the borrower. The transaction risk or facility risk is related to the structure of a credit (tenor, terms, collateral).

Through its participation in loans or interests in loans to/from other institutions within the System or outside the System, the District limits its exposure to either a borrower or commodity concentration. This also allows the Bank to manage growth and capital, and to improve geographic diversification. Concentration risk is reviewed and measured by industry, product, geography and customer limits.

AgFirst's loan portfolio is divided into performing and high-risk categories. The high-risk assets, including accrued interest, are detailed below:

| *(dollars in thousands)* | 2005 | 2004 | 2003 |
|---|---|---|---|
| **AgFirst High-risk Assets** | | | |
| Nonaccrual loans | $ 19,197 | $ 26,428 | $ 31,418 |
| Restructured loans | – | – | – |
| Accruing loans 90 days past due | 653 | 245 | 608 |
| Total high-risk loans | 19,850 | 26,673 | 32,026 |
| Other property owned | – | – | – |
| Total high-risk assets | $ 19,850 | $ 26,673 | $ 32,026 |
| **Ratios** | | | |
| Nonaccrual loans to total loans | 0.13% | 0.20% | 0.25% |
| High-risk assets to total assets | 0.10% | 0.16% | 0.20% |

Nonaccrual loans represent all loans where there is a reasonable doubt as to the collection of principal and/or interest under the contractual terms of the loan. Nonaccrual loans decreased $7.2 million, or 27.36 percent in 2005.

Restructuring of loans occurs when a concession is granted to a borrower based on either a court order or good faith in a borrower's ability to return to financial viability. The concessions can be in the form of a modification of terms or rates, a compromise of amounts owed, or deed in lieu of foreclosure. Other receipts of assets and/or equity to pay toward the loan are also considered restructured loans. The type of alternative financing structure chosen is based on minimizing the loss incurred by both the Association and the borrower.

Although the System receives no direct government support, credit quality is an indirect beneficiary of government support as government program payments to borrowers enhance their ability to honor their commitments. However, due to the geographic location of the District and the resulting types of agriculture, government programs account for a relatively small percentage of net farm income in the territory served by the Associations. In addition, the diversified nature and significant non-farm influence on the District's portfolio mitigate the impact of government support for program crops.

***Interest Rate Risk Management***

AgFirst adheres to a philosophy that all loans should be priced competitively in the market and that loan rates and spreads should be contractually established at loan closing such that a borrower is not subject to rate changes at the discretion of management or boards of directors. Therefore, all District Association variable rate and adjustable rate loans are indexed to market rates, and fixed rate loans are priced based on market rates at closing. Loan products offered by the Associations include prime-indexed variable rate loans, LIBOR-indexed variable rate loans, one-, three- and five-year Treasury-indexed adjustable rate loans, and fixed rate loans. Variable rate and adjustable rate loans are offered with or without caps. Terms are available for up to 30 years. A variety of repayment options are offered, with the ability to pay on a monthly, quarterly, semi-annual or annual frequency. In addition, "custom" repayment plans may be negotiated to fit a borrower's unique circumstances.

The objective of the AgFirst asset/liability management process is to generate a stable and adequate level of net interest income in any interest rate environment. AgFirst uses a variety of sophisticated analytical techniques to manage the complexities associated with offering numerous loan options. These include interest rate sensitivity gap analysis to monitor the repricing characteristics of AgFirst's interest-earning assets and interest-bearing liabilities and simulation analysis to determine the change in net interest income and in the market value of equity due to changes in interest rates. The following tables represent AgFirst's projected change in net interest income and market value of equity for various rate movements as of December 31, 2005.

**Net Interest Income**
*(dollars in thousands)*

| Scenarios | Net Interest Income | % Change |
|---|---|---|
| +4.0% Shock | $212,442 | (0.33%) |
| +2.0% Shock | $215,619 | 1.16% |
| Base line | $213,147 | – |
| -2.0% Shock | $258,757 | 21.40% |

**Market Value of Equity**
*(dollars in thousands)*

| Scenarios | Assets | Liabilities | Equity* | % Change |
|---|---|---|---|---|
| Book Value | $20,983,031 | $19,595,603 | $887,428 | – |
| +4.0% Shock | $18,707,537 | $18,209,585 | $497,952 | (35.85%) |
| +2.0% Shock | $19,415,861 | $18,757,181 | $658,680 | (15.15%) |
| Base line | $20,123,102 | $19,346,849 | $776,253 | – |
| -2.0% Shock | $20,700,305 | $19,778,639 | $921,666 | 18.73% |

**For interest rate risk management, the $150.0 million in perpetual preferred stock is included in liabilities rather than equity.*

The following table sets forth the amounts of interest-earning assets and interest-bearing liabilities outstanding at December 31, 2005. The amount of assets and liabilities shown, which reprice or mature during a particular period, were determined in accordance with the earlier of term-to-repricing or contractual maturity, anticipated prepayments, and, in the case of liabilities, the exercise of call options.

| | Repricing/Maturity Gap Analysis | | | |
|---|---|---|---|---|
| *(dollars in thousands)* | Less than or Equal to 1 Year | Greater than 1 Year Less than 5 Years | Greater than or Equal to 5 Years | Total |
| **Short- and Intermediate-Term Loans** | | | | |
| Fixed | $ 1,073,516 | $ 402,625 | $ 492,810 | $ 1,968,951 |
| Variable | 4,323,797 | – | – | 4,323,797 |
| Total Short- and Intermediate-Term Loans | 5,397,313 | 402,625 | 492,810 | 6,292,748 |
| **Long-Term Real Estate Loans** | | | | |
| Fixed | 2,544,752 | 3,574,657 | 1,842,406 | 7,961,815 |
| Variable | 136,120 | 20,156 | 211 | 156,487 |
| Total Long-Term Real Estate Loans | 2,680,872 | 3,594,813 | 1,842,617 | 8,118,302 |
| **Total Loans** | 8,078,185 | 3,997,438 | 2,335,427 | 14,411,050 |
| Cash and Investments | 4,242,922 | 773,335 | 797,370 | 5,813,627 |
| **TOTAL INTEREST EARNING ASSETS** | $ 12,321,107 | $ 4,770,773 | $3,132,797 | $ 20,224,677 |
| **Source of Funds** | | | | |
| Interest Bearing Liabilities | $ 10,244,964 | $ 6,363,000 | $2,272,000 | $ 18,879,964 |
| Mandatorily Redeemable Preferred Stock | – | – | 225,000 | 225,000 |
| Perpetual Preferred Stock | – | – | 150,000 | 150,000 |
| Interest Rate Swaps | 875,000 | (1,215,000) | 340,000 | – |
| Equity | – | – | 969,713 | 969,713 |
| **TOTAL SOURCE OF FUNDS** | $ 11,119,964 | $ 5,148,000 | $3,956,713 | $ 20,224,677 |
| **Interest Rate Sensitivity Gap** | $ 1,201,143 | $ (377,227) | $ (823,916) | |
| Sensitivity Gap as a % of Total Earning Assets | 5.94% | (1.87%) | (4.07%) | |
| Cumulative Gap | $ 1,201,143 | $ 823,916 | $ – | |
| Cumulative Gap as a % of Total Earning Assets | 5.94% | 4.07% | – | |
| Rate Sensitive Assets/Rate Sensitive Liabilities | 1.11 | 0.93 | 0.79 | |

At December 31, 2005, the Repricing/Maturity Gap reflected an asset sensitive position due to the full extension of liabilities. Short- and intermediate-term interest rates increased during the year and resulted in all call options on fixed rate debt to be "out of the money." This extension and the asset sensitive repricing position imply an increase in net interest income given rising interest rates scenario. However, the Repricing/Maturity Gap Analysis is a point in time view and is representative of the interest rate environment at December 31. Increasing or decreasing interest rates alter this position due to options in both assets and debt.

The Net Interest Income (NII) sensitivity analysis as shown above indicates that in a +2.00 percent interest rate shock, AgFirst is slightly asset-sensitive resulting in a modest improvement in NII. At +4.00 percent, the impact of slowing asset prepayment speeds results in a liability sensitive position and lower net interest income. In a falling rate environment, AgFirst becomes liability sensitive due to the exercise of call options on debt, which exceed the impact of increasing asset prepayment speeds. This results in an increase in NII for the -2.00 percent interest rate shock scenario.

At December 31, 2005, AgFirst had outstanding interest rate swaps with notional amounts totaling $2.63 billion and purchased interest rate caps with notional amounts totaling $238.9 million. These derivative transactions were executed to reduce interest rate risk and/or reduce funding costs.

AgFirst policy prohibits the use of derivatives for speculative purposes. See Note 17, *Derivative Instruments and Hedging Activities,* in the Notes to the Consolidated Financial Statements for additional information. The following table shows the activity in derivatives during the year ended December 31, 2005.

**Disclosures for Derivative Financial Instruments**

| Notional amounts *(dollars in millions)* | Receive Fixed | Amortizing Pay Fixed | Amortizing Floating for Floating | Interest Rate Caps | Total |
|---|---|---|---|---|---|
| **Balance at December 31, 2004** | $ 1,355 | $ – | $ 500 | $ 1,806 | $ 3,661 |
| Additions | 625 | 440 | – | – | 1,065 |
| Maturities/amortizations | (25) | – | (236) | (1,567) | (1,828) |
| Terminations | (25) | – | – | – | (25) |
| **Balance at December 31, 2005** | $ 1,930 | $ 440 | $ 264 | $ 239 | $ 2,873 |

**Various Uses of Derivative Instruments at December 31, 2005**
*(dollars in millions)*

| | |
|---|---|
| Derivatives utilized to create synthetic floating-rate debt to achieve a lower cost of funding | $ 1,930 |
| Asset/liability management purposes | 804 |
| Other purposes | 139 |
| Total interest rate swaps and caps outstanding | $ 2,873 |

***Liquidity Risk Management***

AgFirst maintains adequate liquidity to satisfy its daily cash needs. In addition to normal cash flow associated with lending operations, AgFirst has two primary sources of liquidity: investments and the issuance of Systemwide Debt Securities.

*Investments, Cash and Cash Equivalents*

FCA Regulations provide that an FCB may hold certain eligible investments, in an amount not to exceed 35.00 percent of its total loans outstanding to satisfy FCA's liquidity reserve requirement, manage short-term funds, and manage interest rate risk. AgFirst maintains an investment portfolio for this purpose comprised primarily of short-duration, high-quality investments. The nature of this portfolio guarantees that investments can be converted to cash quickly and without significant risk of loss.

In addition, AgFirst maintains a portfolio of investments that are not held for liquidity purposes and are accounted for as a held-to-maturity portfolio. These investments are authorized by FCA Regulations that allow investments in Farmer Mac securities and also in specific investments approved by FCA as a Mission-Related Investment. The vast majority of this portfolio is comprised of Mission-Related Investments for a program to purchase RHMBS, not to exceed 10.00 percent of total outstanding loans (see *Mission-Related Investments* section).

Investment securities and cash equivalents outstanding as of December 31, 2005 for AgFirst totaled $5.81 billion compared to $3.72 billion and $3.30 billion at December 31, 2004 and 2003, respectively. The increase in 2005 is due to revision of FCA Regulations during 2005 to increase the maximum level of liquidity investments from 30.00 percent to 35.00 percent of total loans outstanding, growth of total loans outstanding and AgFirst participating in the Mission-Related Investment program for rural housing.

AgFirst's investment portfolio consisted of the following security types as of December 31, 2005:

**AgFirst Investment Securities**

| *(dollars in thousands)* | 2005 | | 2004 | | 2003 | |
|---|---|---|---|---|---|---|
| **Investment Securities** | | | | | | |
| *Available for Sale* | | | | | | |
| Commercial Paper | $ 69,796 | 1.20% | $ 29,957 | 0.81% | $ 229,879 | 6.96% |
| U.S. Govt. GNMA MBS/CMOs | 1,056,283 | 18.19 | 1,080,843 | 29.06 | 911,176 | 27.60 |
| U.S. Govt. Agency MBS | 2,029,961 | 34.96 | 1,853,148 | 49.83 | 1,634,415 | 49.51 |
| Non-Agency Whole Loans | 597,670 | 10.29 | 292,545 | 7.87 | 20,275 | 0.61 |
| Commercial MBS | – | – | – | – | 1,717 | 0.05 |
| Asset-backed Securities | 132,608 | 2.28 | 21,921 | 0.58 | 35,254 | 1.07 |
| *Total Available for Sale* | 3,886,318 | 66.92 | 3,278,414 | 88.15 | 2,832,716 | 85.80 |
| *Held to Maturity* | | | | | | |
| Rural Housing MBS | 1,347,266 | 23.20 | – | – | – | – |
| MBS Guaranteed by Farmer Mac | 22,161 | 0.38 | – | – | – | – |
| *Total Held to Maturity* | 1,369,427 | 23.58 | – | – | – | – |
| Total Investment Securities | 5,255,745 | 90.50 | 3,278,414 | 88.15 | 2,832,716 | 85.80 |
| **Cash Equivalents** | | | | | | |
| Fed Funds | 168,428 | 2.90 | 58,691 | 1.58 | 108,700 | 3.29 |
| Master Notes | 108,048 | 1.86 | 107,000 | 2.88 | 109,935 | 3.33 |
| Repos | 275,000 | 4.74 | 275,000 | 7.39 | 250,000 | 7.58 |
| Total Cash Equivalents | 551,476 | 9.50 | 440,691 | 11.85 | 468,635 | 14.20 |
| **Total Investment Portfolio** | $ 5,807,221 | 100.00% | $ 3,719,105 | 100.00% | $ 3,301,351 | 100.00% |

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 liquid investments and Agency-guaranteed rural home loans. At December 31, 2005, AgFirst's coverage was 201 days.

*Systemwide Debt Securities*

AgFirst's primary source of liquidity is the ability to issue Systemwide Debt Securities, which are the general unsecured joint and several obligations of the System banks. AgFirst continually raise funds to support the mission to provide credit and related services to the rural and agricultural sectors, repay maturing Systemwide Debt Securities, and meet other obligations. As a government-sponsored enterprise, AgFirst has had access to the nation's and world's capital markets. This access has provided AgFirst with a dependable source of competitively priced debt that is critical to support the mission of providing funding to the rural and agricultural sectors. Moody's Investors Service and Standard & Poor's rate System long-term debt as Aaa and AAA, respectively, and System short-term debt as P-1 and A-1, respectively. These rating agencies base their ratings on many quantitative and qualitative factors, including the System's government-sponsored enterprise status. Material changes to the factors considered could result in a different debt rating. However, as a result of the System's financial performance, credit quality and standing in the capital markets, AgFirst anticipates continued access to funding necessary to support System needs. The U.S. government does not guarantee, directly or indirectly, Systemwide Debt Securities. At December 31, 2005, AgFirst had $18.88 billion in total debt outstanding compared to $15.40 billion at December 31, 2004 and $14.51 billion at December 31, 2003. The year-to-year increases were primarily due to the increases in loan volume and investments.

AgFirst's participation in outstanding Systemwide Debt Securities as of December 31, 2005 is as follows:

| *(dollars in thousands)* | Bonds | | Medium-Term Notes | | Discount Notes | | Total | |
|---|---|---|---|---|---|---|---|---|
| Maturities | Amount | Weighted Average Interest Rate | Amount | Weighted Average Interest Rate | Amount | Weighted Average Interest Rate | Amount | Weighted Average Interest Rate |
| 2006 | $ 5,546,432 | 3.48% | $ – | –% | $ 1,726,225 | 3.87% | $ 7,272,657 | 3.57% |
| 2007 | 4,709,288 | 3.89 | 15,202 | 6.75 | – | – | 4,724,490 | 3.89 |
| 2008 | 2,026,642 | 3.79 | – | – | – | – | 2,026,642 | 3.79 |
| 2009 | 1,643,669 | 4.23 | – | – | – | – | 1,643,669 | 4.23 |
| 2010 | 915,029 | 4.42 | – | – | – | – | 915,029 | 4.42 |
| 2011 | 2,297,477 | 5.18 | – | – | – | – | 2,297,477 | 5.18 |
| Total | $ 17,138,537 | 3.98% | $ 15,202 | 6.75% | $ 1,726,225 | 3.87% | $ 18,879,964 | 3.97% |

In the preceding table, weighted average interest rates include the effect of related derivative financial instruments.

See Note 8, *Bonds and Notes*, in the Notes to the Consolidated Financial Statements, for additional information related to debt.

***Operational Risk Management***

Operational risk is the risk of loss resulting from inadequate or failed processes or systems, human factors or external events, including the execution of unauthorized transactions by employees, errors relating to transaction processing and technology, breaches of the internal control system and the risk of fraud by employees or persons outside the System. AgFirst and the Associations' board of directors are required, by regulation, to adopt an internal control policy that provides adequate direction to the institution in establishing effective control over and accountability for operations, programs and resources. The policy must include, at a minimum, the following items:

- direction to management that assigns responsibility for the internal control function to an officer of the institution,
- adoption of internal audit and control procedures,
- direction for the operation of a program to review and assess its assets,
- adoption of loan, loan-related assets and appraisal review standards, including standards for scope of review selection and standards for work papers and supporting documentation,
- adoption of asset quality classification standards,
- adoption of standards for assessing credit administration, including the appraisal of collateral, and
- adoption of standards for the training required to initiate a program.

In general, System institutions address operational risk through the organization's internal framework under the supervision of the internal auditors. Exposure to operational risk is typically identified with the assistance of senior management and internal audit plans developed with higher risk areas receiving more review.

***Political Risk Management***

System institutions are instrumentalities of the federal government and are intended to further governmental policy concerning the extension of credit to or for the benefit of agricultural and rural America. The System and its borrowers may be significantly affected by federal legislation that affects the System directly, such as changes to the Farm Credit Act, or indirectly, such as agricultural appropriations bills. Political risk to the System is the risk of loss of support for the System or agriculture by the U.S. government.

