# *SECOND QUARTER 2003*

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Chief Executive Officer

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July 29, 2003

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

The following discussion reviews the consolidated financial condition and results of operations of AgFirst Farm Credit Bank (AgFirst) and its subsidiary for the three months and six months ended June 30, 2003. These comments should be read in conjunction with the accompanying financial statements and the 2002 Annual Report of AgFirst Farm Credit Bank and its subsidiary.

## FINANCIAL OVERVIEW

- Net interest income after provision for loan losses for the three months ended June 30, 2003 was $65.6 million compared to $63.1 million in the same period of 2002, an increase of $2.5 million or 3.90%. For the six months ended June 30, 2003, net interest income was $131.9 million compared to $124.2 million for the comparable period of 2002, an increase of $7.7 million or 6.18%. The increases in net interest income for the three months and six months continue to be primarily the result of increased loan volume compared to the prior year combined with AgFirst's ability to call significant amounts of debt in a lower interest rate environment.
- Total assets at June 30, 2003 increased 5.1% compared to December 31, 2002. This increase was primarily attributed to increased loan and investment volume.
- Bonds and notes outstanding at June 30, 2003 increased in order to fund the additional loan and investment volume.
- Credit quality at June 30, 2003 remained relatively stable during the second quarter of 2003.

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

## FINANCIAL CONDITION

*Loan Portfolio*

Gross loan volume at June 30, 2003 was $12.2 billion, a 1.39% increase compared to the volume of $12.0 billion at December 31, 2002, and a 6.39% increase compared to the volume of $11.4 billion at June 30, 2002. Year-over-year growth in the direct note portfolio continued at a robust pace, but was somewhat offset by bulk sales of rural home loans to Fannie Mae, a reduced level of usage of committed credit facilities in the capital markets portfolio, and increased sold participation loan volume. The relatively modest increase compared to December 31, 2002 was due largely to a surge in lending activity around fiscal year-end, which is considered normal in the industry and largely the result of borrower tax management activities. The reduced level of usage of committed credit facilities is primarily attributed to the generally sluggish economy.

The allowance for loan losses at June 30, 2003 of $33.9 million is .28% of total gross loan volume and 2.52% of AgFirst's participation volume. By comparison, the allowance as a percent of participation volume was 1.93% at December 31, 2002. The increase in the percentage is largely due to a decrease in participations outstanding and a $2.5 million provision for loan loss recorded in the first quarter. Management considers this allowance to be adequate to absorb potential losses on existing loans.

Overall credit quality in the AgFirst portfolio at June 30, 2003 improved slightly as compared to December 31, 2002 while declining when compared to June 30, 2002. Nonaccrual loan assets in the AgFirst loan portfolio at June 30, 2003 decreased to $15.6 million compared to $23.6 million at December 31, 2002, and increased from $11.4 million as of June 30, 2002. During the third quarter of 2002, a $24.0 million farm related business loan was classified as nonaccrual, and has now paid down to $13.7 million as of June 30, 2003. This was offset by a charge-off of $2.2 million related to a marketing and processing loan and a pay-off of a $6.2 million telecommunication loan.

Although overall credit quality improved slightly compared to December 31, 2002, adversity in certain discrete sectors of AgFirst's participation portfolio remains a concern.

*Liquidity and Funding Sources*

As of June 30, 2003, AgFirst exceeded the minimum permanent capital, core surplus, total surplus and net collateral ratio requirements under the Farm Credit Administration Regulations. At June 30, 2003, AgFirst's permanent capital ratio was 21.50%, core surplus was 12.74%, total surplus was 21.30%, and net collateral was 106.37%.

Cash and investment securities totaled $3.1 billion or 20.29% of total assets compared to $2.5 billion or 17.09% of total assets at December 31, 2002. "Liquidity Coverage," as defined in AgFirst's liquidity policy, was 165 Days.

Interest-bearing liabilities, consisting of bonds and notes, increased by $798.6 million, or 5.90%, at June 30, 2003, compared to bonds and notes outstanding at December 31, 2002. Interest-bearing liabilities increased primarily due to the increase in loan and investment volume previously mentioned.

*Capital Resources*

Total shareholders' equity increased $82.9 million from December 31, 2002 to June 30, 2003. This 10.95% net increase is the result of an increase of $96.7 million in retained earnings related to net income, which was partially offset by paid dividends for preferred stock of $9.4 million, $4.0 million related to accumulated other comprehensive income and a $361,000 decrease related to net stock issuance/retirement.

