



2013 SECOND QUARTER REPORT  
FARM CREDIT BANK OF TEXAS

JUNE 30, 2013

## ***SECOND QUARTER 2013***

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

*(dollars in thousands, except as noted)*

The following discussion reviews the financial condition and results of operations of the Farm Credit Bank of Texas (bank) for the three and six months ended June 30, 2013. These comments should be read in conjunction with the accompanying financial statements and footnotes, along with the 2012 Annual Report to shareholders. The accompanying financial statements were prepared under the oversight of the bank's audit committee.

The bank is a member of the Farm Credit System (System), a nationwide network of cooperatively owned financial institutions established by and subject to the provisions of the Farm Credit Act of 1971, as amended, and the regulations of the Farm Credit Administration (FCA) promulgated thereunder.

The United States is currently served by three Farm Credit Banks (FCBs), each of which has specific regional lending authority within a chartered territory (or district), and by one Agricultural Credit Bank (ACB), which has the lending authority of an FCB within its chartered territory and limited nationwide lending authority. The FCBs and the ACB are collectively referred to as "System banks." The primary purpose of the System banks is to serve as a source of funding for System associations within their districts. The System associations make loans to or for the benefit of eligible borrowers for qualified purposes.

The bank and its affiliated associations collectively are referred to as the district. At June 30, 2013, the bank provided financing to 17 district associations and certain other financing institutions.

On July 23, 2013, the bank issued \$300.0 million of Class B noncumulative subordinated perpetual preferred stock, Series 2 (Class B-2 preferred stock), representing three million shares at \$100 per share par value for net proceeds of \$296.3 million. Dividends on the preferred stock, if declared by the board of directors at its sole discretion, are noncumulative and are payable quarterly in arrears on the fifteenth day of March, June, September and December in each year, commencing September 15, 2013, at an annual fixed rate of 6.75 percent of par value of \$100 per share up to, but excluding September 15, 2023, from and after which date will pay at an annual rate of the 3-Month USD LIBOR plus 4.01 percent. The Class B-2 preferred stock is not mandatorily redeemable at any time, but may be redeemed in whole or in part at the option of the bank on any dividend payment date on or after September 15, 2023. The Class B-2 preferred stock ranks junior, both as to dividends and upon liquidation to the bank's Class A preferred stock, *pari passu* with respect to the existing Class B-1 preferred stock, and senior to all of the bank's outstanding capital stock. For regulatory purposes, the Class B-2 preferred stock is included in permanent capital, total surplus and core surplus within certain limitations. The net proceeds of the issuance are intended to be used to redeem existing Class A preferred stock, to increase the bank's capital and for general corporate purposes.

### **RESULTS OF OPERATIONS**

#### *Net Income*

Net income for the quarter ended June 30, 2013, was \$42,601, a decrease of \$11,690, or 21.5 percent, over the same period of 2012. The \$11,690 decrease in net income for the second quarter of 2013 consisted of a \$9,236 decrease in noninterest income, a \$2,955 increase in noninterest expense, and a \$1,431 decrease in net interest income, offset by a \$1,932 decrease in provision for credit losses.

Net income for the six months ended June 30, 2013, was \$96,373, an increase of \$7,857, or 8.9 percent, over the same period of 2012. The increase in net income for the six months ended June 30, 2013,

consisted of a \$15,617 decrease in provision for credit losses, offset by a \$3,945 increase in noninterest expense, a \$2,831 decrease in noninterest income and a \$984 decrease in net interest income.

#### *Net Interest Income*

Net interest income for the three months ended June 30, 2013, was \$54,500, a decrease of \$1,431, or 2.6 percent, from the three months ended June 30, 2012. The decrease in net interest income for the quarter ended June 30, 2013, was attributable to an 11-basis-point decrease in the bank's interest rate spread to 140 basis points, offset by a volume increase of \$740.8 million in the bank's average earning assets. Effective interest rates on earning assets decreased 29 basis points from the second quarter of 2012 to the second quarter of 2013, while effective rates on interest-bearing liabilities decreased 18 basis points. The decrease in the interest rate spread is largely the result of retail borrowers' repricings and intensified competition in the participation loan market. The increase in the bank's average earning assets included increases in its participation loans, investments and direct loans to associations.

Net interest income for the six months ended June 30, 2013, was \$110,198, a decrease of \$984, or 0.9 percent, over the same period of 2012. The decrease in net interest income was attributable to a 9-basis-point decrease in the bank's interest rate spread to 144 basis points, offset by the effects of a volume increase of \$904.5 million in the bank's average earning assets. The interest rate spread decrease included a 34-basis-point decrease in the effective rate on earning assets, net of a 25-basis-point reduction in the effective rate on interest-bearing liabilities for the six months ended June 30, 2013, compared to the six months ended June 30, 2012. The effective rates on earning assets have decreased due to borrowers' repricings on loans in a lower-interest-rate environment over the last year and to intensified competition in the participation loan market. Also, there has been compression in interest rate spreads due to current conditions in the financial markets. The year-to-date increase in the bank's average earning assets included an increase in its participation loans, investment portfolio and direct notes from associations. Interest expense for the first six months of 2013 included a \$4,255 decrease in concession expenses recognized on callable debt related to a \$2.06 billion decrease in debt called in the first six months of 2013, compared to the same period in 2012. The bank called \$2.57 billion in debt in the six months ended June 30, 2013. The bank will benefit prospectively from calling debt and replacing it with lower cost debt; however, the benefit, due to the current low interest rate environment at the time of the debt calls, is expected to diminish over time.

#### *Provision for Credit Losses*

The bank's provision for credit losses for the quarter ended June 30, 2013, totaled \$4,250, a decrease of \$1,932 from the \$6,182 provision for the second quarter of 2012.

The bank's provision for credit losses for the six months ended June 30, 2013, totaled \$5,145, a decrease of \$15,617, or 75.2 percent, over the \$20,762 provision for the first six months of 2012. The provision for credit losses for the six months ended June 30, 2013, consisted primarily of specific provisions related to dairy, ethanol, land in transition, and a meat packing plant. The decreases in provision for credit losses for the quarter and six months ended June 30, 2013, from the same period of 2012 resulted primarily from stabilization of collateral valuations or borrower financial performance.

#### *Noninterest Income*

Noninterest income for the quarter ended June 30, 2013, was \$10,197, a decrease of \$9,236, or 47.5 percent, over the same period of 2012. The decrease for the second quarter of 2013 over the same period of 2012 was due mainly to a \$9,820 decrease in Farm Credit System Insurance Corporation (FCSIC) refund distributions in Insurance Fund reserves in excess of its secure base amount and a \$2,424 decrease in fair value on loans purchased in the secondary market, offset by a \$602 increase in loan-related fee

income, a \$286 increase in patronage income, a \$245 increase in services billed to associations, and a \$1,875 increase in all other noninterest income elements which includes a \$1,902 increase in net gains on the sale of loans. The bank has elected a fair value option for financial presentation purposes on certain loans purchased on the secondary market at a significant premium. The fair value option provides an irrevocable option to elect fair value as an alternative measurement for selected financial instruments. As discussed in the “Investments” section of this Management’s Discussion and Analysis, the bank performs other-than-temporary impairment (OTTI) assessments on investment securities based on evaluations of both current and future market and credit conditions at each quarter end. During the second quarter of 2013, the bank recorded no credit losses for OTTI purposes; there were no credit losses recognized in the same period of 2012.

Noninterest income for the six months ended June 30, 2013, was \$25,949, a decrease of \$2,831, or 9.8 percent, over the same period of 2012. The decrease was due mainly to a \$9,820 decrease in refunds from FCSIC related to reserves in excess of their required secure base amount, a \$1,847 decrease in fair value on loans previously purchased in the secondary market, and \$142 increase in credit losses realized on OTTI investment securities, offset by a \$6,120 increase in loan-related fee income, a \$570 increase in patronage income, a \$416 increase in services billed to associations, and a \$1,872 increase in all other income items, collectively, which includes a \$1,902 increase in net gains on the sale of loans. The increase in loan-related fee income is primarily due to a \$6.0 million prepayment fee on one large loan. The \$142 increase in credit losses recognized on other-than-temporarily impaired investments reflects the difference between the credit losses of \$1 and the credit loss of \$143 recognized during the six months ended June 30, 2012 and 2013, respectively. In March 2013, one of the OTTI investments with a book value of \$5,145 was sold, realizing a loss of \$143.

#### *Noninterest Expense*

Noninterest expense for the three months ended June 30, 2013, was \$17,846, an increase of \$2,955, or 19.8 percent, over the same period of 2012. The increase was attributable to a \$1,431 increase in other operating expenses, an \$830 increase in premiums assessed by the FCSIC, a \$441 increase in occupancy and equipment expenses, a \$247 increase in salaries and employee benefits, and a \$6 increase in losses on other property owned (OPO). The increase in other operating expenses included a \$1,257 increase in professional and contract services. Premiums to the FCSIC increased as a result of the rate increase from 5 basis points in 2012 to 10 basis points in 2013 and an increase in debt required to fund earning assets. The increase in occupancy and equipment included a \$381 increase in computer expenses, which included a \$51 increase in software maintenance and a \$330 increase in depreciation.