The District manages political risk by actively supporting the Farm Credit Council, which is a full-service, federal trade association representing the System before Congress, the Executive Branch, and others. The Council provides the mechanism for "grassroots" involvement in the development of System positions and policies with respect to federal legislation and government actions that impact the System. Additionally, the District takes an active role in representing the individual interests of System institutions and their borrowers before Congress. In addition to the Farm Credit Council, each district has its own Council, which is a member of the Farm Credit Council. The district Councils represent the interests of their members on a local and state level, as well as on a federal level.

**ALLOWANCE FOR LOAN LOSSES**

During 2004, AgFirst completed its study to further refine the allowance for loan losses methodology, taking into account guidance from the FCA, the System's regulator, as well as the Securities and Exchange Commission (SEC) and Federal Financial Institutions Examination Council. As a result of this study and resulting refinements in methodology, during the fourth quarter of 2004, AgFirst recorded a reversal of the allowance for loan losses of $15.3 million.

AgFirst's allowance for loan losses methodology was adjusted and revised in the late 1980s to take into account the unusually adverse economic factors affecting American agriculture. Subsequent estimates continued to reflect, to some extent, the loss history of the mid-to-late 1980s. Accordingly, the reserves provided in the mid-to-late 1980s have, in effect, remained part of the allowance for loan losses.

AgFirst's allowance for loan loss methodology has consistently adhered to proper accounting policies, under the regulatory supervision of the FCA in its role as a "safety and soundness" regulator. It was the FCA's view that the allowance for loan losses should include, among others, an assessment of probable losses, economic conditions, and historical loss experience, keeping in mind the potentially long agricultural cycle.

In April 2004, the FCA issued an "Informational Memorandum" to System institutions regarding the criteria and methodologies that would be used in evaluating the adequacy of a System institution's allowance for loan losses. The FCA endorsed the direction provided by other bank regulators and the SEC and indicated that the conceptual framework addressed in their guidelines would be included as part of their examination process.

The refinement in methodology resulted in a calculated allowance for loan losses that was significantly less than the previously recorded balance due to revised loss factors that are more indicative of actual loss experience in recent years and current borrower analysis. The factors considered in determining the revised level of allowance for loan losses were generally based on recent historical charge-off experience adjusted for relevant environmental factors. AgFirst considered the following when adjusting the historical charge-offs experience:

- Credit risk classifications,
- Collateral values,
- Risk concentrations,
- Weather related conditions, and
- Economic conditions.

While the $15.3 million reversal had a significant impact on 2004 results of operations and the previously recorded allowance for loan losses, the refinement in methodology is not expected to have a significant impact on comparative results of operations in future periods. Additionally, the refinement in methodology did not have a significant impact on the level of risk bearing capacity of AgFirst. "Risk funds" (capital plus the allowance for loan losses), totaled $1.05 billion at December 31, 2005 (7.27 percent of AgFirst loans), as compared with $1.04 billion at December 31, 2004 (8.05 percent of AgFirst loans) and $988.7 million at December 31, 2003 (7.99 percent of AgFirst loans).

The allowance for loan losses at each period end was considered by AgFirst management to be adequate to absorb probable losses existing in and inherent to its loan portfolio. Management's evaluations consider factors including loan loss experience, portfolio quality, loan portfolio composition, current agricultural production conditions and economic conditions. The allowance for loan losses was $10.1 million at December 31, 2005, as compared with $14.8 million and $34.2 million at December 31, 2004 and 2003, respectively.

The following table presents the activity in the allowance for loan losses for the most recent three years:

| **AgFirst Allowance for Loan Losses Activity** *(dollars in thousands)* | 2005 | 2004 | 2003* |
|---|---|---|---|
| Balance at beginning of year | $ 14,800 | $ 34,168 | $ 31,155 |
| Charge-offs: | | | |
| Production agriculture: | | | |
| Real estate mortgage | – | (225) | – |
| Agribusiness | (41) | (673) | – |
| Communication | (13) | (3,200) | – |
| Other | – | – | (67) |
| Total charge-offs | (54) | (4,098) | (67) |
| Recoveries: | | | |
| Production agriculture: | | | |
| Production and intermediate term | – | 22 | – |
| Communication | 363 | – | – |
| Other | – | – | 580 |
| Total recoveries | 363 | 22 | 580 |
| Net (charge-offs) recoveries | 309 | (4,076) | 513 |
| Provision for (reversal of) loan losses | (4,995) | – | 2,500 |
| Reversal of provision due to change in methodology | – | (15,292) | – |
| Balance at end of year | $ 10,114 | $ 14,800 | $ 34,168 |
| Ratio of net charge-offs (recoveries) during the period to average loans outstanding during the period | (0.002%) | 0.033% | (0.004%) |

* *Beginning with year-end 2004, loan type categories have been expanded to provide additional information on the types of loans made. As a result, three years of comparable data is not available.*

The allowance for loan losses by loan type for the most recent three years is as follows:

| **AgFirst Allowance for Loan Losses by Loan Type** *(dollars in thousands)* | 2005 | 2004 | 2003* |
|---|---|---|---|
| Production agriculture: | | | |
| Real estate mortgage | $ 10,100 | $ 13,400 | $ – |
| Communication | – | 1,400 | – |
| Rural residential real estate | 14 | – | – |
| Other | – | – | 34,168 |
| Total | $ 10,114 | $ 14,800 | $ 34,168 |

* *Beginning with year-end 2004, loan type categories have been expanded to provide additional information on the types of loans made. As a result, three years of comparable data is not available.*

The allowance for loan losses as a percentage of loans outstanding and as a percentage of certain other credit quality indicators is shown below:

| | 2005 | 2004 | 2003 |
|---|---|---|---|
| Allowance for loan losses to loans | 0.07% | 0.11% | 0.28% |
| Allowance for loan losses to nonaccrual loans | 52.68% | 56.00% | 108.76% |
| Allowance for loan losses to participation loans and Correspondent Lending loans | 0.51% | 0.88% | 1.92% |

The financial positions of the District borrowers have generally strengthened during the past decade as farmers' net cash income has been at a favorable level due, in part, to direct federal government payments and steady increases in land values over the period. With borrowers' strengthened financial positions and the continued emphasis on sound underwriting standards, the credit quality of the District loan portfolio has remained healthy.

See Note 5, *Loans and Allowance for Loan Losses* in the Notes to the Consolidated Financial Statements for further information concerning the allowance for loan losses.

## RESULTS OF OPERATIONS

### *Net Income*

AgFirst net income totaled $164.3 million for the year ended December 31, 2005, a decrease of $16.0 million from 2004 and an increase of $2.9 million from December 2003 to December 2004. Major components of the changes in net income for the referenced periods are outlined in the following table and discussion.

| **Changes in Net Income** *(dollars in thousands)* | Year Ended December 31, 2005 | 2004 |
|---|---|---|
| **Net income (for prior year)** | $ 180,306 | $ 177,449 |
| **Increase (decrease) due to:** | | |
| Total interest income | 248,334 | 15,790 |
| Total interest expense | (255,728) | (48,252) |
| Net interest income | (7,394) | (32,462) |
| Provision for loan losses | (10,297) | 17,792 |
| Noninterest income | (1,272) | 8,508 |
| Noninterest expense | 2,916 | 9,019 |
| Total increase (decrease) in net income | (16,047) | 2,857 |
| **Net income** | $ 164,259 | $ 180,306 |

### *Interest Income*

Total interest income for the year ended December 31, 2005 was $792.7 million, an increase of $248.3 million, as compared to the same period of 2004. Total interest income for 2004 was $544.3 million, an increase of $15.8 million, as compared to the same period of 2003. The increase from 2004 to 2005 resulted from increases related to volume and rate. The volume of interest earning assets increased in 2005, with an increase in average earning assets of $1.83 billion. In 2005, interest rates increased in comparison to 2004 and as a result, the average yield on interest earning assets increased 1.04 percent. The increase from 2003 to 2004 was primarily attributable to increases in average earning assets.

The following table illustrates the impact that volume and yield changes had on interest income over these periods.

| **Net Change in Interest Income** *(dollars in thousands)* | Year Ended December 31, 2005-2004 | 2004-2003 |
|---|---|---|
| Increase in average earning assets | $ 1,834,873 | $ 980,296 |
| Average yield (prior year) | 3.40% | 3.51% |
| Interest income variance attributed to change in volume | 62,348 | 34,452 |
| Average earning assets (current year) | 17,854,452 | 16,019,579 |
| Increase (decrease) in average yield | 1.04% | (0.11%) |
| Interest income variance attributed to change in yield | 185,986 | (18,662) |
| **Net change in interest income** | $ 248,334 | $ 15,790 |

*Interest Expense*

Total interest expense for the year ended December 31, 2005 was $588.5 million, an increase of $255.7 million, as compared to the same period of 2004. Total interest expense for the year ended December 31, 2004 was $332.7 million, an increase of $48.3 million, as compared to the same period of 2003. The increases were primarily attributed to an increase in interest-bearing liabilities supporting asset growth, an increase in rates, and the impact of SFAS No. 150, discussed below.

Prior to the adoption of Statement of Financial Accounting Standards (SFAS) No. 150, *Accounting for Certain Financial Instruments with both Characteristics of Liabilities and Equity,* which states that mandatorily redeemable financial instruments are classified as liabilities, dividends on preferred stock were reflected as an adjustment to capital and not as expense. As a result, the issuance of $225.0 million of mandatorily redeemable preferred stock in 2001 and $150.0 million of perpetual preferred stock in 2003 resulted in a decrease in interest expense, as the proceeds from the stock issuances were used to pay down debt.

With the adoption of SFAS No. 150 on July 1, 2003, dividends on mandatorily redeemable preferred stock are required to be reflected prospectively as interest expense. As a result, $9.4 million, which represents dividends from July 1, 2003 to December 31, 2003 on the $225.0 million mandatorily redeemable preferred stock, was reflected as interest expense rather than an adjustment to capital in 2003. In 2004 and 2005, the related interest expense was $18.9 million for both years.

The following table illustrates the impact that volume and rate changes had on interest expense over these periods.

| **Net Change in Interest Expense** *(dollars in thousands)* | **Year Ended December 31, 2005-2004** | **2004-2003** |
|---|---|---|
| Increase in average interest-bearing liabilities | $ 1,775,396 | $ 787,349 |
| Average rate (prior year) | 2.21% | 2.00% |
| Interest expense variance attributed to change in volume of interest-bearing liabilities | 39,293 | 15,723 |
| Average interest-bearing liabilities (current year) | 16,809,481 | 15,034,085 |
| Increase (decrease) in average rate | 1.29% | 0.21% |
| Interest expense variance attributed to change in rate | 216,435 | 32,529 |
| **Net change in interest expense** | $ 255,728 | $ 48,252 |

*Net Interest Income*

Net interest income declined from 2003 to 2004 and from 2004 to 2005, as illustrated by the following table:

**AgFirst Analysis of Net Interest Income**

| *(dollars in thousands)* | **2005 Avg. Balance** | **2005 Interest** | **2004 Avg. Balance** | **2004 Interest** | **2003 Avg. Balance** | **2003 Interest** |
|---|---|---|---|---|---|---|
| Loans | $ 13,448,845 | $ 624,945 | $ 12,464,633 | $ 469,774 | $ 12,058,243 | $ 469,148 |
| Cash & investments | 4,405,607 | 167,728 | 3,554,946 | 74,565 | 2,981,040 | 59,401 |
| Total earning assets | $ 17,854,452 | $ 792,673 | $ 16,019,579 | $ 544,339 | $ 15,039,283 | $ 528,549 |
| Interest-bearing liabilities | $ 16,809,481 | $ (588,472) | $ 15,034,085 | $ (332,744) | $ 14,246,736 | $ (284,492) |
| Impact of capital | $ 1,044,971 | | $ 985,494 | | $ 792,547 | |
| Net interest income | | $ 204,201 | | $ 211,595 | | $ 244,057 |

| | **2005 Average Yield** | **2004 Average Yield** | **2003 Average Yield** |
|---|---|---|---|
| Yield on loans | 4.65% | 3.77% | 3.89% |
| Yield on cash & investments | 3.81% | 2.10% | 1.99% |
| Yield on earning assets | 4.44% | 3.40% | 3.51% |
| Cost of interest-bearing liabilities | 3.50% | 2.21% | 2.00% |
| Spread | 0.94% | 1.19% | 1.51% |
| Impact of capital | 0.20% | 0.13% | 0.11% |
| Net interest income/avg. earning assets | 1.14% | 1.32% | 1.62% |

The decline in net interest income is attributed to the decrease in spread between assets and funding costs, substantially offset by the positive variance in interest earning assets. While both loans and investments increased significantly in 2005, debt costs increased faster than asset yields due to several factors. A flattening yield curve resulting from rising short-term rates reduced earnings margin. In addition, investments increased as a percent of interest earning assets. Investments have lower spreads to debt costs than loans due to their high credit quality and liquidity. The decline in net interest income also reflects the extraordinary levels achieved in 2003, which were due to temporary reductions in debt costs. When interest rates fell in previous years, AgFirst was able to execute call options embedded in fixed rate debt and refinance that debt at lower interest rates. Since debt transactions are in larger dollar increments than the average loan size, debt was refinanced faster than loans, resulting in widening earnings spreads. However, the improved performance of net interest income was temporary as the refinancing of assets gradually brought asset yields in line with debt costs.

*Provision for Loan Losses*

AgFirst assesses risks inherent in its portfolio on an ongoing basis and establishes an appropriate reserve for loan losses. A reversal of the provision for the twelve months ended December 31, 2005 of $5.0 million resulted from decreased exposure and payments related to loans in the Participation/Syndication portfolio. As referenced above, the $15.3 million reversal in 2004 resulted from the AgFirst study, and the resulting refinements in methodology completed during the fourth quarter of 2004. Provisions of $2.5 million in 2003 represented the establishment of reserves in response to deterioration in certain discreet loans and loan segments.

*Noninterest Income*

Noninterest income for the year ended December 31, 2005 was $16.7 million, a decrease of $1.3 million, compared to 2004. The decrease in 2005 was primarily the result of decreases of $310 thousand in loan fees and $4.0 million in other noninterest income, offset by increases of $483 thousand in gains on sales of investments and $2.5 million increases in income on Correspondent Lending operations. The majority of the 2005 decrease in other noninterest income resulted from a $3.4 million recovery recorded in 2004 on an investment previously charged-off. Noninterest income for the year ended December 31, 2004 was $18.0 million, an increase of $8.5 million, compared to 2003. The increase in 2004 was primarily due to an increase in Correspondent Lending operations noninterest income and the increase in other noninterest income for the above-mentioned recovery on the investment previously charged-off .

Correspondent Lending operations noninterest income (loss) consisted of the following:

| **Correspondent Lending Income (Loss)** *(dollars in thousands)* | **Year Ended December 31, 2005** | **2004** | **2003** |
|---|---|---|---|
| Servicing income | $ 1,099 | $ 3,523 | $ 3,014 |
| Gain (loss) on sale of loans | (32) | (2,445) | (1,859) |
| Amortization of servicing rights | (1,358) | (3,808) | (5,284) |
| Gain on sale of servicing assets | 1,078 | – | – |
| (Impairment)/recovery of impairment of servicing assets | 797 | 1,803 | (2,600) |
| Total Correspondent Lending income (loss) | $ 1,584 | $ (927) | $ (6,729) |

*Noninterest Expense*

Noninterest expense for the year ended December 31, 2005 was $61.7 million, a decrease of $2.9 million, as compared to the same period of 2004.

The following table illustrates the sources of variance:

| **Change in Noninterest Expense** *(dollars in thousands)* | **2005** | **2004** |
|---|---|---|
| **Prior year noninterest expense** | $ 64,602 | $ 73,621 |
| **Change in expense:** | | |
| Salaries and employee benefits | 1,785 | 2,805 |
| Occupancy and equipment | 1,285 | 1,271 |
| Insurance Fund premium | 39 | (1,169) |
| Other operating expenses | 434 | 2,360 |
| Intra-System financial assistance expense | (3,573) | (6,514) |
| Called debt expense | (2,704) | (8,376) |
| Other noninterest expenses | (182) | 604 |
| **Noninterest expense** | $ 61,686 | $ 64,602 |

Occupancy and equipment expenses increased during 2005 and 2004, primarily the result of a technology renovation aimed at improving AgFirst's technical infrastructure and updating various systems.

Financial assistance expense declined due to the retirement of several Financial Assistance Corporation bonds. See Note 12, *Intra-System Financial Assistance,* in the Notes to the Consolidated Financial Statements for further information. AgFirst fully extinguished its obligations in 2005 with the maturity of the last Financial Assistance Corporation bonds.

The Farm Credit System Insurance Corporation (FCSIC) targets a secure base amount equal to 2.00 percent of System obligations. FCSIC premiums decreased in 2004 in response to the moderate growth in System obligations. This resulted in lowering the rate to 0.05 percent in 2004 and 2005, compared to 0.12 percent of retail loans outstanding in 2003.

Other operating expenses increased $2.4 million from 2003 to 2004, and increased $434 thousand from 2004 to 2005. The increase from 2003 to 2004 was primarily the result of professional fees paid for consultants' assistance related to AgFirst's compliance with new System disclosure and governance practices.

Concession (debt issuance expense) is amortized over the life of the underlying debt security. When securities are called prior to maturity, any unamortized concession is expensed. For 2005, the called debt expense was $656 thousand, a decrease of $2.7 million, compared to 2004. For 2004, the called debt expense was $3.4 million, a decrease of $8.3 million, compared to the comparable period in 2003. Falling interest rates in 2003 enabled AgFirst to call a substantial amount of debt resulting in the called debt expense of $11.7 million. Called debt volume was $352.0 million, $2.53 billion, and $8.59 billion for 2005, 2004, and 2003, respectively. Stable-to-rising rates in 2005 significantly reduced call opportunities.

## EMPLOYEE RETIREMENT PLANS

For the years ended December 31, 2005 and 2004, AgFirst had contributed $4.6 million and $18.9 million, respectively, to the Districtwide defined benefit retirement plan. The Districtwide funding in 2004 brought the retirement plan's assets to an amount that exceeded the Accumulated Benefit Obligation as of the Plan's measurement date, eliminating the minimum pension liability and the charge to accumulated other comprehensive income. The funding in 2005 maintained the Plan's assets to exceed the Accumulated Benefit Obligation. See Note 11, *Employee Benefit Plans,* in the Notes to the Consolidated Financial Statements of this report for further information.