***Key financial condition comparisons:***

| | **6/30/03** | **12/31/02** |
|---|---|---|
| Shareholders' Equity to Assets | 5.42% | 5.15% |
| Total Liabilities to Shareholders' Equity | 17.17:1 | 18.13:1 |
| Allowance for Loan Losses to Loans | .28% | .26% |

## RESULTS OF OPERATIONS

*Net Interest Income*

Net interest income for the three months ended June 30, 2003 was $65.6 million compared to $63.1 million in the same period of 2002, an increase of $2.5 million or 3.90%. For the six months ended June 30, 2003, net interest income was $131.9 million compared to $124.2 million for the comparable period of 2002, an increase of $7.7 million or 6.18%. The increases in net interest income for the three months and six months continue to be primarily the result of increased loan volume compared to the prior year combined with AgFirst's ability to call significant amounts of debt in a lower interest rate environment.

*Noninterest Income*

Noninterest income decreased $2.0 million for the quarter ended June 30, 2003, and increased $2.5 million for the six months ended June 30, 2003, compared to the same periods of 2002. The decrease for the quarter is mostly attributed to the $2.1 million realized gain related to the sale of rural home loans to Fannie Mae compared to $4.6 million for the second quarter of 2002. The year-to-date increase is primarily due to increases of $1.3 million in loan fee income related to participation loan activity, $900,000 in dividend income from other Farm Credit Institutions and $309,194 in realized gains related to the sale of rural home loans to Fannie Mae.

*Noninterest Expense*

Noninterest expense for the three and six months ended June 30, 2003 was $25.0 million and $45.3 million, respectively, an increase of $7.1 million and $7.5 million, respectively, as compared to the corresponding periods in 2002. The three-month increase was primarily attributed to the $3.0 million write-down of mortgage servicing rights to reflect the current market value and increases of $2.7 million in expenses related to called debt and $1.8 million in financial assistance expense. The six-month increase was primarily attributed to the $3.0 million write-down of mortgage servicing rights to reflect the current market value, increases of $6.3 million in expenses related to called debt and $1.7 million in financial assistance expense. These increases were offset by the $3.0 million positive variance in net realized losses on investments recorded in 2002 of $2.8 million compared to recoveries of $200,152 recorded in 2003.

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

| | Annualized for the six months ended 6/30/03 | For the year ended 12/31/02 |
|---|---|---|
| Return on Average Assets | 1.31% | 1.43% |
| Return on Average Shareholders' Equity | 23.99% | 23.75% |
| Net Interest Income as a Percentage of Average Earning Assets | 1.81% | 1.91% |

# Consolidated Balance Sheets

| (dollars in thousands) | June 30, 2003 | December 31, 2002 |
|---|---|---|
| | (unaudited) | |
| **Assets** | | |
| Cash and cash equivalents | $ 361,171 | $ 359,819 |
| Investment securities | 2,781,964 | 2,153,118 |
| Loans | 12,174,897 | 12,008,041 |
| Less: allowance for loan losses | 33,852 | 31,155 |
| Net loans | 12,141,045 | 11,976,886 |
| Accrued interest receivable | 47,365 | 50,470 |
| Investments in other Farm Credit System institutions | 78,248 | 78,251 |
| Premises and equipment, net | 21,228 | 18,722 |
| Other assets | 56,728 | 63,924 |
| Total assets | $ 15,487,749 | $ 14,701,190 |
| **Liabilities** | | |
| Bonds and notes | $ 14,337,143 | $ 13,538,536 |
| Accrued interest payable | 32,999 | 43,732 |
| Patronage distribution payable | — | 85,477 |
| Postretirement benefits other than pensions | 11,299 | 10,512 |
| Minimum pension liability | 9,469 | 10,449 |
| Other liabilities | 31,259 | 29,800 |
| Total liabilities | 14,422,169 | 13,718,506 |
| Commitments and contingencies | | |
| **Preferred Stock** | 225,839 | 225,839 |
| **Shareholders' Equity** | | |
| Capital stock and participation certificates | 249,083 | 249,444 |
| Retained earnings | 614,969 | 527,673 |
| Accumulated other comprehensive income | (24,311) | (20,272) |
| Total shareholders' equity | 839,741 | 756,845 |
| Total liabilities and equity | $ 15,487,749 | $ 14,701,190 |