Noninterest expense for the six months ended June 30, 2013, was \$34,629, an increase of \$3,945, or 12.9 percent, over the same period of 2012. The increase was attributable to a \$2,306 increase in other operating expenses, a \$1,657 increase in premiums assessed by the FCSIC, an \$877 increase in occupancy and equipment expenses, and a \$796 increase in salaries and employee benefits, offset by a \$1,691 decrease in losses on OPO. The increase in other operating expenses included a \$1,934 increase in professional and contract services. Premiums to the FCSIC increased as a result of the rate increase from 5 basis points in 2012 to 10 basis points in 2013 and an increase in debt required to fund earning assets. The increase in occupancy and equipment included an \$802 increase in computer expenses, which included a \$292 increase in software maintenance and a \$510 increase in depreciation. The \$796 increase in salaries and benefits included a \$535 increase in compensation and related payroll taxes and a \$208 increase in retirement benefits. The decrease in losses on OPO included a \$1,246 decrease in provision for losses on OPO, a \$382 increase in net gains on disposition of OPO, and a \$63 decrease in net expenses on OPO.

**Key results of operations comparisons:**

	<b>Annualized for the Six Months Ended 6/30/2013</b>	Annualized for the Six Months Ended 6/30/2012
Return on average assets	<b>1.26%</b>	1.23%
Return on average shareholders' equity	<b>14.75%</b>	14.21%
Net interest income as a percentage of average earning assets	<b>1.50%</b>	1.61%
Charge-offs, net of recoveries, to average loans	<b>0.11%</b>	0.37%
Operating expenses as a percentage of net interest income and noninterest income	<b>24.83%</b>	20.13%
Operating expenses as a percentage of average earning assets	<b>0.46%</b>	0.41%

*Other Comprehensive Loss*

Other comprehensive loss consists of certain gains, losses or costs for which values are included in assets or liabilities on the balance sheets, but which have not yet been recognized in earnings. In the balance sheet, they are included in accumulated other comprehensive loss in the shareholders' equity section. For the bank, these elements include unrealized gains or losses on the bank's available-for-sale investment portfolio, elements of certain postretirement benefit changes, and changes in the value of cash flow derivative instruments.

The table below summarizes the changes in elements included in other comprehensive loss for the six months ended June 30:

	Six Months Ended June 30,	
	2013	2012
Change in unrealized gains on available-for-sale securities		
Net decrease in unrealized gains on investment securities	\$ (39,457)	\$ (3,366)
Decrease in noncredit portion of other-than-temporary impairment (OTTI) losses	970	1,665
Reclassification adjustment for OTTI credit losses included in net income	143	1
Net increase in unrealized losses on securities	(38,344)	(1,700)
Change in postretirement benefit plans		
Amounts amortized into net periodic expense:		
Amortization of prior service credits	(96)	(118)
Amortization of net losses	9	-
Net change in postretirement benefit plans	(87)	(118)
Change in cash flow derivative instruments		
Gains (losses) on interest rate caps	393	(892)
Reclassification of loss recognized in interest expense	627	169
Net change in cash flow derivative instruments	1,020	(723)
Other comprehensive loss	\$ (37,411)	\$ (2,541)

## FINANCIAL CONDITION

### *Loan Portfolio*

Gross loan volume at June 30, 2013, was \$11,358,012, an increase of \$19,182, or 0.2 percent, compared to \$11,338,830 at December 31, 2012. The increase in the loan portfolio is attributable to growth in the bank's participation loan portfolio, offset by a slight decrease in the bank's direct loans to associations.

During the second quarter of 2013, the bank sold participations of \$250.0 million in direct notes of district associations and \$23.1 million in direct notes from other financing institutions (OFIs) to another System Bank. The sales provided diversification benefits between Farm Credit entities.

In 2011 and 2012, the bank purchased \$20,653 in loan participations from a district association in Capitalized Participation Pool (CPP) transactions. As a condition of the transactions, the bank redeemed stock in the amount of 2.0 percent of the par value of the loans purchased, and the association bought bank stock equal to 8.0 percent of the purchased loans' par value. CPP loans held at June 30, 2013, totaled \$10,830.

Loans classified under the Farm Credit Administration's Uniform Loan Classification System as "acceptable" or "other assets especially mentioned" were 97.7 percent of total loans and accrued interest at June 30, 2013, compared to 97.5 percent at December 31, 2012. The increase included the effects of high-quality loans added to the bank's participation loan portfolio.

The table below summarizes the balances of the bank's high-risk assets at June 30, 2013, compared to the balances at December 31, 2012:

	<b>June 30, 2013</b>	Increase (Decrease)		<b>December 31, 2012</b>
		\$	%	
Nonaccrual loans	<b>\$ 44,528</b>	\$ (19,169)	(30.09) %	\$ 63,697
Formally restructured loans	<b>9,681</b>	(2,320)	(19.33)	12,001
Total impaired loans	<b>54,209</b>	(21,489)	(28.39)	75,698
Other property owned, net	<b>18,036</b>	(12,703)	(41.33)	30,739
Total high-risk assets	<b><u>\$ 72,245</u></b>	<b><u>\$ (34,192)</u></b>	<b><u>(32.12) %</u></b>	<b><u>\$ 106,437</u></b>

The decrease in nonaccrual loans (including significant decreases in the timber tracts, meat packing plants, and radiotelephone communications, offset by an increase in the dairy sector), was due mainly to repayments of \$29,535, net charge-offs of \$6,452, reinstatements to accrual status of \$2,574, and transfers to other property owned (OPO) of \$2,277, net of \$21,683 in transfers to and advances on nonaccrual loans. During the six months ended June 30, 2013, the bank recorded charge-offs totaling \$6.7 million against the allowance for loan losses due to known losses on loans in the meat packing plants and ethanol sectors. At June 30, 2013, \$21.2 million, or 47.6 percent, of the bank's nonaccrual loans were considered current as to principal and interest. Continued satisfactory payment performance on these loans may indicate potential for a return to accrual status. At June 30, 2013, the bank had \$3.7 million in nonaccrual loans on which cash payments are recognized as interest income, compared to \$26.8 million at December 31, 2012. The decrease in formally restructured loans was primarily due to \$2.4 million in loans related to one borrower moving to nonaccrual status. The decrease in other property owned included a \$12,143 net decrease in real estate properties held, and a \$560 increase in the allowance for losses on other property owned. The decrease in properties held resulted primarily from the disposal of three properties totaling \$14,023, with a net gain of \$264 on disposition, offset by the addition of two properties totaling \$2,143. The bank had no loans 90 days or more past due and still accruing interest at June 30, 2013, or December 31, 2012.

Impaired loans, consisting of nonaccrual loans and formally restructured loans, and loans 90 days past due and still accruing interest, constituted 0.5 percent of gross loans at June 30, 2013, and 0.7 percent of gross loans at December 31, 2012.

At June 30, 2013, the bank had reserves for credit losses totaling \$21,551, including an allowance for loan losses of \$17,641 and a reserve for losses on unfunded commitments of \$3,910. The allowance for loan losses of \$17,641 equated to 0.16 percent of total loans outstanding and 0.4 percent of participation loans outstanding. The \$3,910 reserve for losses on unfunded commitments included a general reserve for losses on letters of credit and a specific reserve related to a letter of credit, representing management's estimate of probable credit losses related to letters of credit.

The allowance for loan losses as a percentage of impaired loans was 32.5 percent as of June 30, 2013, as compared to 22.8 percent as of December 31, 2012. The nature of the collateral (primarily first lien real estate) supporting many of the impaired loans is considered in the determination of necessary allowances for loan losses.

#### *Liquidity and Funding Sources*

Cash and investment securities totaled \$3,866,981, or 25.1 percent, of total assets at June 30, 2013, compared to \$3,872,858, or 25.2 percent, at December 31, 2012, a decrease of \$5,877, or 0.2 percent. At June 30, 2013, the bank's cash balance was \$374,588, a \$127,654 decrease from December 31, 2012. Cash held at the Federal Reserve Bank at June 30, 2013, totaled \$360,967, compared to \$462,282 at December 31, 2012. Levels of cash and other highly liquid assets are maintained to meet loan demand,

debt servicing and other liquidity needs. At June 30, 2013, the bank had 284 days of liquidity to cover maturing debt obligations. In June 2013, the bank implemented FCA's final rule, effective June 12, 2013, regarding liquidity reserve requirements for Farm Credit System banks (see the Regulatory Matters section of this Management's Discussion and Analysis). Interest-bearing liabilities, consisting of bonds, notes and subordinated debt, increased by \$19,215, or 0.1 percent, from December 31, 2012, to June 30, 2013.

### *Investments*

The bank's investments are all considered available for sale, and include a liquidity portfolio and a portfolio of other investments. The liquidity portfolio had a fair value of \$3.36 billion at June 30, 2013, and consisted primarily of federal agency collateralized mortgage-backed securities, corporate debt, agency-guaranteed debt, other collateralized mortgage-backed securities and asset-backed securities. The bank's other investments, totaling \$105.6 million, consisted of Federal Agricultural Mortgage Corporation (Farmer Mac) guaranteed agricultural mortgage-backed securities (AMBS) purchased from district associations. The Farmer Mac securities are backed by loans originated by the associations and previously held by the associations under the Farmer Mac long-term standby commitment to purchase agreements.

Farmer Mac is a government-sponsored enterprise and is examined and regulated by FCA. It provides a secondary market for agricultural and rural home mortgage loans that meet certain underwriting standards. Farmer Mac is authorized to provide loan guarantees and to be a direct pooler of agricultural mortgage loans. Farmer Mac is owned by both System and non-System investors, and its board of directors has both System and non-System representation. Farmer Mac is not liable for any debt or obligation of any System institution, and no System institution other than Farmer Mac is liable for any debt or obligation of Farmer Mac.