## PREFERRED STOCK

On May 17, 2001, AgFirst issued 225 thousand shares of Mandatorily Redeemable Cumulative Preferred Stock at a par value of $1 thousand per share. This stock is mandatorily redeemable on December 15, 2016 and carries a stated annual dividend rate of (1) 8.393 percent until December 15, 2011, with dividends paid semi-annually on June 15th and December 15th: and (2) thereafter at a floating rate per annum equal to 3 month LIBOR plus 3.615 percent with dividends payable quarterly commencing March 15, 2012. On or after the dividend payment date in December, 2011, the preferred stock will be redeemable in whole or in part at the option of AgFirst on any dividend payment date at its par value of $1 thousand per share.

On October 14, 2003, AgFirst issued 150 thousand shares of Perpetual Non-Cumulative Preferred Stock at a par value of $1 thousand per share. Dividends on the stock are non-cumulative and payable on the 15th day of June and December in each year, commencing December 15, 2003, at an annual rate equal to 7.30 percent. In the event dividends are not declared on the preferred stock for payment on any dividend payment date, then such dividends shall not be cumulative and shall cease to accrue and be payable. On or after the dividend payment date in December 2008, AgFirst may, at its option, redeem the preferred stock in whole or in part at any time at the redemption price of $1 thousand per share plus accrued and unpaid dividends for then current dividend period to the date of redemption.

See Note 9, *Mandatorily Redeemable Preferred Stock,* and Note 10, *Shareholders' Equity,* of the Notes to the Consolidated Financial Statements of this annual report for more detailed information concerning the preferred stock issuances.

## CAPITAL

Capital serves to support asset growth and provide protection against unexpected credit and interest rate risk and operating losses. Capital is also needed for future growth and investment in new products and services. A sound capital position is critical to providing protection to investors in Systemwide Debt Securities and to long-term financial success.

Total shareholders' equity at December 31, 2005 was $1.04 billion, compared to $1.02 billion and $954.5 million at December 31, 2004 and 2003, respectively. The increasing trend in shareholders' equity is attributed to the increases in retained earnings, offset somewhat by a decrease in outstanding capital stock resulting from the redemption by AgFirst of a portion of its capital stock.

FCA sets minimum regulatory capital requirements for banks and associations. Capital adequacy is evaluated using a number of regulatory ratios. According to the FCA regulations, each institution's permanent capital ratio is calculated by dividing permanent capital by a risk-adjusted asset base. Risk-adjusted assets mean the total dollar amount of the institution's assets adjusted by an appropriate credit conversion factor as defined by regulation. For all periods presented, AgFirst exceeded minimum regulatory standards for all of the ratios. Subsequent to the issuance of the mandatorily redeemable preferred stock, FCA now requires AgFirst to maintain a minimum net collateral ratio of 104.00 percent compared to the regulatory minimum of 103.00 percent. Unlike the permanent capital, total surplus and core surplus ratios, the net collateral ratio does not incorporate any risk-weighting of assets.

At December 31, regulatory ratios were:

| | **Regulatory Minimum** | **AgFirst Ratio as of 12/31/05** | **12/31/04** | **12/31/03** |
|---|---|---|---|---|
| Permanent Capital Ratio | 7.00% | 23.90% | 26.86% | 25.99% |
| Total Surplus Ratio | 7.00% | 23.84% | 26.76% | 25.79% |
| Core Surplus Ratio | 3.50% | 14.15% | 15.60% | 14.45% |
| Collateral Ratio | 103.00% * | 105.70% | 106.88% | 106.94% |

**FCA requires AgFirst to maintain a minimum net collateral ratio of 104.00 percent.*

See Note 10, *Shareholders' Equity,* in the Notes to the Consolidated Financial Statements for additional information.

## THE DISTRICTWIDE YOUNG, BEGINNING, AND SMALL (YBS) FARMERS AND RANCHERS PROGRAM

AgFirst's and the Associations' mission is to provide financial services to agriculture and the rural community, which includes providing credit to young*, beginning** and small*** farmers. Because of the unique needs of these individuals, and their importance to the future growth of the Associations, the Associations have established annual marketing goals to increase our market share of loans to YBS farmers. Specific marketing plans have been developed to target these groups, and resources have been designated to help ensure YBS borrowers access to a stable source of credit.

YBS farmers and ranchers are defined as:

* Young farmers are defined as those farmers, ranchers, producers or harvesters of aquatic products who are age 35 or younger as of the date the loan is originally made.

** Beginning farmers are defined as those farmers, ranchers, producers or harvesters of aquatic products who have 10 years or less farming or ranching experience as of the date the loan is originally made.

*** Small farmers are defined as those farmers, ranchers, producers or harvesters of aquatic products who normally generate less than $250 thousand in annual gross sales of agricultural or aquatic products at the date the loan is originally made.

AgFirst and the District Associations recognize that YBS farmers are vitally important to the future of agriculture and are committed to continue offering programs to help educate, assist, and provide quality financial services to YBS farmers. AgFirst's affiliated Associations have sponsored and supported the majority of the YBS farmer programs throughout the District. In addition, AgFirst has sponsored YBS initiatives jointly with its Associations as well as supported individual state and national programs. The 2005 YBS program that AgFirst sponsored included numerous state Cooperative Councils. Management will continue to consider sponsorship of future, district-wide YBS farmer activities as opportunities arise.

All District Associations offer some types of credit and related services to YBS borrowers with 100.00 percent of the Associations offering services with the Farm Service Agency. Many also coordinate with state programs, dealers/merchants, and other farm groups.

The following tables reflect the December 31, 2005 business activity with young, beginning, and small farmers, ranchers, and producers or harvesters of aquatic products:

**AgFirst Farm Credit District**
**Young, Beginning, and Small Farmers and Ranchers**
**Number/Volume of Loans Outstanding**
**December 31, 2005**
*(dollars in thousands)*

| Category | Number of Loans | Volume Outstanding |
|---|---|---|
| Total loans and commitments outstanding | 132,453 | $20,540,198 |
| Young farmers and ranchers | 21,042 | 1,790,408 |
| Beginning farmers and ranchers | 31,875 | 3,604,104 |
| Small farmers and ranchers | 90,293 | 6,557,771 |

*For purposes of the above table, a loan could be classified in more than one category depending upon the characteristics of the underlying borrower.*

**Number/Volume Outstanding by Loan Size**
**December 31, 2005**

| Number/Volume Outstanding | $0-$50,000 | $50,000-$100,000 | $100,001-$250,000 | $250,001 and greater |
|---|---|---|---|---|
| Total number of loans and commitments outstanding | 81,525 | 20,779 | 18,747 | 11,402 |
| Total volume of loans and commitments outstanding | $1,577,358 | $1,742,833 | $3,389,900 | $13,830,107 |

## LEGAL PROCEEDINGS

On the basis of information presently available, management and legal counsel are of the opinion that the ultimate liability, if any, from legal actions pending against AgFirst would be immaterial in relation to the financial position of AgFirst. Refer to Note 15, *Commitments and Contingencies,* in the Notes to the Consolidated Financial Statements for additional information.

## RECENT REGULATORY MATTERS

On February 24, 2004, the FCA published a final notice in the Federal Register that loan syndication transactions by System institutions to eligible borrowers must be treated as direct loans meeting all statutory and regulatory requirements, rather than as loan participations. In addition, FCA indicated that since FCBs can no longer make direct loans to eligible borrowers, they cannot directly take part in loan syndication transactions to eligible borrowers. Syndication transactions with certain entities whose operations are functionally similar to those of an eligible borrower (similar entity) are not impacted by the final notice. FCA included certain transitional provisions with respect to existing loan syndications to eligible borrowers.

Loan syndication transactions under the direct lending authorities now require associations to address borrower rights, territorial concurrency, and stock requirements. To date, the District has been able to minimize the impact of FCA's ruling on syndications through the cooperation of commercial lenders and System institutions not subject to all aspects of the ruling. However, the FCA ruling has resulted in higher cost and more complexity to achieve the same volume and resulted in slowing of growth opportunity. FCA subsequently adopted a regulation allowing the waiver of borrower rights under certain circumstances for loan syndication transactions.

In January 2006, FCA approved final governance regulations for System banks and associations. The regulations are intended to promote the continued safety and soundness of the System by establishing governance standards and improving transparency in public disclosures. While the regulation will require changes to governance processes/disclosures, it is not expected to materially impact Bank operations.

## FORWARD LOOKING INFORMATION

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

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

# Additional Disclosures Required by Farm Credit Administration Regulations

**Description of Business**

Descriptions of the territory served, persons eligible to borrow, types of lending activities engaged in, financial services offered and related Farm Credit organizations are incorporated herein by reference to Note 1 to the consolidated financial statements, *Organization and Operations,* included in this annual report to shareholders.

The description of significant developments that had or could have a material impact on earnings or interest rates to borrowers, acquisitions or dispositions of material assets, material changes in the manner of conducting the business, seasonal characteristics, and concentrations of assets, if any, is incorporated in *Management's Discussion and Analysis of Financial Condition and Results of Operations* included in this annual report to shareholders.

**Description of Property**

The following table sets forth certain information regarding the properties of the reporting entity, all of which are located in Columbia, South Carolina:

| Location | Description |
|---|---|
| 1401 Hampton Street | Bank building and adjacent parking |
| 1441 Hampton Street | Leased |
| 1443 Hampton Street | AgFirst Federal Credit Union |
| 1447 Hampton Street | Vacant |
| 1428 Taylor Street | AgFirst training center |
| 1436 Taylor Street | Leased |

**Legal Proceedings**

Information, if any, to be disclosed in this section is incorporated herein by reference to Note 15 to the consolidated financial statements, *Commitments and Contingencies,* included in this annual report to shareholders.

**Description of Capital Structure**

Information to be disclosed in this section is incorporated herein by reference to Note 10 to the consolidated financial statements, *Shareholders' Equity,* included in this annual report to shareholders.

**Description of Liabilities**

The description of liabilities, contingent liabilities and intrasystem financial assistance rights and obligations to be disclosed in this section is incorporated herein by reference to Notes 2, 7, 8, 9, 11, 12 and 15 to the consolidated financial statements included in this annual report to shareholders.

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

*Management's Discussion and Analysis of Financial Condition and Results of Operations,* which appears in this annual report to shareholders and is to be disclosed in this section, is incorporated herein by reference.

**Senior Officers**

The following represents certain information regarding the directors and senior officers of the reporting entity.

The business experience for the past five years for senior officers is with the Farm Credit System.

| Senior Officer | Position |
|---|---|
| F. A. (Andy) Lowrey | President and Chief Executive Officer |
| Thomas S. Welsh | Executive Vice President, Chief Administrative and Legislative Officer & Corporate Secretary |
| Leon T. Amerson | Senior Vice President & Chief Financial Officer |
| Benjamin F. Blakewood | Senior Vice President, Chief Operations & Technology Officer |
| William L. Melton | Senior Vice President, Chief Lending Officer |

The total amount of compensation earned by the CEO and the highest paid officers as a group (including the CEO) during the years ended December 31, 2005, 2004 and 2003, is as follows:

| Name of Individual or Number in Group | Year | Annual | | Deferred Comp. | Perq./ Other* | Total |
|---|---|---|---|---|---|---|
| | | Salary | Bonus | | | |
| F. A. Lowrey | 2005 | $ 444,017 | $ 162,332 | $ 6,000 | $ 16,779 | $ 629,128 |
| F. A. Lowrey | 2004 | $ 415,286 | $ 116,280 | $ 29,070 | $ 15,120 | $ 575,756 |
| F. A. Lowrey | 2003 | $ 377,534 | $ 105,710 | $ 26,427 | $ 15,045 | $ 524,716 |
| 5 Officers | 2005 | $ 1,251,913 | $ 311,804 | $ 58,502 | $ 65,204 | $ 1,687,423 |
| 5 Officers | 2004 | $ 1,183,639 | $ 190,409 | $ 99,122 | $ 64,389 | $ 1,537,559 |
| 5 Officers | 2003 | $ 1,075,450 | $ 209,571 | $ 73,444 | $ 62,112 | $ 1,420,577 |

**Primarily comprised of company contributions to thrift plan, group life insurance premiums and automobile compensation.*

In addition to a base salary, senior officers earn additional compensation under the Bank's Corporate Bonus Plan. The plan is designed to motivate employees to exceed specific performance targets, including financial measures and customer satisfaction rating. Those covered by the plan include all employees. Bonuses are shown in the year earned. Payment of the 2005 bonus was made in the first quarter of 2006.

Disclosure of the total compensation in 2005 to any senior officer, or to any other individual included in the total whose compensation exceeds $50,000, is available to shareholders upon request.

**AgFirst Farm Credit Bank Board of Directors**

| Name | Position | Term of Office |
|---|---|---|
| Robert G. Sexton | Chairman | December 31, 2007 |
| Thomas W. Kelly | Vice Chairman | December 31, 2008 |
| E. McDonald Berryman | Director | December 31, 2005 |
| William C. Bess, Jr. | Director | December 31, 2009* |
| Dr. Chester D. Black | Director | December 31, 2006# |
| Robert A. Carson | Director | December 31, 2006 |
| Henry M. Frazee | Director | December 31, 2008 |
| Don W. Freeman | Director | December 31, 2009* |
| Robert L. Holden, Sr. | Director | December 31, 2006 |
| Paul M. House | Director | December 31, 2007 |
| Lyle Ray King | Director | December 31, 2008 |
| Richard Kriebel | Director | December 31, 2007 |
| M. Wayne Lambertson | Director | December 31, 2009* |
| Paul Lemoine | Director | December 31, 2007 |
| F. Merrel Lust | Director | December 31, 2005 |
| James L. May | Director | December 31, 2009** |
| Eugene W. Merritt, Jr. | Director | December 31, 2006 |
| Katherine A. Pace | Director | December 31, 2007## |
| Dale W. Player | Director | December 31, 2007 |
| J. Dan Raines, Jr. | Director | December 31, 2009* |
| Walter L. Schmidlen, Jr. | Director | December 31, 2008 |
| Kenneth A. Spearman | Director | December 31, 2009## |
| Robert H. Spiers, Jr. | Director | December 31, 2009** |

* These directors were re-elected to a new 4-year term ending 12/31/09.
** These directors were newly elected in 2005 to 4-year terms commencing 1/1/06.
\# Dr. Black resigned effective 12/31/05.
\#\# Newly appointed outside directors.

***Robert G. Sexton,*** Chairman of the Board, is from Vero Beach, Florida. He is President of Oslo Citrus Growers Association and co-owner of Orchid Island Juice Company. He serves as a director of Farm Credit of South Florida, ACA, Florida Citrus Packers, Indian River Citrus League, Highland Exchange Service Co-op and McArthur Management Company. In addition, he is a member of the Indian River Farm Bureau.

***Thomas W. Kelly,*** Vice Chairman of the Board, is from Tyrone, Pennsylvania and is owner-operator of a dairy and crop farm. The dairy herd consists of registered Holsteins whose genetics are merchandized. Major crops include corn, alfalfa, soybeans and seed barley. He currently serves on the board of *Ag***Choice** Farm Credit, ACA.

***E. McDonald Berryman,*** a farmer from Elberon, Virginia, is president of Beechland Farms, Inc., a family-owned and operated farm in Surry County, Virginia. His operations consist of 4,000 acres of row crops including peanuts, corn, wheat, soybeans and cotton, and also 1,000 acres of growing timber. He served as past president of Peanut Farmers LLC and is a member of the Surry County Farm Bureau.

***William C. Bess, Jr.,*** from Lincolnton, North Carolina, is co-owner of Farmers & Builders Supply Co., a retail farm equipment business, and has a 70-head cow-calf operation. He serves on the national Farm Credit Council Board, the Farm Credit System's national trade organization, and is a member of the Cleveland County and Catawba Cattlemen's Associations.

***Dr. Chester D. Black*** of Raleigh, North Carolina, served as the board's outside director. Dr. Black previously served as director of the North Carolina Agriculture Extension Service at North Carolina State University.

***Robert A. Carson,*** a row crop farmer in the Mississippi Delta, is active in a number of agricultural organizations. He is a director of the Delta Council.

***Henry M. (Buddy) Frazee*** of Alachua, Florida, is a retired managing partner of a large cow-calf beef cattle and timber operation, headquartered in Gainesville, Florida. He is presently the Trustee of several land holding and development companies and owns commercial timberland. Along with his son, he manages a 2,000-acre game preserve and deer hound kennel. He currently serves on the board of Farm Credit of North Florida, ACA.

***Don W. Freeman*** manages a 400-acre cow-calf operation in Montgomery, Alabama. He is a member of the national Farm Credit Council Board, Lowndes County Farmers Federation Board, and the Lowndes County Cattlemen's Association Board. He is also past president of the Alabama Chapter of the American Society of Farm Managers and Rural Appraisers.

***Robert L. Holden, Sr.*** is co-owner and operator of a dairy, a 900-acre row-crop farm, and a 200,000 broiler operation in Whigham, Georgia. He is a director of the Southwest Georgia Farm Credit, ACA, Georgia Milk Producers, Grady County Farm Bureau, American Dairy Association of Georgia, and First United Ethanol, LLC.

***Paul M. House*** is from Nokesville, Virginia, where he grows corn, soybeans, wheat, hay and turf grass. He also operates a dairy. He serves as a director of the Farm Credit of the Virginias, ACA.

***Lyle Ray King*** of Ash, North Carolina, owns and operates a 2,500-acre farm where he grows, tobacco, corn, soybeans and wheat. He currently serves on the boards of Cape Fear Farm Credit, ACA, Atlantic Telephone Membership Cooperative, and Landbank Resource Management, a real estate company.

***Richard Kriebel*** is a contract farmer from Benton, Pennsylvania, raising contract vegetables, forage and grain. His cropland consists of owned-and-leased acres of corn, hay and vegetables. He is a director of *Ag***Choice** Farm Credit, ACA, and a former member of the Columbia County ASCS, Columbia County Extension and the Columbia County Planning Commission.