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

# Consolidated Statements of Income

*(unaudited)*

| *(dollars in thousands)* | For the three months ended June 30, 2003 | For the three months ended June 30, 2002 | For the six months ended June 30, 2003 | For the six months ended June 30, 2002 |
|---|---|---|---|---|
| **Interest Income** | | | | |
| Investment securities and other | $ 15,365 | $ 16,313 | $ 31,442 | $ 33,012 |
| Loans | 119,477 | 139,960 | 240,768 | 279,075 |
| Total interest income | 134,842 | 156,273 | 272,210 | 312,087 |
| **Interest Expense** | 69,279 | 93,169 | 140,327 | 187,875 |
| Net interest income | 65,563 | 63,104 | 131,883 | 124,212 |
| Provision for loan losses | — | 1,000 | 2,500 | 2,000 |
| Net interest income after provision for loan losses | 65,563 | 62,104 | 129,383 | 122,212 |
| **Noninterest Income** | | | | |
| Loan fees | 2,330 | 2,098 | 6,175 | 4,923 |
| Gain on sale of rural home loans | 2,089 | 4,597 | 4,910 | 4,601 |
| Miscellaneous | 579 | 265 | 1,563 | 610 |
| Total noninterest income | 4,998 | 6,960 | 12,648 | 10,134 |
| **Noninterest Expenses** | | | | |
| Salaries and employee benefits | 5,494 | 5,283 | 11,217 | 10,431 |
| Occupancy and equipment | 1,841 | 1,972 | 3,882 | 3,793 |
| Other operating expenses | 3,780 | 4,586 | 7,248 | 8,204 |
| Intra-System financial assistance expenses | 5,442 | 3,688 | 9,293 | 7,584 |
| Realized losses (gains) on investments, net | (86) | (635) | (200) | 2,788 |
| Called debt expense | 5,201 | 2,516 | 10,164 | 3,911 |
| Impairment of servicing assets | 3,000 | — | 3,000 | — |
| Miscellaneous | 307 | 511 | 688 | 1,032 |
| Total noninterest expenses | 24,979 | 17,921 | 45,292 | 37,743 |
| Net income | $ 45,582 | $ 51,143 | $ 96,739 | $ 94,603 |

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

# Consolidated Statements of Changes in Shareholders' Equity

*(unaudited)*

| *(dollars in thousands)* | Preferred Stock | Capital Stock and Participation Certificates | Retained Earnings | Accumulated Other Comprehensive Income | Total Shareholders' Equity |
|---|---|---|---|---|---|
| Balance at December 31, 2001 | $ 225,839 | $ 281,803 | $ 439,104 | $ 7,041 | $ 953,787 |
| Comprehensive income | | | | | |
| Net income | | | 94,603 | | 94,603 |
| Unrealized gains (losses) on investments available for sale, net of reclassification adjustments | | | | 9,216 | 9,216 |
| Change in fair value of derivative instruments | | | | (6,431) | (6,431) |
| Total comprehensive income | | | | | 97,388 |
| Capital stock/participation certificates issued/retired, net | | (2,358) | | | (2,358) |
| Preferred stock dividends accrued | 9,443 | | (9,443) | | — |
| Preferred stock dividends paid | (9,443) | | | | (9,443) |
| Balance at June 30, 2002 | $ 225,839 | $ 279,445 | $ 524,264 | $ 9,826 | $1,039,374 |
| Balance at December 31, 2002 | $ 225,839 | $ 249,444 | $ 527,673 | $ (20,272) | $ 982,684 |
| Comprehensive income | | | | | |
| Net income | | | 96,739 | | 96,739 |
| Unrealized gains (losses) on investments available for sale, net of reclassification adjustments | | | | (847) | (847) |
| Change in fair value of derivative instruments | | | | (3,192) | (3,192) |
| Total comprehensive income | | | | | 92,700 |
| Capital stock/participation certificates issued/retired, net | | (361) | | | (361) |
| Preferred stock dividends accrued | 9,443 | | (9,443) | | — |
| Preferred stock dividends paid | (9,443) | | | | (9,443) |
| Balance at June 30, 2003 | $ 225,839 | $ 249,083 | $ 614,969 | $ (24,311) | $1,065,580 |