The majority of the bank's mortgage-backed securities were guaranteed federal agency collateralized mortgage-backed securities, including Government National Mortgage Association (GNMA), Federal National Mortgage Association (FNMA) and Federal Home Loan Mortgage Corporation (FHLMC) securities. The following table summarizes the bank's liquidity portfolio holdings:

	<b>June 30, 2013</b>		December 31, 2012	
	<u>Amortized Cost</u>	<u>Fair Value</u>	<u>Amortized Cost</u>	<u>Fair Value</u>
Agency-guaranteed debt	\$ 114,593	\$ 110,368	\$ 65,811	\$ 65,766
Corporate debt	256,430	255,530	208,360	208,622
Federal agency collateralized mortgage-backed securities:				
GNMA	1,594,835	1,600,404	1,593,563	1,615,008
FNMA and FHLMC	1,344,061	1,344,295	1,281,140	1,297,535
Other collateralized mortgage-backed securities	20,557	19,883	28,082	26,938
Asset-backed securities	34,083	33,802	17,852	17,131
Total available-for-sale investments	<u>\$ 3,364,559</u>	<u>\$ 3,364,282</u>	<u>\$ 3,194,808</u>	<u>\$ 3,231,000</u>

The bank's other investments portfolio consisted of Farmer Mac AMBS securities as follows:

	<b>June 30, 2013</b>		December 31, 2012	
	<u>Amortized Cost</u>	<u>Fair Value</u>	<u>Amortized Cost</u>	<u>Fair Value</u>
Agricultural mortgage-backed securities	\$ 109,585	\$ 105,622	\$ 117,567	\$ 115,479

Federal agency collateralized mortgage-backed securities comprised 87.5 percent of the bank's liquidity portfolio at June 30, 2013. The increase in corporate debt was due to purchases of \$48.0 million in par value during 2013.

During the six months ended June 30, 2013, there was a decrease in unrealized gains on investments totaling \$38,344, due primarily to recent changes in the interest rate environment.

At June 30, 2013, the bank had two mortgage-backed securities (MBS) and two ABS that were considered other-than-temporarily impaired (OTTI). During the six months ended June 30, 2013, there was a credit loss of \$143 on one OTTI investment associated with a sale of that security in March of 2013. The non-credit-related unrealized losses on the bank's other-than-temporarily impaired investments, totaling \$434, is included in accumulated other comprehensive loss. The bank performs other-than-temporary impairment assessments on investment securities based on evaluations of both current and future market and credit conditions at each quarter end. The process for evaluation of impairment of investments is more fully discussed in Note 2, "Investments."

FCA regulations define eligible investments by specifying credit rating criteria, final maturity limit, percentage of investment portfolio limit and certain other requirements for each investment type. At the time the investments are purchased, they must be highly rated by at least one Nationally Recognized Statistical Rating Organization (NRSRO), such as Moody's Investors Service, Standard & Poor's or Fitch Ratings. U.S. Treasury securities, U.S. agency securities and other obligations fully insured or guaranteed by the U.S. government, its agencies, instrumentalities and corporations are considered eligible investments under the FCA's regulations, even if downgraded. Under the regulations, these investments have no final maturity limit, no credit rating requirement by NRSROs, no investment portfolio limit or other requirements. If an investment no longer meets the credit rating criteria, the investment becomes ineligible. To date, the FCA has not required disposition of any of these securities. While these investments do not meet the FCA's standards for liquidity, they are included in the net collateral calculation at the lower of market or book value.

At June 30, 2013, the bank held 11 investments that were ineligible for liquidity purposes by FCA regulations, due to credit ratings that were below AAA rating by all NRSROs. Those ineligible securities had an amortized cost basis of \$23,959 and a fair value of \$23,078 at June 30, 2013.

The following table sets forth the bank's portfolio of liquidity investments at fair value by credit rating:

	Eligible				Ineligible						Total
	AAA/Aaa	AA/Aa	F1/P1/A1	Split Rated	AA/Aa	A/A	BBB/Baa	B/B	CCC/Caa	CC/Ca	
<b>June 30, 2013</b>											
Agency guaranteed debt	\$ -	\$ -	\$ -	\$ 110,368	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 110,368
Corporate debt	-	116,037	25,012	114,481	-	-	-	-	-	-	255,530
Federal agency collateralized mortgage-backed securities*											
GNMA	-	-	-	1,600,404	-	-	-	-	-	-	1,600,404
FNMA and FHLMC	-	-	-	1,344,295	-	-	-	-	-	-	1,344,295
Other collateralized mortgage-backed securities	-	-	-	-	2,832	-	5,442	7,942	1,331	2,336	19,883
Asset-backed securities	30,607	-	-	-	-	1,095	-	-	2,100	-	33,802
<b>Total</b>	<b>\$ 30,607</b>	<b>\$ 116,037</b>	<b>\$ 25,012</b>	<b>\$ 3,169,548</b>	<b>\$ 2,832</b>	<b>\$ 1,095</b>	<b>\$ 5,442</b>	<b>\$ 7,942</b>	<b>\$ 3,431</b>	<b>\$ 2,336</b>	<b>\$ 3,364,282</b>
<b>December 31, 2012</b>											
Agency guaranteed debt	\$ -	\$ -	\$ -	\$ 65,766	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 65,766
Corporate debt	-	101,448	25,018	82,156	-	-	-	-	-	-	208,622
Federal agency collateralized mortgage-backed securities*											
GNMA	-	-	-	1,615,008	-	-	-	-	-	-	1,615,008
FNMA and FHLMC	-	-	-	1,297,535	-	-	-	-	-	-	1,297,535
Other collateralized mortgage-backed securities	-	-	-	-	3,371	320	5,749	8,817	6,199	2,482	26,938
Asset-backed securities	8,291	-	5,743	1,384	-	-	-	-	1,713	-	17,131
<b>Total</b>	<b>\$ 8,291</b>	<b>\$ 101,448</b>	<b>\$ 30,761</b>	<b>\$ 3,061,849</b>	<b>\$ 3,371</b>	<b>\$ 320</b>	<b>\$ 5,749</b>	<b>\$ 8,817</b>	<b>\$ 7,912</b>	<b>\$ 2,482</b>	<b>\$ 3,231,000</b>

\*Due to credit rating actions in 2011 which downgraded the credit rating of the U.S. government from "AAA" to "AA+" and also lowered the long-term credit ratings of government-sponsored enterprises due to the potential reduction in the capacity of the U.S. government to support these securities, these investments were reported as eligible split-rated investments.

### Capital Resources

At June 30, 2013, the bank had \$482.0 million in preferred stock outstanding, consisting of \$182.0 million in Class A cumulative perpetual preferred stock and \$300.0 million of Class B noncumulative subordinated perpetual preferred stock.

At a special stockholders' meeting held on February 28, 2013, the bank's Class A common stockholders approved amendments to the bank's capitalization bylaws that increased the amount of preferred stock the bank is authorized to issue and have outstanding at any one time from \$500 million to \$1 billion and that provide greater flexibility in determining the par value of such stock. At the same time, the Class A common stockholders also approved an Omnibus Approval of Preferred Stock Revolver that allows the bank to issue up to \$1 billion of preferred stock outstanding at any time for a period of 10 years. On July 23, 2013, the bank issued \$300.0 million of Class B noncumulative subordinated perpetual preferred stock, Series 2 (Class B-2 preferred stock), representing three million shares at \$100 per share par value for net proceeds of \$296.3 million. Dividends on the preferred stock, if declared by the board of directors at its sole discretion, are noncumulative and are payable quarterly in arrears on the fifteenth day of March, June, September and December in each year, commencing September 15, 2013, at an annual fixed rate of 6.75 percent of par value of \$100 per share up to, but excluding September 15, 2023, from and after which date will pay at an annual rate of the 3-Month USD LIBOR plus 4.01 percent. The Class B-2 preferred stock is not mandatorily redeemable at any time, but may be redeemed in whole or in part at the option of the bank on any dividend payment date on or after September 15, 2023. The Class B-2 preferred stock ranks junior, both as to dividends and upon liquidation to the bank's Class A preferred stock, pari passu with respect to the existing Class B-1 preferred stock, and senior to all of the bank's outstanding capital stock. For regulatory purposes, the Class B-2 preferred stock is included in permanent capital, total surplus and core surplus within certain limitations.

As of June 30, 2013, the bank exceeded the minimum permanent capital, core surplus, total surplus and net collateral ratio requirements under Farm Credit Administration regulations. At June 30, 2013, the bank's permanent capital ratio was 17.90 percent, core surplus was 9.71 percent, total surplus was 15.34 percent and the net collateral ratio was 108.42 percent. Shareholders' equity at June 30, 2013, totaled \$1,309,061, an increase of \$35,218 from December 31, 2012. This increase is the result of net income of \$96,373 for the six months ended June 30, 2013, offset by a \$37,411 decrease in accumulated other comprehensive income, dividends on preferred stock totaling \$21,881 and patronage paid of \$1,863, primarily on the associations' and OFIs' stock investment in the bank. Other comprehensive loss of \$37,411 included a decrease in unrealized gains on investments of \$38,344 and an \$87 amortization of other postretirement benefits, net of a \$1,020 decrease in unrealized losses on cash flow derivative instruments. The decrease in unrealized gains on investment securities was due primarily to recent changes in the interest rate environment and to potential adjustments in policies and initiatives of the Federal Reserve Board.