***M. Wayne Lambertson*** of Pokomoke City, Maryland, owns and operates with his two sons a 2,700-acre farm of corn, soybeans, and wheat, and a 300,000 capacity broiler operation. He is co-owner of a restaurant and partner in a development and construction company. He currently serves on the national Farm Credit Council Board, MidAtlantic Farm Credit, ACA board of directors and the board of the Delmarva Poultry Industry DPI, a trade organization.

***Paul Lemoine*** is a cattle and row crop farmer from Plaucheville, Louisiana. He is active in a number of organizations related to farming and is employed as a crop sales consultant with Agriliance Chemical Co. He is a member of the Louisiana Cattlemen's Association and the Avoyelles Parish Farm Bureau.

***F. Merrel Lust*** is from Marion, Ohio, and grows corn, soybeans, and wheat on a 5,900-acre operation in partnership with his twin brother, son and nephew. He currently serves as a member of the board of Ag Credit ACA.

***James L. May*** is owner and operator of Mayhaven Farm in Waynesboro, Kentucky, where he owns 250 acres and leases another 500 acres. He is involved in the development and marketing of 400 recipient heifers for embryo transfer each year. May's operation also includes 150 acres of alfalfa hay, 300 acres of corn and soybeans, and 100 acres of wheat. He currently serves as a member of the boards of Central Kentucky Ag Credit, Lincoln County Extension Council, and the Lincoln County Cattlemen's Association.

***Eugene W. Merritt, Jr.,*** from Easley, South Carolina, is co-owner of an ornamental tree farm and is a landscape contractor. He also operates a 400-acre timber and grass farm. He serves on the board of AgSouth Farm Credit, ACA.

***Katherine A. Pace,*** from Orlando, Florida, is a certified public accountant with 22 years in public accounting. She provides consulting services to family owned businesses through her company Family Business Consulting, LLC. Previously, she was a tax partner with KPMG, LLP, an audit, tax and advisory service firm, from 1985-2005 where her practice included a variety of cooperative and agribusiness clients as well as participation in trade associations such as the National Society of Accountants for Cooperatives. She is a member of the American Institute of Certified Public Accountants and currently serves on the boards of several charitable and for profit organizations. She obtained her B.S. degree in accounting from Furman University.

***Dale W. Player*** is co-owner of a 1,850-acre row crop operation, with cotton being the primary crop. He is a director of Pee Dee Farm Credit, ACA, member of the South Carolina Cotton Board of Directors, and director of the Carolinas Cotton Cooperative.

***J. Dan Raines, Jr.*** is a beef producer from Ashburn, Georgia. His operations include commercial beef cattle, registered Angus cattle and timber. He serves as a director on the boards of *Ag***Georgia** Farm Credit, ACA and the Federal Agricultural Mortgage Corporation (Farmer Mac). He also serves on the board for Raines Commercial Group, Inc., which is primarily engaged in employee leasing.

***Walter L. Schmidlen, Jr.,*** from Elkins, West Virginia, is a dairy and beef farmer. He is owner and operator of a farm machinery business and grows hay and corn on a 700-acre farm. He presently serves on the board of the Farm Credit of the Virginias, ACA, and was a former director of Southern States Cooperative and Sire Power.

***Kenneth A. Spearman,*** from Winter Haven, Florida, currently works for Florida's Natural Growers, Inc. as Director of Internal Audit. Prior to this, he worked as Controller for Citrus Central, Inc. from 1980-1991. He obtained his Masters Degree in Business Administration from Governors State University in University Park, Ill., and his B.S. degree in accounting from Indiana University. He serves as chairman of the board of trustees for the Lake Wales Medical Center. He is a member of the Institute of Internal Auditors, and the National Society of Accountants for Cooperatives, where he was also past National President.

***Robert H. Spiers, Jr.,*** is a full-time farmer, with a tobacco, peanut, soybean and cotton operation on 1,100 acres in Dinwiddie County, Virginia. He currently serves on the boards of Colonial Farm Credit, ACA, and Appomattox River Soil and Water Conservation District. He has been active in several farming organizations, including the Virginia Peanut Growers Association, Farm Service Agency and Virginia Farm Bureau.

**Compensation of Directors**

Directors were compensated in 2005 in cash at the rate of $27,060 per year, the maximum allowed by FCA regulations. This is compensation for attendance at board meetings, certain other meetings pre-approved by the board, and other duties as assigned. FCA regulations also allow additional compensation to be paid to a director in exceptional circumstances where extraordinary time and effort are involved. Amounts paid in excess of $27,060 to board officers and board members represented compensation for service for Farm Credit Council (FCC) activities, including FCC board meetings, meetings with other district and national FCC representatives, congressional visitations, and other FCC board activities and issues. Total cash compensation paid to all directors as a group during 2005 was $605,340. Additional information for each director who served during 2005 is provided below.

| | Number of Days Served | | | |
|---|---|---|---|---|
| Name of Director | Board Meetings | Farm Credit Council Bd. Activities | Other Official Activities** | Total Comp. Paid During 2005 |
| E. McDonald Berryman | 20 | 9.0 | 16.75 | $ 31,860 |
| William C. Bess, Jr. | 23 | 9.0 | 12.75 | 31,860 |
| Dr. Chester D. Black | 20 | 9.0 | 13.25 | 31,860 |
| Robert A. Carson | 23 | 9.0 | 15.75 | 31,860 |
| Henry M. Frazee | 23 | 9.0 | 18.25 | 31,860 |
| Don W. Freeman | 23 | 9.0 | 12.25 | 31,860 |
| Robert L. Holden, Sr. | 23 | 9.0 | 13.75 | 31,860 |
| Paul M. House | 23 | 9.0 | 11.75 | 31,860 |
| Thomas W. Kelly | 23 | 10.0 | 16.75 | 31,860 |
| Lyle Ray King | 23 | 9.0 | 13.50 | 31,860 |
| Richard Kriebel | 22 | 5.0 | 15.00 | 31,860 |
| M. Wayne Lambertson | 23 | 9.0 | 16.50 | 31,860 |
| Paul Lemoine | 23 | 9.0 | 10.50 | 31,860 |
| F. Merrel Lust | 20 | 9.0 | 13.50 | 31,860 |
| Eugene W. Merritt, Jr. | 23 | 9.0 | 12.00 | 31,860 |
| Dale W. Player | 23 | 9.0 | 16.00 | 31,860 |
| J. Dan Raines, Jr. | 23 | 9.0 | 17.75 | 31,860 |
| Walter L. Schmidlen, Jr. | 23 | 9.0 | 15.25 | 31,860 |
| Robert G. Sexton | 23 | 9.0 | 16.25 | 31,860 |
| Total | | | | $ 605,340 |

*** Includes board committee meetings and board training.*

Directors are reimbursed on an actual cost basis for all expenses incurred in the performance of official duties. Such expenses may include transportation, lodging, meals, tips, tolls, parking of cars, laundry, registration fees, and other expenses associated with travel on official business. A copy of the policy is available to shareholders upon request.

The aggregate amount of reimbursement for travel, subsistence and other related expenses for all directors as a group was $202,283 for 2005, $183,164 for 2004, and $181,020 for 2003.

**Transactions with Senior Officers and Directors**

The reporting entity's policies on loans to and transactions with its officers and directors, to be disclosed in this section are incorporated herein by reference to Note 13 to the consolidated financial statements, *Related Party Transactions,* included in this annual report to shareholders.

**Involvement in Certain Legal Proceedings**

There were no matters which came to the attention of management or the board of directors regarding involvement of current directors or senior officers in specified legal proceedings which should be disclosed in this section.

**Relationship with Independent Auditors**

There were no material disagreements with our independent auditors on any matter of accounting principles or financial statement disclosure during this period.

**Consolidated Financial Statements**

The consolidated financial statements, together with the report thereon of PricewaterhouseCoopers LLP, dated March 1, 2006, and the Report of Management, which appear in this annual report to shareholders are incorporated herein by reference.

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 Jay Wise, AgFirst Farm Credit Bank, P.O. Box 1499, Columbia, SC 29202. Information concerning AgFirst Farm Credit Bank can also be obtained at their website, www.agfirst.com. AgFirst prepares a quarterly report within 45 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.

# Report of the Audit Committee

The Audit Committee of the Board of Directors (the Committee) is comprised of the directors named below. None of the directors who serve on the Audit Committee is an employee of AgFirst Farm Credit Bank (the Bank) and in the opinion of the Board of Directors, each is free of any relationship with the Bank or management that would interfere with the director's independent judgment on the Committee.

The Committee has adopted a written charter that has been approved by the Board of Directors. The Committee has reviewed and discussed the Bank's audited financial statements with management, which has primary responsibility for the financial statements.

PricewaterhouseCoopers LLP (PwC), the Bank's independent auditor for 2005, is responsible for expressing an opinion on the conformity of the Bank's audited financial statements with generally accepted accounting principles. The Committee has discussed with PwC the matters that are required to be discussed by Statement on Auditing Standards No. 61 *(Communication With Audit Committees)*. PwC has provided to the Committee the written disclosures and the letter required by Independence Standards Board Standard No. 1 *(Independence Discussions with Audit Committees),* and the Committee has discussed with PwC that firm's independence.

The Committee has also concluded that PwC's provision of non-audit services to the Bank is compatible with PwC's independence.

Based on the considerations referred to above, the Committee recommended to the Board of Directors that the audited financial statements be included in the Company's Annual Report for 2005. The foregoing report is provided by the following independent directors, who constitute the Audit Committee:

Paul House

Paul M. House
Chairman of the Audit Committee

**Members of Audit Committee**

Robert A. Carson

Richard Kriebel

Paul Lemoine

Katherine A. Pace

Walter L. Schmidlen, Jr.

March 1, 2006

PRICEWATERHOUSECOOPERS

**PricewaterhouseCoopers LLP**
10 Tenth Street, Suite 1400
Atlanta, GA 30309
Telephone (678) 419 1000

# Report of Independent Auditors

To the Board of Directors and Shareholders
of AgFirst Farm Credit Bank

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of income, of changes in shareholders' equity and of cash flows present fairly, in all material respects, the financial position of AgFirst Farm Credit Bank (the Bank) and its subsidiary at December 31, 2005, 2004 and 2003, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2005 in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Bank's management. Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As discussed in Note 2, the Bank changed its method of accounting for its mandatorily redeemable preferred stock effective July 1, 2003.

PricewaterhouseCoopers LLP

March 1, 2006

# Consolidated Balance Sheets

| (dollars in thousands) | December 31, 2005 | December 31, 2004 | December 31, 2003 |
|---|---|---|---|
| **Assets** | | | |
| Cash and cash equivalents | $ 557,882 | $ 470,258 | $ 469,945 |
| Investment securities: | | | |
| Available for sale (amortized cost of $3,888,889, $3,268,041 and $2,824,203 respectively) | 3,886,318 | 3,278,414 | 2,832,716 |
| Held to maturity (fair value of $1,337,860) | 1,369,427 | — | — |
| Total Investment securities | 5,255,745 | 3,278,414 | 2,832,716 |
| Loans | 14,411,050 | 12,908,249 | 12,375,351 |
| Less: allowance for loan losses | 10,114 | 14,800 | 34,168 |
| Net loans | 14,400,936 | 12,893,449 | 12,341,183 |
| Accrued interest receivable | 75,410 | 50,630 | 44,978 |
| Investments in other Farm Credit System institutions | 67,139 | 66,646 | 78,672 |
| Premises and equipment, net | 25,851 | 27,920 | 24,995 |
| Due from associations | 28,808 | 30,385 | 39,839 |
| Other assets | 71,260 | 69,821 | 47,220 |
| Total assets | $ 20,483,031 | $ 16,887,523 | $ 15,879,548 |
| **Liabilities** | | | |
| Bonds and notes | $ 18,879,964 | $ 15,402,385 | $ 14,507,105 |
| Mandatorily redeemable preferred stock (Note 9) | 225,000 | 225,000 | 225,000 |
| Accrued interest and dividends payable | 133,855 | 65,854 | 52,024 |
| Patronage distribution payable | 132,226 | 126,689 | 92,129 |
| Postretirement benefits other than pensions | 14,999 | 13,943 | 11,688 |
| Minimum pension liability | — | — | 8,751 |
| Other liabilities | 59,559 | 29,356 | 28,319 |
| Total liabilities | 19,445,603 | 15,863,227 | 14,925,016 |
| Commitments and contingencies (Note 15) | | | |
| **Shareholders' Equity** | | | |
| Perpetual preferred stock (Note 10) | 150,000 | 150,000 | 150,000 |
| Capital stock and participation certificates | 224,554 | 226,200 | 229,083 |
| Retained earnings | 665,445 | 644,366 | 601,699 |
| Accumulated other comprehensive income (loss) | (2,571) | 3,730 | (26,250) |
| Total shareholders' equity | 1,037,428 | 1,024,296 | 954,532 |
| Total liabilities and shareholders' equity | $ 20,483,031 | $ 16,887,523 | $ 15,879,548 |

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

# Consolidated Statements of Income

| (dollars in thousands) | For the year ended December 31, 2005 | 2004 | 2003 |
|---|---|---|---|
| **Interest Income** | | | |
| Investment securities and other | $ 167,728 | $ 74,565 | $ 59,401 |
| Loans | 624,945 | 469,774 | 469,148 |
| Total interest income | 792,673 | 544,339 | 528,549 |
| **Interest Expense** | 588,472 | 332,744 | 284,492 |
| Net interest income | 204,201 | 211,595 | 244,057 |
| Provision for (reversal of) loan losses | (4,995) | (15,292) | 2,500 |
| Net interest income after provision for loan losses | 209,196 | 226,887 | 241,557 |
| **Noninterest Income** | | | |
| Loan fees | 11,441 | 11,751 | 14,140 |
| Realized gains (losses) on investments, net | 466 | (17) | 247 |
| Correspondent lending operations income (loss) | 1,584 | (927) | (6,729) |
| Other noninterest income | 3,258 | 7,214 | 1,855 |
| Total noninterest income | 16,749 | 18,021 | 9,513 |
| **Noninterest Expenses** | | | |
| Salaries and employee benefits | 27,957 | 26,172 | 23,367 |
| Occupancy and equipment | 11,108 | 9,823 | 8,552 |
| Insurance fund premium | 884 | 845 | 2,014 |
| Other operating expenses | 15,882 | 15,448 | 13,088 |
| Intra-System financial assistance expenses | 3,221 | 6,794 | 13,308 |
| Called debt expense | 656 | 3,360 | 11,736 |
| Other noninterest expenses | 1,978 | 2,160 | 1,556 |
| Total noninterest expenses | 61,686 | 64,602 | 73,621 |
| Net income | $ 164,259 | $ 180,306 | $ 177,449 |

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

## Consolidated Statements of Changes in Shareholders' Equity

| (dollars in thousands) | Perpetual Preferred Stock | Capital Stock and Participation Certificates | Retained Earnings | Accumulated Other Comprehensive Income | Total Shareholders' Equity |
|---|---|---|---|---|---|
| Balance at December 31, 2002 | $ — | $ 249,444 | $ 527,673 | $ (20,272) | $ 756,845 |
| Comprehensive income | | | | | |
| Net income | | | 177,449 | | 177,449 |
| Unrealized gains (losses) on investments available for sale, net of reclassification adjustments of $247 | | | | (9,480) | (9,480) |
| Change in fair value of derivative instruments, includes reclassification adjustments of $45 | | | | 2,116 | 2,116 |
| Minimum pension liability adjustment | | | | 1,386 | 1,386 |
| Total comprehensive income | | | | | 171,471 |
| Perpetual preferred stock issued | 150,000 | | | | 150,000 |
| Capital stock/participation certificates issued/retired, net | | (20,361) | | | (20,361) |
| Perpetual preferred stock dividends paid | | | (1,851) | | (1,851) |
| Mandatorily redeemable preferred stock dividends accrued | | | (9,443) | | (9,443) |
| Cash distributions declared | | | (92,129) | | (92,129) |
| Balance at December 31, 2003 | 150,000 | 229,083 | 601,699 | (26,250) | 954,532 |
| Comprehensive income | | | | | |
| Net income | | | 180,306 | | 180,306 |
| Unrealized gains (losses) on investments available for sale, net of reclassification adjustments of ($17) | | | | 1,859 | 1,859 |
| Change in fair value of derivative instruments, includes reclassification adjustments of $96 | | | | 12,120 | 12,120 |
| Minimum pension liability adjustment | | | | 16,001 | 16,001 |
| Total comprehensive income | | | | | 210,286 |
| Capital stock/participation certificates issued/retired, net | | (2,883) | | | (2,883) |
| Perpetual preferred stock dividends paid | | | (10,950) | | (10,950) |
| Cash distributions declared | | | (126,689) | | (126,689) |
| Balance at December 31, 2004 | 150,000 | 226,200 | 644,366 | 3,730 | 1,024,296 |
| Comprehensive income | | | | | |
| Net income | | | 164,259 | | 164,259 |
| Unrealized gains (losses) on investments available for sale, net of reclassification adjustments of $466 | | | | (12,944) | (12,944) |
| Change in fair value of derivative instruments, includes reclassification adjustments of $94 | | | | 6,643 | 6,643 |
| Total comprehensive income | | | | | 157,958 |
| Capital stock/participation certificates issued/retired, net | | (1,646) | | | (1,646) |
| Perpetual preferred stock dividends paid | | | (10,950) | | (10,950) |
| Cash distributions declared | | | (132,230) | | (132,230) |
| Balance at December 31, 2005 | $ 150,000 | $ 224,554 | $ 665,445 | $ (2,571) | $ 1,037,428 |