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

# Consolidated Statements of Cash Flows

*(unaudited)*

| *(dollars in thousands)* | For the six months ended June 30, 2003 | 2002 |
|---|---|---|
| **Cash flows from operating activities:** | | |
| Net income | $ 96,739 | $ 94,603 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation on premises and equipment | 2,449 | 2,051 |
| Provision for loan losses | 2,500 | 2,000 |
| Realized (gains) losses on investments, net | (200) | 2,788 |
| Changes in operating assets and liabilities: | | |
| (Increase) decrease in accrued interest receivable | 3,105 | 1,607 |
| (Increase) decrease in investments in other Farm Credit System institutions | 3 | 46 |
| (Increase) decrease in other assets | 7,196 | (3,631) |
| Increase (decrease) in accrued interest payable | (10,733) | (3,786) |
| Increase (decrease) in other liabilities | 1,266 | (1,570) |
| Total adjustments | 5,586 | (495) |
| Net cash provided by (used in) operating activities | 102,325 | 94,108 |
| **Cash flows from investing activities:** | | |
| Investment securities purchased | (2,292,399) | (1,088,140) |
| Investment securities sold or matured | 1,662,906 | 1,175,998 |
| Net (increase) decrease in loans | (166,659) | (314,776) |
| Purchase of premises and equipment, net | (4,955) | (3,400) |
| Net cash provided by (used in) investing activities | (801,107) | (230,318) |
| **Cash flows from financing activities:** | | |
| Bonds and notes issued | 31,463,028 | 24,022,415 |
| Bonds and notes retired | (30,667,613) | (23,718,200) |
| Capital stock and participation certificates issued/retired, net | (361) | (2,358) |
| Patronage refunds and dividends paid | (85,477) | 67,786 |
| Dividends paid on preferred stock | (9,443) | (9,443) |
| Net cash provided by (used in) financing activities | 700,134 | 360,200 |
| Net increase (decrease) in cash and cash equivalents | 1,352 | 223,990 |
| Cash and cash equivalents, beginning of period | 359,819 | 265,254 |
| Cash and cash equivalents, end of period | $ 361,171 | $ 489,244 |
| **Non-cash changes related to hedging activities:** | | |
| Decrease (increase) in loans | $ (2,005) | $ (1,144) |
| Increase (decrease) in bonds and notes | 4,038 | (9,332) |
| Decrease (increase) in other assets | (3,872) | 9,704 |
| Increase (decrease) in other liabilities | (1,199) | (249) |
| **Supplemental information:** | | |
| Interest paid | $ 151,060 | $ 191,661 |

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

# Notes to the Consolidated Financial Statements

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

## NOTE 1 — ORGANIZATION AND SIGNIFICANT ACCOUNTING POLICIES

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

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

In May 2003, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 150, *"Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity"* (SFAS No. 150 or the Statement). The Statement requires that certain instruments having characteristics of both liabilities and equity be classified as liabilities effective July 1, 2003. The Statement is to be implemented by reporting the cumulative effect of a change in accounting principle for financial instruments created before the issue date of the Statement and still existing at the beginning of the interim period of adoption. Restatement is not permitted.

Prior to the implementation of SFAS No. 150, the mandatorily redeemable preferred stock issued by AgFirst in May 2001 in the amount of $225 million (225,000 shares) was classified as mezzanine equity (between the liability section and the equity section of the financial statement of position) and was considered to be a component of capital for certain regulatory ratios. The dividends accrued and paid on the preferred stock were charged directly to unallocated surplus. Effective July 1, 2003, the preferred stock will be reclassified as a liability and dividends will be recorded in interest expense prospectively. However, it will continue to be treated as a component of capital in the Bank's regulatory ratios.

The accompanying consolidated financial statements contain all adjustments necessary for a fair presentation of the interim financial condition and results of operations and conform with accounting principles generally accepted in the United States of America (GAAP). The results for the six months ended June 30, 2003 are not necessarily indicative of the results to be expected for the year ending December 31, 2003.

The Bank maintains an allowance for loan losses in accordance with GAAP. The loan portfolio is reviewed quarterly to determine the adequacy of the allowance for losses. As of June 30, 2003, the allowance for losses was adequate in management's opinion to provide for possible losses on existing loans.

**NOTE 2 — ALLOWANCE FOR LOAN LOSSES**

An analysis of the allowance for loan losses follows:

| | |
|---|---|
| Balance at 12-31-01 | $ 25,616 |
| Provision for loan losses | 2,000 |
| Loans (charged off), net of recoveries | (227) |
| Balance at 6-30-02 | $ 27,389 |
| | |
| Balance at 12-31-02 | $ 31,155 |
| Provision for loan losses | 2,500 |
| Recoveries, net of loans charged off | 197 |
| Balance at 6-30-03 | $ 33,852 |

**NOTE 3 — COMMITMENTS AND CONTINGENT LIABILITIES**

Under the Farm Credit Act of 1971, each System bank is primarily liable for its portion of Systemwide bond and discount note obligations. Additionally, the banks are contingently liable for the Systemwide obligations of the System banks. The total consolidated Systemwide debt securities of the System were $92.2 billion at June 30, 2003.