***Key financial condition comparisons:***

	<b>June 30, 2013</b>	<b>December 31, 2012</b>
Permanent capital ratio	<b>17.90%</b>	18.64%
Net collateral ratio	<b>108.42%</b>	107.94%
Allowance and reserve for credit losses to total loans	<b>0.19%</b>	0.20%

**OTHER**

**CONDITIONS IN THE TEXAS FARM CREDIT DISTRICT**

As of the second quarter of 2013, early spring and summer rains have reversed drought conditions across much of the eastern district states. While both Texas and New Mexico have also received better than average early summer rainfall, all regions in both states remain in drought conditions ranging from abnormally dry to exceptional which continues to strain farm and livestock conditions in certain areas. During the second quarter, Central, far South, and far West Texas have all shown improvement in soil moisture and farm conditions due to recent rains, while much of the Cross-Timbers region in north Central Texas, the High Plains, and the Panhandle remain within the extreme to exceptional drought ranges. Current NOAA (National Oceanic and Atmospheric Administration) long-term forecasts predict lingering drought across most of the western U.S. for the remainder of 2013. However, short-term predictions indicate that normal to above average rain is possible over portions of northeastern New Mexico and the Texas Panhandle, which could provide relief for livestock producers and farmers.

For the 2013 farm season, crops across most district states have been planted and farmers have had the benefit of recent rains in the early summer. According to June USDA crop progress and condition reports for all three eastern states, all major crops (corn, cotton, hay, and soybeans) are reporting percentages in the "good" to "excellent" ranges. While the eastern states have improved, conditions across both Texas and New Mexico vary significantly depending on drought conditions within the region. Dry-land cotton farmers in Texas and New Mexico will continue to use multi-peril crop insurance as protection against the risk of returning drought, and those who can turn a crop will benefit from the recent rise in cotton prices. According to the Texas USDA crop and progress report, both dry-land and irrigated farmers across the Central, Eastern, and the Coastal Prairies regions of Texas are reporting good growing conditions, while producers in the areas most affected by drought could be facing higher production costs and average yields. New Mexico producers should benefit from recent rains in key dry-land farming areas, but June USDA crop conditions indicate a majority of the crop in poor to fair condition, increasing the impact of production costs associated with water and fertilizer.

Across most of the district the recent drop in feed prices coupled with generally higher protein prices has had a positive impact on both livestock industry and dairymen. Throughout most of Texas and New Mexico the cattle industry continues to experience significant contraction due to prolonged drought, and some producers will remove livestock this year in order to let pastures rest. Most feedlots will continue to struggle with cattle numbers and price spreads. However, a downward trend in corn should help feeder profitability. While prices for milk are still under pressure, dairymen will have some relief from reduced feed costs. As corn prices remain low, the general rise in meat prices could help poultry growers' and hog producers' margins.

As the district growing season of 2013 advances into the late summer, there is optimism about expected crop yields and livestock production across the eastern states and into areas of Texas that have received good rains during the quarter. While the threat of continued drought remains, the cost of feed is expected to remain low, as USDA continues to predict record acreage and a strong national corn crop. Lower feed and generally higher livestock prices should benefit livestock producers, while better than average moisture should produce strong crop yields supporting overall district profitability. As farmers work toward the harvest season, and livestock producers manage herds, risk management of operations will continue to provide protection from commodity price volatility and rising production costs. Weather conditions and larger macro-economic forces such as unemployment and foreign demand may impact portfolio profitability for the remainder of 2013. However, the district continues to be supported by high levels of non-ag-dependent repayment sources, strong credit quality, and well balanced portfolio diversification.

## **ASSOCIATION MERGERS**

On June 27, 2013, Lone Star, ACA and Texas Land Bank, ACA requested preliminary approval of a merger from the FCA. On June 25, 2013, the boards of directors of Texas AgFinance, Farm Credit Services and AgriLand, Farm Credit Services signed a letter of intent to merge. If approved by the FCA and the respective associations' stockholders, both mergers would be effective January 1, 2014.

## **RATING AGENCY ACTIONS**

### *Moody's Investors Service Rating Actions*

On June 17, 2013, Moody's Investors Service downgraded the bank's subordinated debt rating to A2 from A1, cumulative preferred stock rating to A3 from A2, noncumulative preferred stock rating to Baa1 from A3 and Issuer rating to Aa3 from Aa2. The one-notch downgrade is due to the lowering of the standalone baseline credit assessment (BCA) of the System. The outlook for the subordinated debt and preferred stock is stable. The outlook for the Issuer rating was "negative" due to the negative outlook of the long-term U.S. government's debt rating. Any rating actions on the U.S. government may result in a change in the bank's Issuer rating. The bank's BCA was raised to a1 from a2, reflecting its improved asset quality performance. The bank's BCA incorporates the bank's solid capital levels, adequate risk-adjusted profitability and liquidity as well as the benefits associated with its lending to district associations and their strong capital levels.

On July 18, as a result of affirming the U.S. government's Aaa debt rating with the outlook updated to "stable" from "negative," Moody's affirmed the Aa3 Issuer rating of Farm Credit Bank of Texas and updated the outlook to "stable" from "negative."

*Fitch Ratings Actions*

On July 2, 2013, Fitch Ratings affirmed the bank's long-term and short-term issuer default ratings (IDRs) at "AA-" and "F1," respectively, while affirming the System's long-term and short-term IDRs at "AAA" and "F1," respectively. These rating actions follow Fitch's affirmation of the U.S. government's "AAA" IDR. As a government-sponsored entity, the System benefits from implicit government support, and thus, the ratings and rating outlook are directly linked to the U.S. Sovereign rating. The affirmation of the System banks' IDRs reflect their prudent, conservative credit culture, their unique funding advantage and their structural second-loss position on the majority of their loan portfolio. The stable outlook on the System banks reflects Fitch's view that their IDRs are at their Support Rating Floor of "AA-" and therefore are not likely to be downgraded unless Fitch changes its view of support.

**REGULATORY MATTERS**

As of June 30, 2013, FCA had enforcement actions in place against three associations in the district, which have not had, and are not expected to have, a significant impact on the bank.

In June 2013, the bank implemented the FCA's final rule, effective June 12, 2013, regarding liquidity reserve requirements for Farm Credit System banks. The final rule formalized language related to liquidity definitions, calculation and policy, and did not have a significant impact on the bank's liquidity calculations.

The undersigned certify that we have reviewed the June 30, 2013, quarterly report of the Farm Credit Bank of Texas, that the report has been prepared in accordance with all applicable statutory or regulatory requirements, and that the information included herein is true, accurate and complete to the best of our knowledge and belief.



Larry R. Doyle  
Chief Executive Officer



James F. Dodson  
Chairman of the Board



Amie Pala  
Chief Financial Officer

August 9, 2013

## Controls and Procedures

The Farm Credit Bank of Texas (bank) maintains a system of disclosure controls and procedures. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information disclosed by us in our quarterly and annual reports is accumulated and communicated to our management, including our principal executive officer and our principal financial officer, as appropriate, to allow timely decisions to be made regarding disclosure. With management's input, the chief executive officer and the chief financial officer have evaluated our disclosure controls and procedures as of the end of and for the period covered by this quarterly report, and have concluded that our disclosure controls and procedures are effective as of that date.

The bank also maintains a system of internal controls. The "internal controls" as defined by the American Institute of Certified Public Accountants' Codification of Statement on Auditing Standards, AU Section 319, means a process — effected by the board of directors, management and other personnel — designed to provide reasonable assurance regarding the achievement of objectives in the reliability of our financial reporting, the effectiveness and efficiency of operations, and of compliance with applicable laws and regulations. We continually assess the adequacy of our internal control over financial reporting and enhance our controls in response to internal control assessments, and internal and external audit and regulatory recommendations. There have been no significant changes in our internal controls or in other factors that could significantly affect such controls subsequent to the date we carried out our evaluations.



Larry R. Doyle  
Chief Executive Officer



Amie Pala  
Chief Financial Officer

August 9, 2013

## Balance Sheets

(dollars in thousands)	June 30, 2013 (Unaudited)	December 31, 2012
<b>Assets</b>		
Cash	\$ 374,588	\$ 502,242
Federal funds sold and overnight investments	22,489	24,137
Investment securities	3,469,904	3,346,479
Loans (includes \$58,970 and \$60,310 at fair value held under fair value option)	11,358,012	11,338,830
Less allowance for loan losses	17,641	17,258
Net loans	11,340,371	11,321,572
Accrued interest receivable	36,799	35,635
Other property owned, net	18,036	30,739
Premises and equipment, net	22,390	19,349
Other assets	101,854	95,516
<b>Total assets</b>	<b>\$ 15,386,431</b>	<b>\$ 15,375,669</b>
<b>Liabilities and shareholders' equity</b>		
<b>Liabilities</b>		
Bonds and notes, net	\$ 13,930,075	\$ 13,910,860
Subordinated debt	50,000	50,000
Accrued interest payable	33,398	32,328
Reserve for credit losses	3,910	5,600
Preferred stock dividends payable	21,881	21,881
Other liabilities	38,106	81,157
<b>Total liabilities</b>	<b>14,077,370</b>	<b>14,101,826</b>
<b>Commitments and contingent liabilities (Note 4)</b>		
<b>Shareholders' equity</b>		
Preferred stock, net	482,000	482,000
Capital stock	212,588	212,588
Allocated retained earnings	16,985	16,984
Unallocated retained earnings	607,066	534,438
Accumulated other comprehensive (loss) income	(9,578)	27,833
<b>Total shareholders' equity</b>	<b>1,309,061</b>	<b>1,273,843</b>
<b>Total liabilities and shareholders' equity</b>	<b>\$ 15,386,431</b>	<b>\$ 15,375,669</b>