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

## Consolidated Statements of Cash Flows

| (dollars in thousands) | For the year ended December 31, 2005 | 2004 | 2003 |
|---|---|---|---|
| **Cash flows from operating activities:** | | | |
| Net income | $ 164,259 | $ 180,306 | $ 177,449 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | | |
| Depreciation on premises and equipment | 6,491 | 6,016 | 4,955 |
| Provision for (reversal of) loan losses | (4,995) | (15,292) | 2,500 |
| Realized (gains) losses on investments, net | (466) | 17 | (247) |
| Realized (gains) losses on derivatives, net | (94) | (96) | (45) |
| Realized (gains) losses on mortgage loans held for sale | 32 | 2,445 | 1,859 |
| Proceeds from sale of mortgage loans held for sale | 6,664 | 255,951 | 754,486 |
| Purchases of mortgage loans held for sale (net of principal repayment) | (264,032) | (329,939) | (667,196) |
| Realized (gains) losses on sales of servicing assets | (1,078) | — | — |
| Proceeds from sale of mortgage servicing assets | 10,039 | — | — |
| Changes in operating assets and liabilities: | | | |
| (Increase) decrease in accrued interest receivable | (24,780) | (5,652) | 5,492 |
| (Increase) decrease in due from associations | 1,577 | 9,454 | (15,327) |
| (Increase) decrease in other assets | (10,541) | (8,958) | (7,808) |
| Increase (decrease) in accrued interest and dividend payable | 68,001 | 13,830 | 8,292 |
| Increase (decrease) in postretirement benefits other than pensions | 1,056 | 2,255 | 1,176 |
| Increase (decrease) in minimum pension liability | — | (8,751) | (1,698) |
| Increase (decrease) in other liabilities | 2,396 | (7,053) | (95) |
| Total adjustments | (209,730) | (85,773) | 86,344 |
| Net cash provided by (used in) operating activities | (45,471) | 94,533 | 263,793 |
| **Cash flows from investing activities:** | | | |
| Investment securities purchased | (4,118,358) | (4,091,449) | (4,826,206) |
| Investment securities sold or matured | 2,128,549 | 3,647,593 | 4,137,375 |
| Net (increase) decrease in loans | (1,244,133) | (465,088) | (454,746) |
| (Increase) decrease in investments in other Farm Credit System institutions | (493) | 12,026 | (421) |
| Purchase of premises and equipment, net | (4,422) | (8,941) | (11,228) |
| Net cash used in investing activities | (3,238,857) | (905,859) | (1,155,226) |
| **Cash flows from financing activities:** | | | |
| Bonds and notes issued | 38,071,784 | 41,613,349 | 57,612,100 |
| Bonds and notes retired | (34,560,543) | (40,695,748) | (56,641,370) |
| Perpetual preferred stock issued | — | — | 150,000 |
| Capital stock and participation certificates issued/retired, net | (1,646) | (2,883) | (20,361) |
| Cash distributions to shareholders | (126,693) | (92,129) | (86,677) |
| Dividends paid on perpetual preferred stock | (10,950) | (10,950) | (1,851) |
| Dividends paid on mandatorily redeemable preferred stock | — | — | (10,282) |
| Net cash provided by financing activities | 3,371,952 | 811,639 | 1,001,559 |
| Net increase (decrease) in cash and cash equivalents | 87,624 | 313 | 110,126 |
| Cash and cash equivalents, beginning of period | 470,258 | 469,945 | 359,819 |
| Cash and cash equivalents, end of period | $ 557,882 | $ 470,258 | $ 469,945 |
| **Supplemental schedule of non-cash investing and financing activities:** | | | |
| Change in unrealized gains (losses) on investments | $ (12,944) | $ 1,859 | $ (9,480) |
| Change in fair value of derivative instruments | 6,643 | 12,120 | 2,116 |
| Change in pension liability related to other comprehensive income | — | 16,001 | 1,386 |
| **Non-cash changes related to hedging activities:** | | | |
| Decrease (increase) in loans | $ 55 | $ (344) | $ (1,894) |
| Increase (decrease) in bonds and notes | (33,662) | (22,225) | 1,082 |
| Decrease (increase) in other assets | (937) | 2,359 | (1,564) |
| Increase (decrease) in other liabilities | 27,807 | 8,090 | (3,107) |
| **Supplemental information:** | | | |
| Interest paid | $ 520,471 | $ 318,914 | $ 276,200 |

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

# Notes to the Consolidated Financial Statements

**Note 1 — Organization and Operations**

A. **Organization:** AgFirst Farm Credit Bank (the Bank or AgFirst) is one of the banks of the Farm Credit System (the System), a nationwide system of cooperatively owned banks (the banks) and associations. Banks and associations are collectively referred to as a district (district). The System was established by Acts of Congress and is subject to the provisions of the Farm Credit Act of 1971, as amended (the Farm Credit Act).

The nation is currently served by four Farm Credit Banks (FCBs) and one Agricultural Credit Bank (ACB), each of which has specific lending authorities within its chartered territory. The ACB also has additional specific nationwide lending authorities. The Bank is chartered to service the states of Pennsylvania, Delaware, Maryland, Virginia, West Virginia, North Carolina, South Carolina, Georgia, Florida, Alabama, Mississippi, the Commonwealth of Puerto Rico and portions of the states of Ohio, Tennessee, Kentucky and Louisiana.

Each FCB and the ACB serves one or more Production Credit Associations (PCAs) that originate and service short- and intermediate-term loans, Federal Land Credit Associations (FLCAs) that originate and service long-term real estate mortgage loans and/or Agricultural Credit Associations (ACAs) that originate both long-term and short- and intermediate-term loans. PCAs, FLCAs and ACAs are collectively referred to as associations. AgFirst and its related associations (Associations or District Associations) are collectively referred to as the District. The District Associations jointly own all of AgFirst's voting stock. As of December 31, 2005, the District consisted of the Bank and twenty-three District ACAs. All twenty-three are structured as holding companies, which include FLCA and PCA subsidiaries.

Each FCB and the ACB is responsible for supervising the activities of the Associations within its district. The FCBs and/or Associations make loans to or for the benefit of eligible borrowers/shareholders for qualified purposes. Funds for the FCBs and the ACB are raised principally through the sale of consolidated Systemwide bonds and notes to the public.

The Farm Credit Administration (FCA) is delegated authority by Congress to regulate the System banks and associations. The activities of the banks and associations are examined by the FCA and certain actions by these entities are subject to the FCA's prior approval.

The Farm Credit Act established the Farm Credit System Insurance Corporation (Insurance Corporation) to administer the Farm Credit Insurance Fund (Insurance Fund). The Insurance Fund is required to be used (1) to ensure the timely payment of principal and interest on Systemwide debt obligations (insured debt), (2) to ensure the retirement of protected borrower capital at par or stated value, and (3) for other specified purposes. The Insurance Fund is also available for the discretionary uses by the Insurance Corporation of providing assistance to certain troubled System institutions and to cover the operating expenses of the Insurance Corporation. Each System bank is required to pay premiums into the Insurance Fund based on its annual average District loans outstanding until the assets in the Insurance Fund reach the "secure base amount," which is defined in the Farm Credit Act as 2.00 percent of the aggregate insured obligations (Systemwide debt obligations) or such other percentage of the aggregate obligations as the Insurance Corporation in its sole discretion determines to be actuarially sound. When the amount in the Insurance Fund exceeds the secure base amount, the Insurance Corporation is required to reduce premiums, but it still must ensure that reduced premiums are sufficient to maintain the level of the Insurance Fund at the secure base amount.

B. **Operations:** The Farm Credit Act sets forth the types of authorized lending activity, persons eligible to borrow and financial services which can be offered by the Bank.

The Bank primarily lends to the District Associations in the form of a line of credit to fund the Associations' loan portfolios. These lines of credit are collateralized by a pledge of substantially all of each Association's assets. The terms of the revolving lines of credit are governed by a general financing agreement between the Bank and each Association. Each advance is structured such that the principal cash flow, repricing characteristics, and underlying index (if any) of the advance match those of the assets being funded. By match-funding the Association loans, the Associations' exposure to interest rate risk is minimized. Advances are also made to fund general operating expenses of the Associations.

The Associations borrow from the Bank and in turn may originate and service both long-term real estate mortgage and short- and intermediate-term loans to their members.

In addition to providing loan funds to District Associations, the Bank provides to the District Associations banking and support services such as accounting, human resources, information systems, and marketing. The costs of these support services are included in the interest charges to the Associations.

The Bank is also authorized to provide, in participation with other lenders and the secondary market, credit, credit commitments and related services to eligible borrowers. Eligible borrowers include farmers, ranchers, producers or harvesters of aquatic products, rural residents and farm-related businesses. The Bank may also lend to other financial institutions qualified to engage in lending to eligible borrowers.

The Bank owns the Farm Credit Finance Corporation of Puerto Rico (the Finance Corporation). The Finance Corporation borrowed funds from the Bank and eligible funds from qualified companies doing business in Puerto Rico under Section 2(j) of the Puerto Rico Tax Incentive Act of 1987, as amended, or the Puerto Rico Tax Incentive Act of 1998, including corporations that had elections under Section 936 and 30(A) of the Internal Revenue Code of 1986, as amended (Code). The funds so borrowed were primarily used to acquire from AgFirst the note receivable from Puerto Rico Farm Credit, ACA, and to acquire eligible loans originated by other System institutions. Savings in interest costs were, in part, passed along to borrowers in Puerto Rico who met certain eligibility requirements.

The operations of the Finance Corporation were suspended effective December 31, 2005. The Board of Directors of the Finance Corporation determined there was insufficient financial benefit resulting from island-based tax treatment of the corporation to justify continuing the operations of the corporation at this time. All outstanding capital of the Finance Corporation was transferred to AgFirst on December 31, 2005. This will not have a material effect on the financial condition of AgFirst.

The Bank, in conjunction with other System banks, jointly owns service organizations, which were created to provide a variety of services for the System:

- *Federal Farm Credit Banks Funding Corporation (Funding Corporation)* — provides for the issuance, marketing and processing of Systemwide Debt Securities using a network of investment dealers and dealer banks. The Funding Corporation also provides financial management and reporting services.
- *FCS Building Association* — leases premises and equipment to the FCA.
- *Farm Credit System Association Captive Insurance Company* — being a reciprocal insurer, provides insurance services to its member organizations.

These investments are accounted for using the cost method. In addition, the *Farm Credit Council* acts as a full-service federated trade association, which represents the System before Congress, the Executive Branch and others, and provides support services to System institutions on a fee basis.

**Note 2 — Summary of Significant Accounting Policies**

The accounting and reporting policies of the Bank conform to accounting principles generally accepted in the United States of America (GAAP) and prevailing practices within the banking industry. The preparation of consolidated financial statements in conformity with GAAP requires the management of the Bank to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. Significant estimates are discussed in these footnotes, as applicable. Actual results can differ from these estimates. Certain amounts in prior years' financial statements have been reclassified to conform to the current year's presentation.

The accompanying consolidated financial statements include the accounts of the Bank (including the Finance Corporation), and reflect the investments in and allocated earnings of the service organizations in which the Bank has partial ownership interests. All significant transactions and balances between the Bank and the Finance Corporation have been eliminated.

A. **Cash and Cash Equivalents:** Cash and Cash Equivalents include cash on hand and short-term investments with original maturities of three months or less.

B. **Investment Securities**: The Bank, as permitted under the FCA regulations, holds investments for purposes of maintaining a liquidity reserve, managing short-term surplus funds, managing interest rate risk and, in the case of certain Mission-Related Investments, to stimulate economic growth and development in rural areas. Investments are classified based on management's intention on the date of purchase and recorded on the Consolidated Balance Sheet as securities as of the trade date. Investment securities which management has the intent and ability to hold to maturity are classified as held-to-maturity and reported at amortized cost. Investment securities classified as available-for sale (AFS) are carried at fair market value with net unrealized gains and losses included in Accumulated Other Comprehensive Income (OCI).

   Interest on investment securities, including amortization of premiums and accretion of discounts, are included in Interest Income. Realized gains and losses from the sales of investment securities, which are included in Realized Gains/ (Losses) on Investments, Net, are determined using the specific identification method.

   The Bank reviews all investments that are in a loss position in order to determine whether the unrealized loss, which is considered an impairment, is temporary or other than temporary. In the event of other-than-temporary impairment, the cost basis of the investment would be written down to its fair value, and the unrealized loss would be included in current earnings.

C. **Loans and Allowance for Loan Losses:** Long-term real estate mortgage loans generally have maturities ranging up to 30 years. Substantially all short- and intermediate-term loans for agricultural production or operating purposes have maturities of 10 years or less.

   Loans are carried at their principal amount outstanding less unearned income adjusted for Statement of Financial Accounting Standards (SFAS) No. 133 valuation adjustments. Interest on loans is accrued and credited to interest income based upon the daily principal amount outstanding. Loans are generally placed in nonaccrual status when principal or interest is delinquent for 90 days or more (unless adequately secured and in the process of collection) or circumstances indicate that collection of principal and/or interest is in doubt. When a loan is placed in nonaccrual status, accrued interest deemed uncollectible is reversed (if accrued in the current year) and/or charged against the allowance for loan losses (if accrued in prior years).

   When loans are in nonaccrual status, the interest portion of payments received in cash is generally recognized as interest income if collection of the recorded investment in the loan is fully expected and the loan does not have a remaining unrecovered prior charge-off associated with it. Otherwise, loan payments are applied against the recorded investment in the loan asset. Nonaccrual loans may be transferred to accrual status when principal and interest are current, prior charge-offs have been recovered, the ability of the borrower to fulfill the contractual repayment terms is fully expected and the loan is not classified "doubtful" or "loss."

   Loans are charged-off, wholly or partially, as appropriate, at the time they are determined to be uncollectible.

   The allowance for loan losses is maintained at a level considered adequate by management to provide for probable losses inherent in the loan portfolio. The allowance is based on a periodic evaluation of the loan portfolio by management in which numerous factors are considered, including economic conditions, loan portfolio composition and prior loan loss experience. It is based on estimates, appraisals and evaluations of loans which, by their nature, contain elements of uncertainty and imprecision. The possibility exists that changes in the economy and its impact on borrower repayment capacity will cause these estimates, appraisals and evaluations to change.

   The allowance for loan losses is a valuation account used to reasonably estimate loan and lease losses as of the financial statement date. Determining the appropriate allowance for the loan losses balance involves significant judgment about when a loss has been incurred and the amount of that loss. The determination of the allowance for loan losses is based on management's current judgments about the credit quality of its loan and lease portfolio. A specific allowance may be established for impaired loans under SFAS No. 114. 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, as practically expedient, at the loan's observable market price or fair value of the collateral if the loan is collateral dependent. See Note 3 for a discussion on the refinement of the allowance for loan losses methodology.

   The level of allowance for loan losses is generally based on recent charge-off experience adjusted for relevant environmental factors. The Bank considers the following factors when adjusting the historical charge-offs experience:

   - Credit risk classifications,
   - Collateral values,
   - Risk concentrations,
   - Weather related conditions, and
   - Economic conditions.

D. **Premises and Equipment:** Premises and equipment are carried at cost less accumulated depreciation. Land is carried at cost. Depreciation is provided on the straight-line method over the estimated useful lives of the asset, which range from 3 to 40 years. Gains and losses on dispositions are reflected in current operations. Maintenance and repairs are charged to operating expense and improvements are capitalized.

E. **Other Assets and Liabilities:** Direct expenses incurred in issuing debt and preferred stock are deferred and amortized using the straight-line method (which approximates the interest method) over the term of the related indebtedness and term of the preferred stock.

F. **Employee Benefit Plans:** Bank employees may be eligible to participate in a districtwide defined benefit retirement plan (the Plan) within the District. The "Projected Unit Credit" actuarial method is used for financial reporting purposes. Based on the funded status at the Plan's measurement date (September 30) of the underlying Plan, the Bank may record a minimum liability, an intangible asset relating to unrecognized prior service cost and an adjustment to other comprehensive income (loss). For participants hired before January 1, 2003, benefits are determined based on a final average pay formula. For those participants hired on or after January 1, 2003, benefits are determined using a cash balance formula. Pension costs are allocated by multiplying the District's net pension expense times each institution's salary expense as a percentage of the District's salary expense.

   Bank employees are eligible to participate in the thrift/deferred compensation plan (Thrift Plan), which qualifies as a 401(k) plan as defined by the Internal Revenue Code. For employees hired on or prior to December 31, 2002, the Bank contributes $0.50 for each $1.00 of the employee's first 6.00 percent of contribution up to the maximum employer contribution of 3.00 percent of total compensation. For employees hired after January 1, 2003, the Bank contributes $1.00 for each $1.00 of the employee's first 6.00 percent of contribution up to the maximum employer contribution of 6.00 percent of total compensation. Employee deferrals are not to exceed the maximum deferral as determined and adjusted by the Internal Revenue Service. Generally, Thrift Plan costs are expensed as funded.

   In addition to providing pension benefits, the Bank provides certain health care and life insurance benefits for retired employees (other postretirement benefits). Substantially all of the Bank's employees are eligible for those benefits when they reach early retirement age while working for the Bank. Early retirement age is defined as a minimum of age 55 and 10 years of service. Employees hired after December 31, 2002 are required to pay the full cost of their retiree health insurance coverage.

   The Bank also sponsors supplemental retirement and deferred compensation plans for certain key employees. The plans are nonqualified: therefore, the associated liabilities are included in the Bank's consolidated balance sheets in other liabilities.

G. **Income Taxes:** The Bank is exempt from Federal and other income taxes as provided in the Farm Credit Act.

H. **Derivative Instruments and Hedging Activity:** The Bank is party to derivative financial instruments, primarily interest rate swaps and caps, which are principally used to manage interest rate risk on assets, liabilities and anticipated transactions. Derivatives are included in the consolidated balance sheet as assets and liabilities and reflected at fair value.

Changes in the fair value of a derivative are recorded in current period earnings or accumulated other comprehensive income (loss) depending on the use of the derivative and whether it qualifies for hedge accounting. For fair-value hedge transactions which hedge changes in the fair value of assets, liabilities, or firm commitments, changes in the fair value of the derivative will generally be offset by changes in the hedged item's fair value. For cash-flow hedge transactions, which hedge the variability of future cash flows related to a variable-rate asset, liability, or a forecasted transaction, changes in the fair value of the derivative will generally be deferred and reported in accumulated other comprehensive income (loss). The gains and losses on the derivative that are deferred and reported in accumulated other comprehensive income (loss) will be reclassified into earnings in the periods in which earnings are impacted by the variability of the cash flows of the hedged item. The ineffective portion of all hedges is recorded in current period earnings. For derivatives not designated as a hedging instrument, the related change in fair value is recorded in current period earnings.

The Bank formally documents all relationships between hedging instruments and hedged items, as well as its risk management objective and strategy for undertaking various hedge transactions. This process includes linking all derivatives that are designated as fair value or cash flow hedges to (1) specific assets or liabilities on the balance sheet or (2) firm commitments or forecasted transactions. The Bank also formally assesses (both at the hedge's inception and on an ongoing basis) whether the derivatives that are used in hedging transactions have been highly effective in offsetting changes in the fair value or cash flows of hedged items and whether those derivatives may be expected to remain highly effective in future periods. The Bank uses regression analysis (or other statistical analysis) to assess the effectiveness of its hedges. The Bank discontinues hedge accounting prospectively when the Bank determines that a hedge has not been or is not expected to be effective as a hedge. For cash flow hedges, any remaining accumulated other comprehensive income (loss) would be amortized into earnings over the remaining life of the original hedged item. For fair value hedges, changes in the fair value of the derivative will be recorded in current period earnings. In all situations in which hedge accounting is discontinued and the derivative remains outstanding, the Bank will carry the derivative at its fair value on the balance sheet, recognizing changes in fair value in current period earnings.

The Bank may occasionally purchase a financial instrument in which a derivative instrument is "embedded." Upon purchasing the financial instrument, the Bank assesses whether the economic characteristics of the embedded derivative are clearly and closely related to the economic characteristics of the remaining component of the financial instrument and whether a separate, non-embedded instrument with the same terms as the embedded instrument would meet the definition of a derivative instrument. When it is determined that (1) the embedded derivative possesses economic characteristics that are not clearly and closely related to the economic characteristics of the host contract and (2) a separate, stand-alone instrument with the same terms would qualify as a derivative instrument, the embedded derivative is separated from the host contract, carried at fair value and designated as either a fair value or cash flow hedge. However, if the entire contract were to be measured at fair value, with changes in fair value reported in current earnings, or if the Bank could not reliably identify and measure the embedded derivative for purposes of separating that derivative from its host contract, the entire contract would be carried on the balance sheet at fair value and not be designated as a hedging instrument.

I. **Valuation Methodologies:** Management of the Bank applies various methodologies to assets and liabilities that often involve a significant degree of judgment, particularly when liquid markets do not exist for the particular items being valued. Quoted market prices are referred to when estimating fair values for certain assets, such as most investment securities. However, for those items for which an observable liquid market does not exist, management utilizes significant estimates and assumptions to value those items. Examples of these items include impaired loans, pension and other postretirement benefit obligations, and certain derivative and other financial instruments. These valuations require the use of various assumptions, including, among others, discount rates, rates of return on assets, repayment rates, cash flows, default rates, costs of servicing and liquidation values. The use of different assumptions could produce significantly different results, which could have material positive or negative effects on the Bank's results of operations.

J. **Recent Accounting Developments:** In May 2003, the Financial Accounting Standards Board (FASB) issued SFAS No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*. SFAS No. 150 establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity. SFAS No. 150 applies specifically to a number of financial instruments that companies have historically presented within their financial statements either as equity or between the liabilities section and the equity section, rather than as liabilities. On November 7, 2003, the FASB issued FASB Staff Position (FSP) 150-3, *Effective Date and Transition for Mandatorily Redeemable Financial Instruments of Certain Nonpublic Entities*. FSP 150-3 defers the effective date of certain provisions of SFAS No. 150, specifically the provisions that apply to mandatorily redeemable noncontrolling interests. This deferral is expected to remain in effect indefinitely until the accounting for these interests is addressed in later guidance. The remaining provisions of SFAS No. 150 were effective for financial instruments entered into or modified after May 31, 2003, and otherwise were effective and adopted by the Bank on July 1, 2003. As a result of adoption, effective July 1, 2003, the Bank's mandatorily redeemable preferred stock of $225.0 million was reclassified to liabilities and the related dividends paid on that stock are treated as interest expense beginning July 1, 2003 rather than as a direct reduction of unallocated surplus. See Note 9 for further discussion.

In November 2005, the Financial Accounting Standards Board released, FSP Nos. FAS 115-1 and FAS 124-1, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments*. This FASB Staff Position (FSP) addresses the determination as to when an investment is considered impaired, whether that impairment is other than temporary, and the measurement of an impairment loss. This FSP also includes accounting considerations subsequent to the recognition of an other-than-temporary impairment and requires certain disclosures about unrealized losses that have not been recognized as other-than-temporary impairments. The guidance in this FSP amends FASB Statements No. 115, *Accounting for Certain Investments in Debt and Equity Securities* and nullifies certain guidance in Emerging Issues Task Force (EITF) Issue 03-1, *The Meaning of Other-Than-Temporary Impairment and its Application to Certain Investments*. The guidance in this FSP shall be applied to reporting periods beginning after December 15, 2005.

**Note 3 — Refinement of the Allowance for Loan Losses Methodology**

During 2004, the Bank completed a study to further refine their allowance for loan losses methodology taking into account recently issued guidance by the FCA, the System's regulator, as well as the Securities and Exchange Commission (SEC) and Federal Financial Institutions Examination Council guidelines.

The Bank's allowance for loan losses methodology was adjusted and revised in the late 1980s to take into account unusually adverse economic factors affecting American agriculture. Subsequent estimates continued to reflect, to some extent, the loss history of the mid-to-late 1980s. Accordingly, the reserves provided in the mid-to-late 1980s, in effect, remained part of the allowance for loan losses.

The Bank's allowance for loan losses methodology has consistently adhered to proper accounting policies, under the regulatory supervision of the FCA in its role as a "safety and soundness" regulator. It was the FCA's view that the allowance for loan losses should include among others, an assessment of probable losses, economic conditions and historical loss experience keeping in mind the potentially long agricultural credit cycle.

In April 2004, the FCA issued an "Informational Memorandum" to System institutions regarding the criteria and methodologies that would be used in evaluating the adequacy of a System institution's allowance for loan losses. The FCA endorsed the direction provided by other bank regulators and the SEC and indicated the conceptual framework addressed in their guidance would be included as part of their examination process.

During the fourth quarter of 2004, the Bank completed a study and refined their methodology to be in compliance with the guidance discussed in the previous paragraph. The refinement in methodology resulted in a calculated allowance for loan losses that was significantly less than the previously recorded balance due to revised loss factors that are more indicative of actual loss experience in recent years and current borrower analysis.

While the $15.3 million reversal had a significant impact on 2004 results of operations and the previously recorded allowance for loan losses, the refinement in methodology is not expected to have a significant impact on comparative results of operations in future periods.

**Note 4 — Investment Securities**

**Available-for-Sale**

A summary of the amortized cost and fair value of debt securities held as available-for-sale investments at December 31, 2005, 2004 and 2003, follows:

| | December 31, 2005 | | | | |
|---|---|---|---|---|---|
| *(dollars in thousands)* | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value | Yield |
| Commercial Paper | $ 69,813 | $ – | $ (17) | $ 69,796 | 4.37% |
| U.S. Govt. GNMA MBS/CMOs | 1,060,168 | 1,779 | (5,664) | 1,056,283 | 4.39 |
| U.S. Govt. Agency MBS | 2,029,368 | 5,714 | (5,121) | 2,029,961 | 4.50 |
| Non-Agency whole loans | 596,956 | 899 | (185) | 597,670 | 4.74 |
| Commercial MBS | – | – | – | – | – |
| Asset backed securities | 132,584 | 31 | (7) | 132,608 | 5.43 |
| Total | $ 3,888,889 | $ 8,423 | $ (10,994) | $ 3,886,318 | 4.54% |

| | December 31, 2004 | | | | |
|---|---|---|---|---|---|
| *(dollars in thousands)* | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value | Yield |
| Commercial Paper | $ 29,957 | $ – | $ – | $ 29,957 | 2.35% |
| U.S. Govt. GNMA MBS/CMOs | 1,079,707 | 3,047 | (1,911) | 1,080,843 | 2.47 |
| U.S. Govt. Agency MBS | 1,843,914 | 10,720 | (1,486) | 1,853,148 | 3.02 |
| Non-Agency whole loans | 292,537 | 9 | (1) | 292,545 | 2.68 |
| Commercial MBS | – | – | – | – | – |
| Asset backed securities | 21,926 | 3 | (8) | 21,921 | 2.60 |
| Total | $ 3,268,041 | $ 13,779 | $ (3,406) | $ 3,278,414 | 2.80% |

| | December 31, 2003 | | | | |
|---|---|---|---|---|---|
| *(dollars in thousands)* | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value | Yield |
| Commercial Paper | $ 229,881 | $ – | $ (2) | $ 229,879 | 1.10% |
| U.S. Govt. GNMA MBS/CMOs | 910,675 | 3,154 | (2,653) | 911,176 | 1.99 |
| U.S. Govt. Agency MBS | 1,626,361 | 14,272 | (6,218) | 1,634,415 | 2.51 |
| Non-Agency whole loans | 20,281 | 1 | (7) | 20,275 | 1.49 |
| Commercial MBS | 1,717 | – | – | 1,717 | 1.39 |
| Asset backed securities | 35,288 | 3 | (37) | 35,254 | 1.49 |
| Total | $ 2,824,203 | $ 17,430 | $ (8,917) | $ 2,832,716 | 2.21% |

**Held-to-Maturity**

A summary of the amortized cost and fair value of debt securities held as held-to-maturity investments at December 31, 2005 follows:

| | December 31, 2005 | | | | |
|---|---|---|---|---|---|
| *(dollars in thousands)* | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value | Yield |
| U.S. Govt. Agency MBS | $ 1,369,427 | $ 110 | $ (31,677) | $ 1,337,860 | 5.29% |
| Total | $ 1,369,427 | $ 110 | $ (31,677) | $ 1,337,860 | 5.29% |

AgFirst's investments consist primarily of mortgage-backed securities (MBSs), asset backed securities (ABSs), and short-term money market securities. MBSs are collateralized by U.S. Government or US agency guaranteed residential mortgages and have a AAA credit rating. ABSs are also rated AAA due to the senior/subordinate structure and/or a credit wrap by a bond insurer. Money market securities are short term in nature (from overnight maturities to maturities that range from 30 to 90 days) and are only purchased from financial institutions that carry sound credit ratings. All unrealized losses referenced above are related to changes in interest rates and are not credit related.

The following table shows the fair value and gross unrealized losses for investments in a loss position aggregated by investment category at December 31, 2005. The unrealized losses on these investments resulted from interest rate volatility and are not credit related. AgFirst has both the ability and the intent to recover substantially all of our cost in these investments.

| | Less than 12 Months | | Greater than 12 Months | |
|---|---|---|---|---|
| *(dollars in thousands)* | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| Commercial Paper | $ 69,796 | $ 17 | $ – | $ – |
| U.S. Govt. GNMA MBS/CMOs | 368,795 | 3,224 | 59,876 | 2,439 |
| U.S. Govt. Agency MBS | 1,734,120 | 35,222 | 104,967 | 1,577 |
| Non-Agency whole loans | 103,152 | 185 | – | – |
| Asset-backed securities | 9,993 | 7 | – | – |
| Total | $ 2,285,856 | $ 38,655 | $ 164,843 | $ 4,016 |

On December 31, 2005, the Bank held certain investments having continuous unrealized loss positions for more than 12 months with a fair value totaling $164.8 million and an unrealized loss position totaling $4.0 million. Substantially all of these investments were in U. S. Government Agency securities and the Bank expects that these securities would not be settled at a price less than their amortized cost. Because the decline in market value was caused by interest rate increases and not credit quality, and because the Bank has the ability and intent to hold these investments until a recovery of fair value, which may be maturity, the Bank has not recognized any other-than-temporary impairment in connection with these investments.

A summary of the expected maturity, amortized cost and estimated fair value of investment securities at December 31, 2005, follows:

**Available-for-sale:**

| *(dollars in thousands)* | Amortized Cost | Fair Value | Weighted Average Yield |
|---|---|---|---|
| In one year or less | $ 69,813 | $ 69,796 | 4.37% |
| After one year through five years | 20,869 | 20,614 | 4.65 |
| After five years through ten years | 7,018 | 7,028 | 4.89 |
| After ten years | 3,791,189 | 3,788,880 | 4.54 |
| Total | $ 3,888,889 | $ 3,886,318 | 4.54% |

**Held-to-maturity:**

| *(dollars in thousands)* | Amortized Cost | Fair Value | Weighted Average Yield |
|---|---|---|---|
| In one year or less | $ – | $ – | –% |
| After one year through five years | – | – | – |
| After five years through ten years | – | – | – |
| After ten years | 1,369,427 | 1,337,860 | 5.29 |
| Total | $ 1,369,427 | $ 1,337,860 | 5.29% |

Included in the available-for-sale investments are collateralized mortgage obligations. Substantially all collateralized mortgage obligations have contractual maturities in excess of ten years. However, expected maturities for collateralized mortgage obligations will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

Proceeds from and realized gains and losses on investments in debt securities are as follows:

| | Year Ended December 31, | | |
|---|---|---|---|
| *(dollars in thousands)* | 2005 | 2004 | 2003 |
| Proceeds on sales | $ 383,676 | $ 197,340 | $ 69,242 |
| Realized gains | 908 | 6 | 247 |
| Realized losses | 442 | 23 | – |

## Note 5 — Loans and Allowance for Loan Losses

A summary of loans follows:

| (dollars in thousands) | December 31, 2005 | 2004 | 2003 |
|---|---|---|---|
| Direct notes receivable from District Associations | $ 12,441,170 | $ 11,229,197 | $ 10,592,325 |
| Participations/syndications, net | 1,411,802 | 1,374,863 | 1,554,762 |
| Mortgage loans purchased in the secondary market | 555,421 | 302,226 | 228,046 |
| SFAS No. 133 adjustment | 7 | 63 | (282) |
| Loans to Other Financing Institutions | 2,650 | 1,900 | 500 |
| Total | $ 14,411,050 | $ 12,908,249 | $ 12,375,351 |

A substantial portion of the Bank's loan portfolio consists of notes receivable from District Associations. As described in Note 1(B) — *Operations*, these notes are used by the Associations to fund their loan portfolios, and therefore, the Bank's concentration of credit risk in various agricultural commodities approximates that of the District as a whole. Loan concentrations are considered to exist when there are amounts loaned to a multiple number of borrowers engaged in similar activities, which would cause them to be similarly impacted by economic or other conditions. While the amounts below represent the Associations' maximum potential credit risk as it relates to recorded loan principal, a substantial portion of the Associations' lending activities is collateralized and the Associations' exposure to credit loss associated with lending activities is reduced accordingly. An estimate of the Bank's credit risk exposure is considered in the Bank's allowance for loan losses.

Total Association loans consisted of the following commodity types:

| Commodity Group | Percent of Portfolio 2005 | 2004 | 2003 |
|---|---|---|---|
| Poultry | 14% | 13% | 13% |
| Forestry | 13 | 12 | 12 |
| Fruits/Vegetables | 10 | 9 | 5 |
| Cattle | 9 | 9 | 9 |
| Grain | 7 | 8 | 10 |
| Dairy | 7 | 8 | 8 |
| Nursery/Greenhouse | 5 | 5 | 5 |
| Rural Home | 4 | 4 | 4 |
| Processing | 3 | 4 | 4 |
| Tobacco | 3 | 4 | 4 |
| Swine | 3 | 3 | 3 |
| Cotton | 3 | 3 | 3 |
| Citrus | 2 | 2 | 3 |
| Other | 17 | 16 | 17 |
| Total | 100% | 100% | 100% |

Impaired loans are loans in which it is probable that principal and interest will not be collected according to the contractual terms. Interest income recognized and cash payments received on nonaccrual impaired loans are applied as described in Note 2.

The following table presents information relating to the Bank's impaired loans.

| (dollars in thousands) | December 31, 2005 | 2004 | 2003 |
|---|---|---|---|
| Nonaccrual: | | | |
| Current as to principal and interest | $ 18,448 | $ 26,077 | $ 11,401 |
| Past due | 749 | 351 | 20,017 |
| Accrual: | | | |
| Restructured | – | – | – |
| 90 days or more past due | 653 | 245 | 608 |
| Total impaired loans | $ 19,850 | $ 26,673 | $ 32,026 |

The average recorded investment in impaired loans during 2005, 2004 and 2003 was $20.4 million, $29.9 million and $31.6 million, respectively. Impaired loans of $19.2 million, $26.4 million and $31.4 million at December 31, 2005, 2004 and 2003 had a specific allowance for loan losses totaling $10.1 million, $14.8 million and $12.7 million, respectively.

There were no material commitments to lend additional funds to debtors whose loans were classified as impaired at December 31, 2005.

A summary of changes in the allowance for loan losses, all of which relates to the Bank's participation loan portfolio, follows:

| (dollars in thousands) | Year Ended December 31, 2005 | 2004 | 2003 |
|---|---|---|---|
| Balance at beginning of year | $ 14,800 | $ 34,168 | $ 31,155 |
| Provision for (reversal of) loan losses | (4,995) | – | 2,500 |
| Reversal of provision due to change in methodology | – | (15,292) | – |
| Loans charged off | (54) | (4,098) | (67) |
| Recoveries | 363 | 22 | 580 |
| Balance at end of year | $ 10,114 | $ 14,800 | $ 34,168 |

To mitigate risk of loan losses, District Associations have entered into long-term standby commitment to purchase agreements with the Federal Agricultural Mortgage Corporation (Farmer Mac) through an arrangement with the Bank. The agreements, which are effectively credit guarantees that will remain in place until the loans are paid in full, give the Associations the right to sell the loans identified in the agreements to the Bank, which can, in turn, sell them to Farmer Mac in the event of default, subject to certain conditions. The balance of loans under long-term standby commitments to purchase was $306.0 million at December 31, 2005. Fees paid to Farmer Mac for such commitments are paid by the Associations. Fees paid to government sponsored enterprises (GSEs) other than Farmer Mac were $581 thousand, $628 thousand and $96 thousand for 2005, 2004 and 2003, respectively.