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

## Statements of Comprehensive Income

(unaudited)

(dollars in thousands)	Quarter Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
<b>Interest Income</b>				
Investment securities	\$ 13,248	\$ 13,359	\$ 26,671	\$ 28,459
Loans	78,903	84,256	158,416	169,649
<b>Total interest income</b>	<b>92,151</b>	97,615	<b>185,087</b>	198,108
<b>Interest Expense</b>				
Bonds, notes and subordinated debt	37,651	41,684	74,889	86,926
<b>Total interest expense</b>	<b>37,651</b>	41,684	<b>74,889</b>	86,926
<b>Net interest income</b>	<b>54,500</b>	55,931	<b>110,198</b>	111,182
Provision for credit losses	4,250	6,182	5,145	20,762
<b>Net interest income after provision for credit losses</b>	<b>50,250</b>	49,749	<b>105,053</b>	90,420
<b>Noninterest Income</b>				
Patronage income	4,469	4,183	9,739	9,169
Fees for services to associations	902	657	1,610	1,194
Loan-related fees	3,722	3,120	12,811	6,691
Refunds from Farm Credit System Insurance Corporation	-	9,820	-	9,820
(Loss) gain on loans held under fair value option	(871)	1,553	(294)	1,553
Miscellaneous income, net	1,975	100	2,226	354
Impairment losses on investments				
Total other-than-temporary impairment gains (losses)	-	21	(143)	(1)
Less: portion of gain (loss) recognized in other comprehensive income	-	21	-	-
Net impairment loss recognized in earnings	-	-	(143)	(1)
<b>Total noninterest income</b>	<b>10,197</b>	19,433	<b>25,949</b>	28,780
<b>Noninterest Expense</b>				
Salaries and employee benefits	6,755	6,508	13,954	13,158
Occupancy and equipment	2,540	2,099	4,987	4,110
Insurance Fund premiums	1,496	666	2,903	1,246
Losses on other property owned, net	463	457	818	2,509
Other operating expenses	6,592	5,161	11,967	9,661
<b>Total noninterest expense</b>	<b>17,846</b>	14,891	<b>34,629</b>	30,684
<b>Net Income</b>	<b>42,601</b>	54,291	<b>96,373</b>	88,516
<b>Other comprehensive loss</b>				
Change in postretirement benefit plans	(43)	(59)	(87)	(118)
Change in unrealized gain on investments	(32,179)	(3,225)	(38,344)	(1,700)
Change in cash flow derivative instruments	693	(364)	1,020	(723)
<b>Total other comprehensive loss</b>	<b>(31,529)</b>	(3,648)	<b>(37,411)</b>	(2,541)
<b>Comprehensive Income</b>	<b>\$ 11,072</b>	\$ 50,643	<b>\$ 58,962</b>	\$ 85,975

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

## Statements of Changes in Shareholders' Equity

(unaudited)

(dollars in thousands)	Preferred Stock	Capital Stock	Allocated Retained Earnings	Unallocated Retained Earnings	Accumulated Other Comprehensive (Loss) Income	Total Shareholders' Equity
Balance at December 31, 2011	\$ 482,000	\$ 216,839	\$ 14,438	\$ 471,933	\$ 25,146	\$ 1,210,356
Net income	-	-	-	88,516	-	88,516
Other comprehensive loss	-	-	-	-	(2,541)	(2,541)
Capital stock issued	-	749	-	-	-	749
Capital stock retired	-	(749)	-	-	-	(749)
Preferred stock dividends accrued	-	-	-	(21,881)	-	(21,881)
Patronage distributions						
Cash	-	-	-	(2,283)	-	(2,283)
Shareholders' equity	-	-	(3)	3	-	-
Balance at June 30, 2012	<u>\$ 482,000</u>	<u>\$ 216,839</u>	<u>\$ 14,435</u>	<u>\$ 536,288</u>	<u>\$ 22,605</u>	<u>\$ 1,272,167</u>
Balance at December 31, 2012	\$ 482,000	\$ 212,588	\$ 16,984	\$ 534,438	\$ 27,833	\$ 1,273,843
Net income	-	-	-	96,373	-	96,373
Other comprehensive loss	-	-	-	-	(37,411)	(37,411)
Preferred stock dividends accrued	-	-	-	(21,881)	-	(21,881)
Patronage distributions						
Cash	-	-	-	(1,863)	-	(1,863)
Shareholders' equity	-	-	1	(1)	-	-
<b>Balance at June 30, 2013</b>	<b><u>\$ 482,000</u></b>	<b><u>\$ 212,588</u></b>	<b><u>\$ 16,985</u></b>	<b><u>\$ 607,066</u></b>	<b><u>\$ (9,578)</u></b>	<b><u>\$ 1,309,061</u></b>

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

## Statements of Cash Flows

(unaudited)

(dollars in thousands)	Six Months Ended June 30,	
	2013	2012
<b>Operating activities</b>		
Net income	\$ 96,373	\$ 88,516
Reconciliation of net income to net cash provided by operating activities		
Provision for credit losses	5,145	20,762
Provision for losses on other property owned	983	2,229
Depreciation and amortization on premises and equipment	1,923	1,408
Accretion of net discount on loans	238	(1,729)
Amortization and accretion on debt instruments	(1,656)	(2,012)
Amortization of net discount on investment securities	(582)	(42)
Decrease (increase) in fair value on loans under fail value option	294	(764)
(Gains) losses from sales of other property owned, net	(264)	118
Losses on impairment of investments available-for-sale	143	1
Allocated equity patronage from System bank	(12,406)	(12,440)
(Increase) decrease in accrued interest receivable	(1,164)	703
Decrease in other assets	6,997	7,493
Increase (decrease) in accrued interest payable	1,070	(1,403)
Decrease in other liabilities	(5,017)	(5,947)
Net cash provided by operating activities	92,077	96,893
<b>Investing activities</b>		
Net decrease (increase) in federal funds	1,648	(577)
Investment securities		
Purchases	(703,993)	(713,096)
Proceeds from maturities, calls and prepayments	536,278	600,254
Proceeds from sales	6,528	-
Increase in loans, net	(378,915)	(749,473)
Proceeds from sale of loans	324,149	-
Proceeds from sales of other property owned, net	14,261	619
Expenditures for premises and equipment	(4,964)	(4,389)
Net cash used in investing activities	(205,008)	(866,662)
<b>Financing activities</b>		
Bonds and notes issued	5,397,677	8,119,415
Bonds and notes retired	(5,376,715)	(7,203,636)
Capital stock issued	-	749
Capital stock retired		
and allocated retained earnings distributed	-	(749)
Cash dividends on preferred stock	(21,881)	(21,881)
Cash patronage distributions paid	(13,804)	(12,644)
Net cash (used in) provided by financing activities	(14,723)	881,254
Net (decrease) increase in cash	(127,654)	111,485
Cash at beginning of year	502,242	424,667
Cash at end of quarter	\$ 374,588	\$ 536,152
<b>Supplemental schedule of noncash investing and financing activities</b>		
Loans transferred to other property owned	\$ 2,277	\$ 6,519
Net decrease in unrealized losses on investment securities	(38,344)	(1,700)
<b>Supplemental schedule of noncash changes in fair value related to hedging activities</b>		
(Decrease) increase in bonds and notes	\$ (91)	\$ 72
<b>Supplemental information</b>		
Interest paid	\$ 73,819	\$ 88,329

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

## Notes to Financial Statements

*Unaudited (dollar amounts in thousands unless otherwise noted)*

### **NOTE 1 — ORGANIZATION AND SIGNIFICANT ACCOUNTING POLICIES**

The accompanying financial statements include the accounts of the Farm Credit Bank of Texas (bank). 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, 2012, are contained in the 2012 Annual Report to shareholders (Annual Report). These unaudited second quarter 2013 financial statements should be read in conjunction with the Annual Report.

In December 2011, the Financial Accounting Standards Board (FASB) issued guidance entitled, “Balance Sheet – Disclosures about Offsetting Assets and Liabilities.” The guidance requires an entity to disclose information about offsetting and related arrangements to enable users of its financial statements to understand the effect of those arrangements on its financial position. This includes the effect or potential effect of rights of setoff associated with an entity’s recognized assets and recognized liabilities. The requirements apply to recognized financial instruments and derivative instruments that are offset in accordance with the rights of offset set forth in accounting guidance and for those recognized financial instruments and derivative instruments that are subject to an enforceable master netting arrangement or similar agreement, irrespective of whether they are offset or not. This guidance is to be applied retrospectively for all comparative periods and is effective for annual reporting periods beginning on or after January 1, 2013, and interim periods within those annual periods. The adoption of this guidance did not impact the financial condition or results of operations but resulted in additional disclosures.

In February 2013, the FASB issued guidance, “Reporting of Amounts Reclassified out of Accumulated Other Comprehensive Income.” The guidance requires entities to present either parenthetically on the face of the financial statements or in the notes to the financial statements, significant amounts reclassified from each component of accumulated other comprehensive income and the income statement line items affected by the reclassification. The guidance is effective for public entities for annual periods beginning after December 15, 2012, and for nonpublic entities for annual periods beginning after December 15, 2013. The adoption of this guidance did not impact the financial condition or results of operations, but resulted in additional disclosures.

The accompanying financial statements contain all adjustments necessary for a fair presentation of the interim financial condition and results of operations of the bank, and conform to generally accepted accounting principles. The preparation of these financial statements requires the use of management’s estimates. The results of operations for any interim period are not necessarily indicative of the results to be expected for the entire year.

The bank and its affiliated associations (district), are part of the federally chartered Farm Credit System (System). The bank provides funding to district associations, which, in turn, provide credit to their borrower-shareholders. At June 30, 2013, the bank provided financing to 17 district associations and certain other financing institutions.

**NOTE 2 — INVESTMENTS****Available for Sale**

The bank's available-for-sale investments include a liquidity portfolio and a portfolio of other investments. The liquidity portfolio consists primarily of corporate debt instruments, agency-guaranteed debt, mortgage-backed securities (MBS) and asset-backed securities (ABS). The majority of the liquidity portfolio's MBS were federal agency collateralized MBS, including Government National Mortgage Association (GNMA), Federal National Mortgage Association (FNMA) and Federal Home Loan Mortgage Corporation (FHLMC) securities. The bank's other investments portfolio consists of Federal Agricultural Mortgage Corporation (Farmer Mac) guaranteed agricultural mortgage-backed securities (AMBS) purchased from district associations. A summary of the amortized cost and fair value of investment securities available for sale, at June 30, 2013, and December 31, 2012, is included in the following tables.

Investments in the available-for-sale liquidity portfolio at June 30, 2013:

	Gross Unrealized Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value	Weighted Average Yield
Agency-guaranteed debt	\$ 114,593	\$ -	\$ (4,225)	\$ 110,368	1.44 %
Corporate debt	256,430	315	(1,215)	255,530	0.85
Federal agency collateralized mortgage-backed securities					
GNMA	1,594,835	14,131	(8,562)	1,600,404	1.56
FNMA and FHLMC	1,344,061	7,931	(7,697)	1,344,295	1.26
Other collateralized mortgage-backed securities	20,557	97	(771)	19,883	2.89
Asset-backed securities	34,083	-	(281)	33,802	0.73
Total available-for-sale investments	<b>\$ 3,364,559</b>	<b>\$ 22,474</b>	<b>\$ (22,751)</b>	<b>\$ 3,364,282</b>	<b>1.38 %</b>

Investments in the available-for-sale other investments portfolio at June 30, 2013:

	Gross Unrealized Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value	Weighted Average Yield
Agricultural mortgage-backed securities	\$ 109,585	\$ -	\$ (3,963)	\$ 105,622	4.32 %

Investments in the available-for-sale liquidity portfolio at December 31, 2012:

	Gross Unrealized Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value	Weighted Average Yield
Agency-guaranteed debt	\$ 65,811	\$ 126	\$ (171)	\$ 65,766	1.53 %
Corporate debt	208,360	486	(224)	208,622	0.99
Federal agency collateralized mortgage-backed securities					
GNMA	1,593,563	22,143	(698)	1,615,008	1.60
FNMA and FHLMC	1,281,140	16,395	-	1,297,535	1.45
Other collateralized mortgage-backed securities	28,082	-	(1,144)	26,938	4.98
Asset-backed securities	17,852	59	(780)	17,131	1.13
Total available-for-sale investments	<b>\$ 3,194,808</b>	<b>\$ 39,209</b>	<b>\$ (3,017)</b>	<b>\$ 3,231,000</b>	<b>1.52 %</b>

Investments in the available-for-sale other investments portfolio at December 31, 2012:

	<b>Amortized Cost</b>	<b>Gross Unrealized Gains</b>	<b>Gross Unrealized Losses</b>	<b>Fair Value</b>	<b>Weighted Average Yield</b>
Agricultural mortgage-backed securities	\$ 117,567	\$ -	\$ (2,088)	\$ 115,479	4.36 %

The following tables summarize the contractual maturity, fair value, amortized cost and weighted average yield of available-for-sale investments at June 30, 2013:

Investments in the available-for-sale liquidity portfolio:

	<b>Due in one year or less</b>	<b>Due after one year through five years</b>	<b>Due after five years through 10 years</b>	<b>Due after 10 years</b>	<b>Total</b>
Agency-guaranteed debt	\$ -	\$ -	\$ -	\$ 110,368	\$ 110,368
Corporate debt	101,601	153,929	-	-	255,530
Federal agency collateralized mortgage-backed securities					
GNMA	-	-	116,455	1,483,949	1,600,404
FNMA and FHLMC	652	1,194	15,854	1,326,595	1,344,295
Other collateralized mortgage-backed securities	-	-	40	19,843	19,883
Asset-backed securities	-	22,963	-	10,839	33,802
Total fair value	<b>\$ 102,253</b>	<b>\$ 178,086</b>	<b>\$ 132,349</b>	<b>\$ 2,951,594</b>	<b>\$ 3,364,282</b>
Total amortized cost	<b>\$ 101,972</b>	<b>\$ 179,277</b>	<b>\$ 128,583</b>	<b>\$ 2,954,727</b>	<b>\$ 3,364,559</b>
Weighted average yield	<b>0.76%</b>	<b>0.87%</b>	<b>2.64%</b>	<b>1.38%</b>	<b>1.38%</b>

Investments in the available-for-sale other investments portfolio:

	<b>Due after one year through five years</b>
Fair value of agricultural mortgage-backed securities	\$ 105,622
Total amortized cost	<b>\$ 109,585</b>
Weighted average yield	<b>4.32%</b>

## Other-Than-Temporarily Impaired Investments Evaluation

The following table shows available-for-sale liquidity portfolio investments by gross unrealized losses and fair value, aggregated by investment category and length of time that the securities have been in a continuous unrealized loss position at June 30, 2013. The continuous loss position is based on the date the impairment was first identified:

	Less Than 12 Months		Greater Than 12 Months		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Agency-guaranteed debt	\$ 110,368	\$ (4,225)	\$ -	\$ -	\$ 110,368	\$ (4,225)
Corporate debt	128,869	(1,215)	-	-	128,869	(1,215)
Federal agency collateralized mortgage-backed securities						
GNMA	515,297	(8,555)	26,860	(7)	542,157	(8,562)
FNMA and FHLMC	607,847	(7,697)	-	-	607,847	(7,697)
Other collateralized mortgage-backed securities	7,941	(242)	6,499	(529)	14,440	(771)
Asset-backed securities	30,607	(74)	3,195	(207)	33,802	(281)
<b>Total</b>	<b>\$ 1,400,929</b>	<b>\$ (22,008)</b>	<b>\$ 36,554</b>	<b>\$ (743)</b>	<b>\$ 1,437,483</b>	<b>\$ (22,751)</b>

The bank evaluates investment securities for other-than-temporary impairment on a quarterly basis. Impairment is considered to be other than temporary if an entity (i) intends to sell the security, (ii) is more likely than not to be required to sell the security before recovering its cost or (iii) does not expect to recover the security's entire amortized cost basis (even if the entity does not intend to sell).

In the six months ended June 30, 2013, the bank recognized other-than-temporary impairment credit losses on one of its four other-than-temporarily impaired investments which was sold in March 2013. The sale of the investment, with a book value of \$5,145, resulted in a realized loss of \$143. The non-credit-related net increase in fair value on the bank's other-than-temporarily impaired investments for the six months ended June 30, 2013, totaling \$1,113, is included as a credit to other comprehensive loss. At June 30, 2013, the bank had two mortgage-backed securities and two asset-backed securities that were considered to be other-than-temporarily impaired.

As the bank has no intention to sell the securities deemed other-than-temporarily impaired and will not more likely than not be required to sell the securities before recovery, the credit loss portion of impairment was recognized through earnings for the first six months of 2013. To measure the amount related to credit loss in the determination of other-than-temporary impairment, the bank utilizes a third-party vendor's services for cash flow modeling and projection of credit losses for specific non-agency residential mortgage-backed securities and subprime asset-backed securities. Significant inputs utilized in the methodology of the modeling include assumptions surrounding market data (interest rates and home prices) and the applicable securities' loan level data. Loan level data evaluated includes loan status, coupon and resets, FICO scores, loan-to-value, geography, property type, etc. Loan level data is then combined with assumptions surrounding future behavior of home prices, prepayment rates, default rates and loss severity to arrive at cash flow projections for the underlying collateral. Default rate assumptions are generally estimated using historical loss and performance information to estimate future defaults. The present value of these cash flow projections is then evaluated against the specific security's structure and credit enhancement to determine if the bond will absorb losses.