## Note 6 — Premises and Equipment

Premises and equipment consisted of the following:

| (dollars in thousands) | December 31, 2005 | 2004 | 2003 |
|---|---|---|---|
| Land | $ 896 | $ 896 | $ 848 |
| Buildings and improvements | 5,853 | 5,707 | 3,932 |
| Furniture and equipment | 43,147 | 37,844 | 30,750 |
| Work in progress | 4,331 | 7,760 | 7,895 |
| | 54,227 | 52,207 | 43,425 |
| Less: accumulated depreciation | 28,376 | 24,287 | 18,430 |
| Total | $ 25,851 | $ 27,920 | $ 24,995 |

## Note 7 — Other Assets and Other Liabilities

A summary of other assets and other liabilities follows:

| (dollars in thousands) | December 31, 2005 | 2004 | 2003 |
|---|---|---|---|
| **Other assets:** | | | |
| Unamortized debt issue costs | $ 12,038 | $ 9,054 | $ 9,109 |
| Prepaid retirement expenses | 24,664 | 23,259 | – |
| Intangible asset related to pension | – | – | 1,583 |
| Deferred issuance costs – preferred stock | 2,701 | 3,385 | 3,974 |
| Derivative assets | 2,066 | 1,125 | 3,484 |
| Receivables and other | 29,791 | 32,998 | 29,070 |
| Total | $ 71,260 | $ 69,821 | $ 47,220 |
| **Other liabilities:** | | | |
| Accounts payable | $ 2,717 | $ 3,030 | $ 2,349 |
| Farm Credit System Ins. Corp. payable | 7,475 | 7,058 | 16,171 |
| Derivative liabilities | 39,100 | 11,278 | 3,188 |
| Other | 10,267 | 7,990 | 6,611 |
| Total | $ 59,559 | $ 29,356 | $ 28,319 |

## Note 8 — Bonds and Notes

The System, unlike commercial banks and other depository institutions, obtains funds for its lending operations primarily from the sale of Systemwide Debt Securities issued by the banks through the Funding Corporation. Certain conditions must be met before AgFirst can participate in the issuance of Systemwide Debt Securities. As one condition of participation, AgFirst is required by the Farm Credit Act and FCA regulations to maintain specified eligible assets, at least equal in value to the total amount of debt obligations outstanding for which it is primarily liable. This requirement does not provide holders of Systemwide Debt Securities with a security interest in any assets of the banks. In 1994, the System banks and the Funding Corporation entered into the Market Access Agreement (MAA), which established criteria and procedures for the banks to provide certain information and, under certain circumstances, for restricting or prohibiting an individual bank's participation in Systemwide debt issuances, thereby reducing other System banks' exposure to statutory joint and several liability. The MAA was amended and restated in July 2003. At December 31, 2005, AgFirst was in compliance with the conditions of participation for the issuances of Systemwide Debt Securities.

Each issuance of Systemwide Debt Securities ranks equally, in accordance with the FCA regulations, with other unsecured Systemwide Debt Securities. Systemwide Debt Securities are not issued under an indenture and no trustee is provided with respect to these securities. Systemwide Debt Securities are not subject to acceleration prior to maturity upon the occurrence of any default or similar event.

The System may issue the following types of Systemwide Debt Securities:

- Federal Farm Credit Banks Consolidated Systemwide Bonds,
- Federal Farm Credit Banks Consolidated Systemwide Discount Notes,
- Federal Farm Credit Banks Consolidated Systemwide Master Notes,
- Federal Farm Credit Banks Global Debt Securities, and
- Federal Farm Credit Banks Consolidated Systemwide Medium-Term Notes.

AgFirst's participation in outstanding Systemwide Debt Securities is as follows:

| | Bonds | | Medium-Term Notes | | Discount Notes | | Total | |
|---|---|---|---|---|---|---|---|---|
| Maturities | Amount | Weighted Average Interest Rate | Amount | Weighted Average Interest Rate | Amount | Weighted Average Interest Rate | Amount | Weighted Average Interest Rate |
| | | | | (dollars in thousands) | | | | |
| 2006 | $ 5,546,432 | 3.48% | $ – | –% | $ 1,726,225 | 3.87% | $ 7,272,657 | 3.57% |
| 2007 | 4,709,288 | 3.89 | 15,202 | 6.75 | – | – | 4,724,490 | 3.89 |
| 2008 | 2,026,642 | 3.79 | – | – | – | – | 2,026,642 | 3.79 |
| 2009 | 1,643,669 | 4.23 | – | – | – | – | 1,643,669 | 4.23 |
| 2010 | 915,029 | 4.42 | – | – | – | – | 915,029 | 4.42 |
| 2011 | 2,297,477 | 5.18 | – | – | – | – | 2,297,477 | 5.18 |
| Total | $ 17,138,537 | 3.98% | $ 15,202 | 6.75% | $ 1,726,225 | 3.87% | $ 18,879,964 | 3.97% |

In the preceding table, weighted average interest rates include the effect of related derivative financial instruments.

Discount notes are issued with maturities ranging from 1 to 365 days. The average maturity of discount notes at December 31, 2005, was 32 days.

Systemwide debt includes callable bonds and medium-term notes consisting of the following:

| Amount | First Call Date | Year of Maturity |
|---|---|---|
| (dollars in thousands) | | |
| $ 8,152,000 | 2006 | 2006-2019 |
| 256,000 | 2007 | 2009-2012 |
| 13,000 | 2008 | 2015-2020 |
| 2,000 | 2010 | 2012 |
| $ 8,423,000 | | |

Callable debt may be called on the first call date and, any time thereafter.

As described in Note 1, the Insurance Fund is available to ensure the timely payment of principal and interest on Systemwide Debt Securities (insured debt) of System banks to the extent net assets are available in the Insurance Fund and not designated for specific use. All other liabilities on the financial statements are uninsured. At December 31, 2005 the assets of the Insurance Fund aggregated $2.06 billion; however, due to the other authorized uses of the Insurance Fund there is no assurance that any available amount in the Insurance Fund will be sufficient to fund the timely payment of principal or interest on an insured debt obligation in the event of a default by any System bank having primary liability thereon. Amounts available in the Insurance Fund were used in June 2005 to repay the Financial Assistance Corporation debt issued to fund the purchase of $374 million of Federal Land Bank of Jackson preferred stock.

**Note 9 — Mandatorily Redeemable Preferred Stock**

As of December 31, 2005, AgFirst had 225 thousand shares issued and outstanding of Mandatorily Redeemable Cumulative Preferred Stock at a par value of $1 thousand per share that is redeemable on December 15, 2016. Dividends on the preferred stock are payable semi-annually in arrears on the 15th day of June and December of each year at an annual rate equal to 8.393 percent of the $1 thousand per share par value. Beginning March 15, 2012, the rate will change to a floating rate indexed to the 3-month LIBOR. On or after the dividend payment date in December 15, 2011, the preferred stock will be redeemable in whole or in part at the option of the Bank on any dividend payment date at its par value of $1 thousand per share together with accrued and unpaid dividends to the redemption date. Beginning in July 1, 2003, the Mandatorily Redeemable Preferred Stock was required to be reported prospectively as a liability and the related dividends reported prospectively as interest expense in accordance with SFAS No. 150. Although the Mandatorily Redeemable Preferred Stock is required to be reported as a liability under GAAP, it qualifies as capital for certain regulatory purposes.

**Note 10 — Shareholders' Equity**

Descriptions of the Bank's capitalization requirements, protection mechanisms, regulatory capitalization requirements and restrictions, and equities are provided below.

A. **Description of Equities:** In accordance with the Farm Credit Act and the Bank's capitalization bylaws, the Bank is authorized to issue and have outstanding Classes B, C and D Common Stock, Participation Certificates, Preferred Stock and other classes of equity as may be provided for in amendments to the bylaws in such amounts as may be necessary to conduct the Bank's business. All Common Stock and Participation Certificates have a par or face value of five dollars ($5.00) per share.

   The Bank had the following shares of common equities outstanding at December 31, 2005:

| | | Shares Outstanding | |
|---|---|---|---|
| | | (dollars in thousands) | |
| Class | Protected Status | Number | Aggregate Par Value |
| B Common/Nonvoting | No | 1,920,800 | $ 9,604 |
| C Common/Voting | No | 41,565,992 | 207,830 |
| D Common/Nonvoting | No | 1,407,808 | 7,039 |
| Participation Certificates/Nonvoting | No | 16,200 | 81 |
| Total Capital Stock and Participation Certificates | | 44,910,800 | $ 224,554 |

B. **Perpetual Preferred Stock:** On October 14, 2003, AgFirst issued 150 thousand shares of Perpetual Non-Cumulative Preferred Stock. Dividends on the stock are payable at an annual rate equal to 7.30 percent. In the event dividends are not declared on the Preferred Stock for payment on any dividend payment date, then such dividends shall not cumulate and shall cease to accrue and be payable. On and after the dividend payment date in December 2008, the Bank may, at its option, redeem the Preferred Stock in whole or in part at any time at the redemption price of $1 thousand per share plus accrued and unpaid dividends for the then current dividend period to the date of redemption.

   Payment of dividends or redemption price on the Preferred Stock may be restricted if the Bank fails to satisfy applicable minimum capital adequacy, surplus and collateral requirements.

C. **Capital Stock:** District Associations are required to maintain ownership in the Bank in the form of Class B or C Common Stock as determined by the Bank. The Bank may require additional capital contributions to maintain its capital requirements.

   Additionally, the Bank has issued Class D Common Stock in connection with participations purchased by the Bank from other System institutions. Class D Common Stock issued in connection with participations has no voting rights. Such Stock may be retired at the discretion of the Board, and, if retired, shall be retired at book value, not to exceed its par value.

   Class D Common Stock shall also be purchased by borrowers eligible to hold it as a condition for obtaining a loan in an amount as may be determined by the Board at its discretion within a range between a minimum of two percent (2.00%) of the loan amount or $1 thousand, whichever is less, and a maximum not to exceed ten percent (10.00%) of the loan amount. The Bank currently has no such loans outstanding.

D. **Other Equity:** At the inception of each Other Financing Institution (OFI) loan, the Bank requires OFIs to make cash purchases of participation certificates in the Bank. The Bank has a first lien on these equities for the repayment of any indebtedness to the Bank.

E. **Regulatory Capitalization Requirements and Restrictions:** FCA's capital adequacy regulations require the Bank to achieve permanent capital of seven percent of risk-adjusted assets and off-balance-sheet commitments. Failure to meet the seven percent capital requirement can initiate certain mandatory and possibly additional discretionary actions by FCA that, if undertaken, could have a direct material effect on the Bank's consolidated financial statements. The Bank is prohibited from reducing permanent capital by retiring stock or making certain other distributions to shareholders unless the prescribed capital standard is met. FCA Regulations also require all System institutions to achieve and maintain additional capital adequacy ratios as defined by FCA Regulations. These required ratios are total surplus as a percentage of risk-adjusted assets of seven percent and core surplus as a percentage of risk-adjusted assets of three and one-half percent. The Bank's permanent capital, total surplus and core surplus ratios at December 31, 2005 were 23.90 percent, 23.84 percent and 14.15 percent, respectively.

   Capital adequacy is also evaluated using a ratio of net collateral to total liabilities. Subsequent to the issuance of the preferred stock, FCA now requires AgFirst to maintain a minimum net collateral ratio of 104.00 percent compared to the regulatory minimum of 103.00 percent. At December 31, 2005, the Bank's net collateral ratio was 105.70 percent.

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

F. **Accumulated Other Comprehensive Income (Loss):** Accumulated other comprehensive income (loss) at December 31, 2005, 2004 and 2003 was comprised of the following components:

| *(dollars in thousands)* | 2005 | 2004 | 2003 |
|---|---|---|---|
| Unrealized (losses) gains on investments available-for-sale | $ (2,571) | $ 10,373 | $ 8,514 |
| Unrealized (losses) on cash flow hedges | – | (6,643) | (18,763) |
| Minimum pension liability adjustment | – | – | (16,001) |
| | $ (2,571) | $ 3,730 | $ (26,250) |

## Note 11 — Employee Benefit Plans

The employees of the Bank may participate in a Districtwide defined benefit retirement plan. This plan is noncontributory and covers most Bank employees. For participants hired prior to January 1, 2003, benefits are based on eligible compensation and years of service. The assets, liabilities and costs of the plan are not segregated by participating entities but are allocated among the participating entities. Pension costs are allocated by multiplying the District's net pension expense times each institution's salary expense as a percentage of the District's salary expense. For participants hired on or after January 1, 2003, benefits are determined using a cash balance formula. This formula is based on employer contributions (3.00-5.00 percent of eligible compensation depending on years of service) and interest credits as allocated to an employee's theoretical account balance. The measurement date for the plan is September 30.

At December 31, 2003, the Accumulated Benefit Obligation (ABO) of the District's defined benefit plan (the Plan) exceeded the fair value of plan assets, and accordingly, the recognition of a minimum liability in the amount of the excess of the ABO over the fair value of plan assets was required. At December 31, 2003, a minimum liability for the Bank was recognized in the amount of $8.8 million. The fair value of the plan assets and the ABO were measured as of September 30, 2004 and 2005. No liability was required at December 31, 2005 and 2004, as the fair value of plan assets exceeded the ABO.

The Bank also sponsors supplemental retirement and deferred compensation plans for certain key employees. The plans are nonqualified; therefore, the associated liabilities are included in the Bank's consolidated balance sheets in other liabilities. The expenses of these plans included in the Bank's retirement costs were $237 thousand, $283 thousand and ($49) thousand for the years ended December 31, 2005, 2004 and 2003, respectively.

The Bank also participates in a Districtwide Thrift Plan, which qualifies as a 401(k) plan as defined by Internal Revenue Code. For employees hired on or prior to December 31, 2002, the Bank contributes $0.50 for each $1.00 of the employee's first 6.00 percent of contribution up to the maximum employer contribution of 3.00 percent of total compensation. For employees hired on or after January 1, 2003, the Bank contributes $1.00 for each $1.00 of the employee's first 6.00 percent of contribution up to the maximum employer contribution of 6.00 percent of total compensation. Employee deferrals are not to exceed the maximum deferral as determined and adjusted by the Internal Revenue Service.

Effective January 1, 2006 the Districtwide 401(k) Plan known as the AgFirst Farm Credit Employee Thrift Plan merged with the Farm Credit Bank of Texas Thrift Plus Plan. The new plan is known as the AgFirst/FCBT 401 (k) Employee Benefit Plan.

In addition to providing pension benefits, the Bank provides certain health care and life insurance benefits for the retired employees (other postretirement benefits). Substantially all employees may become eligible for the benefits if they reach early retirement age while working for the Bank. Early retirement age is defined as a minimum of age 55 and 10 years of service. Employees hired after December 31, 2002 are required to pay the full cost of their retiree health insurance coverage.

On December 8, 2003, the Medicare Prescription Drug, Improvement and Modernization Act of 2003 (Medicare Act) was signed into law. This act introduces a prescription drug benefit under Medicare (Medicare Part D) as well as a federal subsidy to sponsors of retiree health care benefit plans that provide a benefit that is at least actuarially equivalent to Medicare Part D. In May 2004, the FASB issued FASB Staff Position (FSP) 106-2, *Accounting and Disclosure Requirements Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003* (the Act). This Staff Position provides guidance on the accounting for the effects of the Act for employers that sponsor postretirement health care plans that provide prescription drug benefits. The District sponsored plan adopted FSP 106-2 effective July 1, 2004 (measured as of March 31, 2004). The benefit obligation valuation as of December 31, 2004 reflects the impact of the Medicare Act.

In determining the benefit obligation as of December 31, 2004, the expected per capita claims cost were estimated to be reduced by 12.00 percent beginning in 2006, for Medicare-eligible participants receiving actuarially equivalent drug benefits, due to a government reimbursement of a portion of prescription drug benefits. The District reduced its accumulated postretirement benefit obligation (APBO) for the subsidy related to benefits attributed to past service. The effect of the subsidy on the measurement of net periodic postretirement cost for 2005 was a reduction of 2005 expense. The effect included lower amortization of actuarial losses, lower service costs and lower interest costs on the APBO.

The Retiree and Disabled Medical Plan was amended effective January 1, 2006 to change the medical and prescription drug coverage for Medicare-eligible retirees and/or eligible spouses 65 years and older. Beginning in 2006, the AgFirst/FCBT Retiree and Disabled Medical Plan will provide medical and prescription drug coverage to Medicare-eligible retirees and/or eligible spouses 65 years and older through fully-insured AARP endorsed Medicare Supplement policies and subsidized basic Medicare D coverage through a selected Prescription Drug Plan. Dental coverage was not changed. Certain other retirees who are grandfathered under insured arrangements were not impacted by the change. The benefit obligation valuation as of December 31, 2005 reflects the impact of this plan amendment.

In determining the benefit obligation as of December 31, 2005, there was no impact due to government reimbursement of prescription drug benefits. After the plan amendment, the plan no longer provides prescription drug benefits directly for retirees and/or eligible spouses 65 years and older. Instead, the District subsidizes the cost of coverage obtained under the Medicare D program through the selected Prescription Drug Provider.

For further information on postretirement costs, see "Postretirement Benefits" section in the Notes to the Combined Financial Statements for AgFirst Farm Credit Bank and District Associations 2005 Annual Report.

The following is a table of retirement and postretirement benefit expenses:

| *(dollars in thousands)* | 2005 | 2004 | 2003 |
|---|---|---|---|
| Pension | $ 3,614 | $ 3,858 | $ 3,560 |
| Thrift/deferred compensation | 820 | 500 | 425 |
| Other postretirement benefits | 1,991 | 2,631 | 2,595 |
| Total | $ 6,425 | $ 6,989 | $ 6,580 |

**Note 12 — Intra-System Financial Assistance**

The Farm Credit Act provided for capital assistance to System institutions experiencing severe financial stress through the issuance, prior to October 1, 1992, by the Farm Credit System Financial Assistance Corporation, (Financial Assistance Corporation) of U.S. Treasury-guaranteed 15-year bonds, of which $1.26 billion in principal amount was originally issued. The last remaining Financial Assistance Corporation bonds matured and were repaid on June 10, 2005.

The proceeds from the debt offerings were used to fund existing intra-System financial assistance payables ($417 million), to purchase preferred stock from certain troubled System banks ($808 million), and for other purposes ($36 million). Pursuant to the Farm Credit Act, the U.S. Treasury paid the interest on $844 million of the Financial Assistance Corporation bonds for the first five years of the respective terms of such bonds. The payment of interest on this debt was allocated between the U.S. Treasury and System banks during the second five years. As the result of growth of the System's surplus, the allocation provisions of the Farm Credit Act required that banks pay 100.00 percent of the interest beginning in 1999.

Financial assistance was provided by the Financial Assistance Corporation to five System banks in other districts through its purchase of preferred stock of those institutions. Through 1994, four System banks redeemed their preferred stock in the amount of $419 million through the transfer of assets to the Financial Assistance Corporation, which were placed in trusts. The Federal Land Bank of Jackson, whose charter was canceled in January of 1995, received $374 million of financial assistance for which the related preferred stock has not been redeemed.

All interest advanced by the U.S. Treasury was repaid by System banks in June 2005. System banks recorded their share of the liability based upon each bank's proportionate share of average accruing retail loan volume. To fund the repayment obligation, annual annuity-type payments were made by each bank to the Financial Assistance Corporation in an amount designed to accumulate, in total, including earnings thereon, the total amount of each bank's ultimate obligation.

The Bank's financial assistance expense totaled $3.2 million, $6.8 million and $13.2 million in 2005, 2004 and 2003, respectively.

**Note 13 — Related Party Transactions**

As discussed in Note 1, the Bank lends funds to the District Associations to fund their loan portfolios. Further disclosure regarding these related party transactions is found in Notes 5, 10 and 15.

Interest income recognized on direct notes receivable from District Associations was $532.6 million, $400.2 million and $396.1 million for 2005, 2004 and 2003, respectively.

**Note 14 — Regulatory Enforcement Matters**

At December 31, 2005, there were no regulatory enforcement matters or agreements in place with the FCA.

**Note 15 — Commitments and Contingencies**

The Bank has various contingent liabilities and commitments outstanding as discussed elsewhere in these notes to the consolidated financial statements. While primarily liable for its portion of bonds and notes, the Bank is jointly and severally liable for the bonds and notes of the other System banks. The total bonds and notes of the System at December 31, 2005, were $112.70 billion.

In the normal course of business, the Bank may participate in credit related financial instruments with off-balance-sheet risk to satisfy the financing needs of its borrowers or the borrowers of the District Associations. These financial instruments include standby letters of credit, various guarantees and commitments to extend credit.

Standby letters of credit are unconditional commitments issued by the Bank to guarantee the performance of a customer to a third party. As of December 31, 2005, the Bank had $23.9 million letters of credit issued on behalf of Association customers. Of the outstanding amount, $3.0 million will expire in less than one year, $10.5 million are due to expire in one to three years, $10.2 million are due to expire in three to five years and the remaining $113 thousand have terms that will expire in 2011. The Bank also guarantees letters of credit with commercial banks on behalf of certain District Associations in the amount of $7.6 million.

In addition, the Bank had $76.7 million in letters of credit issued on behalf of non-district entities with $8.4 million expiring in less than one year, $14.7 million due to expire in one to three years, $47.5 million expiring in three to five years and the remaining $6.1 million have terms that will expire from 2011 to 2016.

The Bank also guarantees certain loans held by District Associations in the amount of $24.1 million with $18.8 million expiring in less than one year and the remaining $5.3 million will expire in 2024. The notional amounts of these guarantees represent the maximum amount of exposure the Bank has related to these instruments as of December 31, 2005.

At December 31, 2005, $2.06 billion of commitments to extend credit were outstanding. Since many of these commitments are expected to expire without being drawn upon, the total commitments do not necessarily represent future cash requirements. However, these financial instruments have off-balance-sheet credit risk because their amounts could be drawn upon at the option of the borrower. The credit risk associated with issuing commitments and letters of credit is substantially the same as that involved in extending loans to borrowers and the same credit policies are applied by management. Upon fully funding a commitment, the credit risk amounts are equal to the contract amounts, assuming that borrowers fail completely to meet their obligations and the loan collateral is of no value. The amount of collateral obtained, if deemed necessary upon extension of credit, is based on management's credit evaluation of the borrower.

As of December 31, 2005, AgFirst also indemnifies leases in the amount of $3.0 million on behalf of the Farm Credit Leasing Services Corporation (FCLSC) with lease terms expiring in 2009.

Other actions are pending against the Bank 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 financial position of the Bank.

**Note 16 — Disclosures about Fair Value of Financial Instruments**

The following table presents the carrying amounts and fair values of the Bank's financial instruments at December 31, 2005, 2004 and 2003. The fair value of a financial instrument is generally defined as the amount at which the instrument could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale.

Quoted market prices are generally not available for certain System financial instruments, 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.

| | December 31, 2005 | | December 31, 2004 | | December 31, 2003 | |
|---|---|---|---|---|---|---|
| *(dollars in thousands)* | Carrying Amount | Estimated Fair Value | Carrying Amount | Estimated Fair Value | Carrying Amount | Estimated Fair Value |
| **Financial assets:** | | | | | | |
| Loans | $ 14,411,050 | $ 14,270,616 | $ 12,908,249 | $ 12,519,613 | $ 12,375,351 | $ 11,742,568 |
| Allowance for loan losses | (10,114) | – | (14,800) | – | (34,168) | – |
| Loans, net | $ 14,400,936 | $ 14,270,616 | $ 12,893,449 | $ 12,519,613 | $ 12,341,183 | $ 11,742,568 |
| Derivative assets | $ 2,066 | $ 2,066 | $ 1,125 | $ 1,125 | $ 3,484 | $ 3,484 |
| Cash and cash equivalents | $ 557,882 | $ 557,882 | $ 470,258 | $ 470,258 | $ 469,945 | $ 469,945 |
| Investment securities | $ 5,255,745 | $ 5,224,178 | $ 3,278,414 | $ 3,278,414 | $ 2,832,716 | $ 2,832,716 |
| **Financial liabilities:** | | | | | | |
| Systemwide Debt Securities | $ 18,879,964 | $ 18,753,747 | $ 15,402,385 | $ 15,206,435 | $ 14,507,105 | $ 14,475,670 |
| Financial assistance related liabilities | $ – | $ – | $ (1,322) | $ (609) | $ 78 | $ 2,660 |
| Derivative liabilities | $ 39,100 | $ 39,100 | $ 11,278 | $ 11,278 | $ 3,188 | $ 3,188 |

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. Since the discount rates are based on the Bank's loan rates as well as management estimates, management has no basis to determine whether the fair values presented would be indicative of the value negotiated in an actual sale.

   For purposes of determining fair value of accruing loans, the loan portfolio is segregated into pools of loans with homogeneous characteristics 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, Federal Funds and Securities Purchased Under Resale Agreements:** The carrying value is a reasonable estimate of fair value.

C. **Investment Securities:** Fair value is based upon currently quoted market prices.

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 spread relationship between Systemwide bonds and notes and comparable Treasury notes.

E. **Financial Assistance Related Liabilities:** As discussed in Note 12, the District was liable for certain obligations of the Financial Assistance Corporation. Fair value of these obligations was determined by discounting the cumulative expected future cash outflows of all of the obligations using an interest rate commensurate with bonds having a similar maturity.

F. **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.

G. **Commitments to Extend Credit and Standby Letters of Credit:** The fair value of commitments is estimated using the fees currently charged to enter similar agreements, taking into account the remaining terms of the agreement and the creditworthiness of the counterparties. For fixed-rate loan commitments, fair value also considers the difference between current levels of interest rates and the committed rates. The fair value of letters of credit is based on an estimate of the cost to terminate the agreement or fees currently charged for similar agreements. The estimated market value of off-balance-sheet commitments is considered to be nominal since the committed rate approximates current rates offered for commitments with similar rate and maturity characteristics and since the related credit risk is also considered not to be significant.

**Note 17 — Derivative Instruments and Hedging Activities**

The Bank maintains an overall interest rate risk management strategy that incorporates the use of derivative instruments to minimize significant unplanned fluctuations in earnings that are caused by interest rate volatility. The Bank's goal is to manage interest rate sensitivity by modifying the repricing or maturity characteristics of certain balance sheet assets and liabilities so that 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, 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 purchase interest rate options 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. There are no floors outstanding currently.

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 of $2.1 million with eight counterparties represents approximately 0.07 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 December 31, 2005, 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 ALCO's oversight of the Bank's asset/liability and treasury functions. The Bank's ALCO is responsible for approving hedging strategies that are developed through its 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.

**Note 18 — Additional Derivative Financial Instruments and Other Financial Instruments Disclosures**

The table below provides information about derivative financial instruments and other financial instruments that are sensitive to changes in interest rates, including debt obligations and interest rate swaps. The debt information below represents the principal cash flows and related weighted average interest rates by expected maturity dates. The derivative information below represents the notional amounts and weighted average interest rates by expected maturity dates.

| | Maturities of 2005 Derivative Products and Other Financial Instruments | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| *December 31, 2005* *(dollars in millions)* | 2006 | 2007 | 2008 | 2009 | 2010 | After 2011 | Total | Fair Value |
| **Systemwide Debt Securities:** | | | | | | | | |
| Fixed rate | $ 4,631 | $ 2,269 | $ 1,713 | $ 1,452 | $ 815 | $ 2,297 | $ 13,177 | $ 13,006 |
| Weighted average interest rate | 3.20% | 3.52% | 3.70% | 4.21% | 4.44% | 5.18% | 4.04% | |
| Variable rate | 2,657 | 2,440 | 313 | 191 | 100 | 2 | 5,703 | 5,747 |
| Weighted average interest rate | 4.24% | 4.24% | 4.32% | 4.31% | 4.28% | 4.23% | 4.27% | |
| **Derivative Instruments:** | | | | | | | | |
| **Receive fixed swaps** | | | | | | | | |
| Notional value | $ 615 | $ 350 | $ 415 | $ 450 | $ – | $ 100 | $ 1,930 | $ (37) |
| Weighted average receive rate | 2.55% | 2.99% | 3.57% | 4.03% | – | 5.01% | 3.32% | |
| Weighted average pay rate | 4.60% | 4.55% | 4.63% | 4.68% | – | 4.67% | 4.62% | |
| **Amortizing pay fixed** | | | | | | | | |
| Notional value | – | – | – | – | – | 440 | 440 | – |
| Weighted average receive rate | – | – | – | – | – | 4.81% | 4.81% | |
| Weighted average pay rate | – | – | – | – | – | 4.95% | 4.95% | |
| **Amortizing floating for floating swaps** | | | | | | | | |
| Notional value | 264 | – | – | – | – | – | 264 | – |
| Weighted average receive rate | 3.20% | – | – | – | – | – | 3.20% | |
| Weighted average pay rate | 3.02% | – | – | – | – | – | 3.02% | |
| **Interest rate caps** | | | | | | | | |
| Notional value | 239 | – | – | – | – | – | 239 | – |
| Total notional value | $ 1,118 | $ 350 | $ 415 | $ 450 | $ – | $ 540 | $ 2,873 | $ (37) |
| **Total weighted average rates on swaps:** | | | | | | | | |
| Receive rate | 2.74% | 2.99% | 3.57% | 4.03% | – | 4.85% | – | 3.56% |
| Pay rate | 4.12% | 4.55% | 4.63% | 4.68% | – | 4.90% | – | 4.51% |

### Note 19 — Quarterly Financial Information (Unaudited)

Quarterly results of operations for the years ended December 31, 2005, 2004 and 2003 follow:

| (dollars in thousands) | 2005 First | 2005 Second | 2005 Third | 2005 Fourth | 2005 Total |
|---|---|---|---|---|---|
| Net interest income | $ 49,366 | $ 51,328 | $ 51,516 | $ 51,991 | $ 204,201 |
| Provision for (reversal of) loan losses | (571) | (39) | (1,300) | (3,085) | (4,995) |
| Noninterest income (expense), net | (11,611) | (8,305) | (12,739) | (12,282) | (44,937) |
| Net income | $ 38,326 | $ 43,062 | $ 40,077 | $ 42,794 | $ 164,259 |

| | 2004 First | 2004 Second | 2004 Third | 2004 Fourth | 2004 Total |
|---|---|---|---|---|---|
| Net interest income | $ 54,801 | $ 54,781 | $ 53,340 | $ 48,673 | $ 211,595 |
| Provision for (reversal of) loan losses | – | – | – | (15,292) | (15,292) |
| Noninterest income (expense), net | (7,948) | (11,625) | (12,987) | (14,021) | (46,581) |
| Net income | $ 46,853 | $ 43,156 | $ 40,353 | $ 49,944 | $ 180,306 |

| | 2003 First | 2003 Second | 2003 Third | 2003 Fourth | 2003 Total |
|---|---|---|---|---|---|
| Net interest income | $ 66,320 | $ 65,563 | $ 56,168 | $ 56,006 | $ 244,057 |
| Provision for loan losses | 2,500 | – | – | – | 2,500 |
| Noninterest income (expense), net | (12,663) | (19,981) | (17,658) | (13,806) | (64,108) |
| Net income | $ 51,157 | $ 45,582 | $ 38,510 | $ 42,200 | $ 177,449 |

### Note 20— Combined Associations Financial Data (Unaudited)

Condensed financial information of the combined Associations follows. All significant transactions and balances between the Associations are eliminated in combination.

#### Balance Sheet

| (dollars in thousands) | December 31, 2005 | 2004 | 2003 |
|---|---|---|---|
| Cash and investment securities | $ 130,169 | $ 65,157 | $ 57,306 |
| Loans | 14,201,692 | 13,157,205 | 12,552,758 |
| Less: allowance for loan losses | 77,437 | 80,619 | 282,567 |
| Net loans | 14,124,255 | 13,076,586 | 12,270,191 |
| Investment in other Farm Credit institutions | 217,496 | 217,467 | 217,051 |
| Other assets | 749,191 | 450,359 | 308,493 |
| Total assets | $ 15,221,111 | $ 13,809,569 | $ 12,853,041 |
| Notes payable to AgFirst Farm Credit Bank | $ 12,441,171 | $ 11,229,198 | $ 10,592,326 |
| Postretirement benefits other than pensions | 87,683 | 79,026 | 67,085 |
| Minimum pension liability | – | – | 48,408 |
| Other liabilities | 309,706 | 251,877 | 263,309 |
| Total liabilities | 12,838,560 | 11,560,101 | 10,971,128 |
| Protected borrowers equity | 7,628 | 10,124 | 12,453 |
| Capital stock and participation certificates | 171,694 | 174,773 | 175,581 |
| Retained earnings | | | |
| Allocated | 925,919 | 849,626 | 792,168 |
| Unallocated | 1,277,714 | 1,215,344 | 984,384 |
| Accumulated other comprehensive (loss) | (404) | (399) | (82,673) |
| Total shareholders' equity | 2,382,551 | 2,249,468 | 1,881,913 |
| Total liabilities and equity | $ 15,221,111 | $ 13,809,569 | $ 12,853,041 |

#### Statement of Income

| (dollars in thousands) | Year Ended December 31, 2005 | 2004 | 2003 |
|---|---|---|---|
| Interest income | $ 935,377 | $ 753,222 | $ 723,994 |
| Interest expense | 532,881 | 400,334 | 396,227 |
| Net interest income | 402,496 | 352,888 | 327,767 |
| Provision for (reversal of) loan losses | (1,496) | (198,096) | 5,653 |
| Net interest income after provision for loan losses | 403,992 | 550,984 | 322,114 |
| Noninterest income | 174,771 | 166,774 | 135,931 |
| Noninterest expenses | | | |
| Salaries and employee benefits | 160,234 | 157,407 | 150,476 |
| Occupancy and equipment | 17,962 | 16,623 | 15,951 |
| Insurance Fund Premium | 6,563 | 6,244 | 14,166 |
| Other operating expenses | 52,355 | 48,764 | 44,964 |
| Total noninterest expenses | 237,114 | 229,038 | 225,557 |
| Income before income taxes | 341,649 | 488,720 | 232,488 |
| Provision (benefit) for income taxes | (2,132) | 10,363 | 858 |
| Net income | $ 343,781 | $ 478,357 | $ 231,630 |

The 2004 net income of the combined Associations included $188.9 million, net of $11.2 million tax impact for the one-time reversal of the allowance for loan losses due to the refinement of methodologies. Excluding the one-time reversal of the allowance for loan losses, net income for the combined Associations would have been $289.5 million for 2004.

## Management

| | |
|---|---|
| F. A. (Andy) Lowrey | President and Chief Executive Officer |
| Thomas S. Welsh | Executive Vice President, Chief Administrative and Legislative Officer & Corporate Secretary |
| Leon T. Amerson | Senior Vice President & Chief Financial Officer |
| Benjamin F. Blakewood | Senior Vice President, Chief Operations & Technology Officer |
| William L. Melton | Senior Vice President, Chief Lending Officer |

## Board of Directors as of January 1, 2006

| | |
|---|---|
| Robert G. Sexton | Chairman |
| Thomas W. Kelly | Vice Chairman |
| William C. Bess, Jr. | Director |
| Robert A. Carson | Director |
| Henry M. Frazee | Director |
| Don W. Freeman | Director |
| Robert L. Holden, Sr. | Director |
| Paul M. House | Director |
| Lyle Ray King | Director |
| Richard Kriebel | Director |
| M. Wayne Lambertson | Director |
| Paul Lemoine | Director |
| James L. May | Director |
| Eugene W. Merritt, Jr. | Director |
| Katherine A. Pace | Director |
| Dale W. Player | Director |
| J. Dan Raines, Jr. | Director |
| Walter L. Schmidlen, Jr. | Director |
| Kenneth A. Spearman | Director |
| Robert H. Spiers, Jr. | Director |

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Farm Credit Bank

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