The following are the assumptions used at:

Assumptions Used	<b>June 30, 2013</b>	
	Mortgage- Backed Securities	Asset-Backed Securities
Default by range	0.1% - 1.9%	2.5% - 4.7%
Prepayments rate by range	2.6% - 11.7%	2.4% - 4.3%
Loss severity by range	31.2% - 63.8%	61.6% - 72.9%

  

Assumptions Used	<b>December 31, 2012</b>	
	Mortgage- Backed Securities	Asset-Backed Securities
Default by range	0.8% - 7.1%	3.9% - 7.5%
Prepayments rate by range	5.0% - 20.7%	2.6% - 6.3%
Loss severity by range	12.5% - 56.1%	51.5% - 62.9%

The following is a rollforward of the amount related to credit losses recognized during the period:

	<b>For the Three Months</b>		<b>For the Six Months</b>	
	<b>Ended June 30,</b>		<b>Ended June 30,</b>	
	<b>2013</b>	2012	<b>2013</b>	2012
Credit loss component, beginning of period	\$ 1,600	\$ 9,922	\$ 5,084	\$ 9,921
Additions:				
Subsequent credit impairment	-	-	143	1
Reductions:				
For securities sold	-	-	(3,627)	-
Credit loss component end of period	\$ 1,600	\$ 9,922	\$ 1,600	\$ 9,922

**NOTE 3 — LOANS AND RESERVES FOR CREDIT LOSSES**

Loans, including direct notes to district associations and other financing institutions (OFIs), participations purchased and other bank-owned loans, comprised the following categories at:

	<b>June 30, 2013</b>	December 31, 2012
Direct notes receivable from district associations and OFIs	\$ 7,207,972	\$ 7,250,641
Participations purchased	4,143,237	4,080,135
Other loans	6,803	8,054
Balance at end of period	\$ 11,358,012	\$ 11,338,830

During the second quarter of 2013, the bank sold participations of \$250.0 million in direct notes of district associations and \$23.1 million in direct notes from other financing institutions (OFIs) to another System Bank. The sales provided diversification benefits between Farm Credit entities.

A summary of the bank's loans by type follows:

	<u>June 30, 2013</u>	<u>December 31, 2012</u>
Direct notes receivable from district associations	\$ 7,170,982	\$ 7,183,535
Real estate mortgage	305,201	328,873
Production and intermediate term	508,679	425,312
Loans to cooperatives	177,116	139,671
Processing and marketing	1,483,330	1,544,518
Farm-related business	112,143	116,567
Communication	219,751	241,697
Energy (rural utilities)	1,199,199	1,143,723
Water and waste disposal	110,056	99,120
Rural residential real estate	26	25
Agricultural export finance	14,461	13,450
Loans to other financing institutions	36,990	67,106
Mission-related	20,078	35,233
Total	<u>\$ 11,358,012</u>	<u>\$ 11,338,830</u>

The bank purchases or sells participation interests with other parties in order to diversify risk, manage loan volume and comply with Farm Credit Administration regulations. The following table presents information regarding the balances of participations purchased and sold, excluding syndications, at June 30, 2013.

	<u>Other Farm Credit Institutions</u>		<u>Non-Farm Credit Institutions</u>		<u>Total</u>	
	Participations	Participations	Participations	Participations	Participations	Participations
	Purchased	Sold	Purchased	Sold	Purchased	Sold
Real estate mortgage	\$ 39,356	\$ 157,054	\$ 29,230	\$ -	\$ 68,586	\$ 157,054
Production and intermediate term	369,546	329,698	24,411	16,858	393,957	346,556
Agribusiness	1,051,925	6,236	99,561	1,438	1,151,486	7,674
Communication	289,052	-	-	-	289,052	-
Energy (rural utilities)	1,375,371	3,418	-	-	1,375,371	3,418
Water and waste disposal	116,159	-	-	-	116,159	-
Agricultural export finance	14,461	-	-	-	14,461	-
Mission-related	2,785	-	-	-	2,785	-
Loans to other financing institutions	-	23,071	-	-	-	23,071
Direct note receivable from district associations	-	3,650,000	-	-	-	3,650,000
<b>Total</b>	<b>\$ 3,258,655</b>	<b>\$ 4,169,477</b>	<b>\$ 153,202</b>	<b>\$ 18,296</b>	<b>\$ 3,411,857</b>	<b>\$ 4,187,773</b>

In 2011, the bank purchased \$18,317 in loan participations from a district association in a Capitalized Participation Pool (CPP) transaction, and in January 2012 purchased another \$2,336 in loan participations from the association under the same terms. The purchases represent 80.0 percent of the outstanding balances of the loans placed by the association in the CPP. As a condition of the transactions, the bank redeemed stock in the amount of 2.0 percent of the par value of the loans purchased, and the association bought bank stock equal to 8.0 percent of the purchased loans' par value. CPP loans held at June 30, 2013, totaled \$10,830.

The bank is authorized under the Farm Credit Act to accept “advance conditional payments” (ACPs) from borrowers. To the extent the borrower’s access to such ACPs is restricted and the legal right of setoff exists, the ACPs are netted against the borrower’s related loan balance. Unrestricted advance conditional payments are included in other liabilities. ACPs are not insured, and interest is generally paid by the bank on such balances. There were no significant balances of ACPs at June 30, 2013, or December 31, 2012.

During 2012, the bank elected the fair value option for certain callable loans purchased on the secondary market at a significant premium. The fair value option provides an irrevocable option to elect fair value as an alternative measurement for selected financial assets. The fair value of loans held under the fair value option totaled \$58,970 at June 30, 2013. Fair value is used for both the initial and subsequent measurement of the designated instrument, with the changes in fair value recognized in net income. On these instruments, the related contractual interest income and premium amortization are recorded as Interest Income in the Statements of Comprehensive Income. The remaining changes in fair value on these instruments are recorded as net gains (losses) in Noninterest Income on the Statements of Comprehensive Income. The fair value of these instruments is included in Level 2 in the fair value hierarchy for assets recorded at fair value on a recurring basis.

The following is a summary of the transactions on loans for which the fair value option has been elected for the six months ended June 30, 2013:

Balance at January 1, 2013	<b>\$ 60,310</b>
New transactions elected for fair value option	-
Maturities, repayments and calls by issuers	-
Net (losses) on financial instruments under fair value option	<b>(294)</b>
Change in premium	<b>(1,046)</b>
Balance at June 30, 2013	<b><u>\$ 58,970</u></b>

Nonperforming assets (including related accrued interest) and related credit quality statistics are as follows:

	<b>June 30, 2013</b>	December 31, 2012
<b>Nonaccrual loans:</b>		
Real estate mortgage	\$ 13,308	\$ 36,405
Production and intermediate term	18,903	1,441
Agribusiness	10,604	23,107
Communication	-	2,744
Energy and water/waste disposal	1,713	-
Total nonaccrual loans	44,528	63,697
<b>Accruing restructured loans:</b>		
Real estate mortgage	925	914
Production and intermediate term	8,756	8,668
Agribusiness	-	2,419
Total accruing restructured loans	9,681	12,001
Total nonperforming loans	54,209	75,698
Other property owned, net	18,036	30,739
Total nonperforming assets	\$ 72,245	\$ 106,437

One credit quality indicator utilized by the bank and associations is the Farm Credit Administration Uniform Loan Classification System that categorizes loans into five categories. The categories are defined as follows:

- 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 factors, conditions and values that make collection in full highly questionable; and
- Loss – assets are considered uncollectible.

The following table shows loans and related accrued interest as a percentage of total loans and related accrued interest receivable by loan type as of:

	June 30, 2013	December 31, 2012
<b>Real estate mortgage:</b>		
Acceptable	90.2 %	80.6 %
OAEM	4.0	6.6
Substandard/Doubtful	5.8	12.8
	<b>100.0 %</b>	<b>100.0 %</b>
<b>Production and intermediate term:</b>		
Acceptable	93.0 %	93.6 %
OAEM	-	3.7
Substandard/Doubtful	7.0	2.7
	<b>100.0 %</b>	<b>100.0 %</b>
<b>Agribusiness:</b>		
Acceptable	97.9 %	95.8 %
OAEM	0.7	2.3
Substandard/Doubtful	1.4	1.9
	<b>100.0 %</b>	<b>100.0 %</b>
<b>Energy and water/waste disposal:</b>		
Acceptable	98.0 %	98.0 %
OAEM	-	-
Substandard/Doubtful	2.0	2.0
	<b>100.0 %</b>	<b>100.0 %</b>
<b>Communication:</b>		
Acceptable	98.9 %	98.9 %
OAEM	1.1	-
Substandard/Doubtful	-	1.1
	<b>100.0 %</b>	<b>100.0 %</b>
<b>Rural residential real estate:</b>		
Acceptable	100.0 %	100.0 %
OAEM	-	-
Substandard/Doubtful	-	-
	<b>100.0 %</b>	<b>100.0 %</b>
<b>Agricultural export finance:</b>		
Acceptable	100.0 %	100.0 %
OAEM	-	-
Substandard/Doubtful	-	-
	<b>100.0 %</b>	<b>100.0 %</b>
<b>Direct notes to associations:</b>		
Acceptable	97.8 %	97.7 %
OAEM	-	-
Substandard/Doubtful	2.2	2.3
	<b>100.0 %</b>	<b>100.0 %</b>
<b>Loans to other financing institutions:</b>		
Acceptable	100.0 %	100.0 %
OAEM	-	-
Substandard/Doubtful	-	-
	<b>100.0 %</b>	<b>100.0 %</b>
<b>Mission-related:</b>		
Acceptable	87.0 %	92.6 %
OAEM	-	-
Substandard/Doubtful	13.0	7.4
	<b>100.0 %</b>	<b>100.0 %</b>
<b>Total loans:</b>		
Acceptable	97.5 %	96.8 %
OAEM	0.2	0.7
Substandard/Doubtful	2.3	2.5
	<b>100.0 %</b>	<b>100.0 %</b>

The following tables provide an age analysis of past due loans (including accrued interest) for the entire loan portfolio (including nonaccrual loans) as of:

June 30, 2013

	30-89 Days Past Due	90 Days or More Past Due	Total Past Due	Not Past Due or Less Than 30 Days Past Due	Total Loans	Recorded Investment > 90 Days and Accruing
Real estate mortgage	\$ -	\$ 14,254	\$ 14,254	\$ 292,888	\$ 307,142	\$ -
Production and intermediate term	-	786	786	509,753	510,539	-
Agribusiness	-	8,291	8,291	1,770,844	1,779,135	-
Communication	-	-	-	219,973	219,973	-
Energy and water/waste disposal	-	-	-	1,315,686	1,315,686	-
Rural residential real estate	-	-	-	26	26	-
Agricultural export finance	-	-	-	14,482	14,482	-
Direct notes to associations	-	-	-	7,185,152	7,185,152	-
Loans to other financing institutions	-	-	-	37,022	37,022	-
Mission-related	2,425	-	2,425	17,744	20,169	-
<b>Total</b>	<b>\$ 2,425</b>	<b>\$ 23,331</b>	<b>\$ 25,756</b>	<b>\$ 11,363,570</b>	<b>\$ 11,389,326</b>	<b>\$ -</b>

December 31, 2012

	30-89 Days Past Due	90 Days or More Past Due	Total Past Due	Not Past Due or Less Than 30 Days Past Due	Total Loans	Recorded Investment > 90 Days and Accruing
Real estate mortgage	\$ -	\$ 35,772	\$ 35,772	\$ 295,580	\$ 331,352	\$ -
Production and intermediate term	-	839	839	425,514	426,353	-
Agribusiness	-	16,526	16,526	1,790,695	1,807,221	-
Communication	-	-	-	241,909	241,909	-
Energy and water/waste disposal	-	-	-	1,247,205	1,247,205	-
Rural residential real estate	-	-	-	25	25	-
Agricultural export finance	-	-	-	13,479	13,479	-
Direct notes to associations	-	-	-	7,198,913	7,198,913	-
Loans to other financing institutions	-	-	-	67,196	67,196	-
Mission-related	-	-	-	35,474	35,474	-
<b>Total</b>	<b>\$ -</b>	<b>\$ 53,137</b>	<b>\$ 53,137</b>	<b>\$ 11,315,990</b>	<b>\$ 11,369,127</b>	<b>\$ -</b>

Additional impaired loan information is as follows:

	At June 30, 2013			At December 31, 2012		
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Recorded Investment	Unpaid Principal Balance	Related Allowance
<b>Impaired loans with a related allowance for credit losses:</b>						
Real estate mortgage	\$ 8,974	\$ 11,749	\$ 3,389	\$ 7,232	\$ 11,709	\$ 2,671
Production and intermediate term	18,299	20,490	221	838	3,030	244
Processing and marketing	10,604	13,533	6,918	23,107	23,107	8,014
Communication	-	-	-	2,136	2,136	1,000
Energy and water/waste disposal	1,713	1,713	1,688	-	-	-
Total	<u>\$ 39,590</u>	<u>\$ 47,485</u>	<u>\$ 12,216</u>	<u>\$ 33,313</u>	<u>\$ 39,982</u>	<u>\$ 11,929</u>
<b>Impaired loans with no related allowance for credit losses:</b>						
Real estate mortgage	\$ 5,259	\$ 8,520	\$ -	\$ 30,087	\$ 30,087	\$ -
Production and intermediate term	9,360	9,360	-	9,271	9,271	-
Processing and marketing	-	1,382	-	2,419	4,599	-
Communication	-	-	-	608	608	-
Energy and water/waste disposal	-	17,619	-	-	17,619	-
Mission-related	-	3,213	-	-	3,213	-
Total	<u>\$ 14,619</u>	<u>\$ 40,094</u>	<u>\$ -</u>	<u>\$ 42,385</u>	<u>\$ 65,397</u>	<u>\$ -</u>
<b>Total impaired loans:</b>						
Real estate mortgage	\$ 14,233	\$ 20,269	\$ 3,389	\$ 37,319	\$ 41,796	\$ 2,671
Production and intermediate term	27,659	29,850	221	10,109	12,301	244
Processing and marketing	10,604	14,915	6,918	25,526	27,706	8,014
Communication	-	-	-	2,744	2,744	1,000
Energy and water/waste disposal	1,713	19,332	1,688	-	17,619	-
Mission-related	-	3,213	-	-	3,213	-
Total	<u>\$ 54,209</u>	<u>\$ 87,579</u>	<u>\$ 12,216</u>	<u>\$ 75,698</u>	<u>\$ 105,379</u>	<u>\$ 11,929</u>

	For the Three Months Ended				For the Six Months Ended			
	June 30, 2013		June 30, 2012		June 30, 2013		June 30, 2012	
	Average Impaired Loans	Interest Income Recognized	Average Impaired Loans	Interest Income Recognized	Average Impaired Loans	Interest Income Recognized	Average Impaired Loans	Interest Income Recognized
<b>Impaired loans with a related allowance for credit losses:</b>								
Real estate mortgage	\$ 9,249	\$ -	\$ 15,553	\$ -	\$ 9,632	\$ -	\$ 16,811	\$ -
Production and intermediate term	3,117	-	966	-	1,963	-	1,959	-
Processing and marketing	12,832	-	13,441	-	16,396	24	9,840	194
Communication	-	-	2,426	-	1,057	-	2,437	-
Energy and water/waste disposal	1,715	-	-	-	1,500	-	4,470	-
Mission-related	-	-	145	-	-	-	73	-
<b>Total</b>	<b>\$ 26,913</b>	<b>\$ -</b>	<b>\$ 32,531</b>	<b>\$ -</b>	<b>\$ 30,548</b>	<b>\$ 24</b>	<b>\$ 35,590</b>	<b>\$ 194</b>
<b>Impaired loans with no related allowance for credit losses:</b>								
Real estate mortgage	\$ 15,044	\$ 60	\$ 37,453	\$ 16	\$ 19,788	\$ 278	\$ 39,727	\$ 247
Production and intermediate term	9,114	147	10,560	137	9,114	606	10,683	190
Processing and marketing	-	-	2,766	510	-	-	5,948	561
Communication	-	-	633	-	301	-	636	-
Energy and water/waste disposal	-	-	5,723	-	-	-	2,862	-
Mission-related	-	-	295	-	-	-	392	-
<b>Total</b>	<b>\$ 24,158</b>	<b>\$ 207</b>	<b>\$ 57,430</b>	<b>\$ 663</b>	<b>\$ 29,203</b>	<b>\$ 884</b>	<b>\$ 60,248</b>	<b>\$ 998</b>
<b>Total impaired loans:</b>								
Real estate mortgage	\$ 24,293	\$ 60	\$ 53,006	\$ 16	\$ 29,420	\$ 278	\$ 56,538	\$ 247
Production and intermediate term	12,231	147	11,526	137	11,077	606	12,642	190
Processing and marketing	12,832	-	16,207	510	16,396	24	15,788	755
Communication	-	-	3,059	-	1,358	-	3,073	-
Energy and water/waste disposal	1,715	-	5,723	-	1,500	-	7,332	-
Mission-related	-	-	440	-	-	-	465	-
<b>Total</b>	<b>\$ 51,071</b>	<b>\$ 207</b>	<b>\$ 89,961</b>	<b>\$ 663</b>	<b>\$ 59,751</b>	<b>\$ 908</b>	<b>\$ 95,838</b>	<b>\$ 1,192</b>

The average recorded investment in impaired loans for the three months ended June 30, 2013, was \$51.1 million. The bank recognized interest income of \$204 on impaired loans during the three months ended June 30, 2013.

The average recorded investment in impaired loans for the six months ended June 30, 2013, was \$59.8 million. The bank recognized interest income of \$908 on impaired loans during the six months ended June 30, 2013.

At June 30, 2013, impaired loans of \$39.6 million had a related specific allowance of \$12.2 million, while the remaining \$14.6 million of impaired loans had no related specific allowance as a result of adequate collateralization.

The bank's impaired loans included loans which were acquired in March 2010 with evidence of credit deterioration. The loans are recorded at the present value of expected future cash flows. These loans had a balance of \$3,625 and \$4,376 at June 30, 2013, and December 31, 2012, respectively. The allowance for loan losses related to these loans was \$938 and \$1,057 at June 30, 2013, and December 31, 2012, respectively.

A summary of changes in the allowance for loan losses and period-end recorded investment in loans is as follows:

	Real Estate Mortgage	Production and Intermediate Term	Agribusiness	Communications	Energy and Water/Waste Disposal	Rural Residential Real Estate	Agricultural Export Finance	Direct Notes to Associations	Loans to OFIs	Mission-Related	Total
<b>Allowance for Credit Losses:</b>											
Balance at March 31, 2013	\$ 3,154	\$ 734	\$ 6,479	\$ 1,228	\$ 3,779	\$ -	\$ 2	\$ -	\$ -	\$ 29	\$ 15,405
Charge-offs	-	-	(2,263)	-	-	-	-	-	-	-	(2,263)
Recoveries	6	-	272	-	-	-	-	-	-	-	278
Provision for credit losses	510	4,259	324	(1,029)	182	-	4	-	-	-	4,250
Other *	8	-	-	-	(37)	-	-	-	-	-	(29)
Balance at June 30, 2013	\$ 3,678	\$ 4,993	\$ 4,812	\$ 199	\$ 3,924	\$ -	\$ 6	\$ -	\$ -	\$ 29	\$ 17,641
Balance at December 31, 2012	\$ 2,992	\$ 633	\$ 10,448	\$ 1,315	\$ 1,859	\$ -	\$ 3	\$ -	\$ -	\$ 8	\$ 17,258
Charge-offs	(56)	-	(6,674)	-	-	-	-	-	-	-	(6,730)
Recoveries	6	-	272	-	-	-	-	-	-	-	278
Provision for credit losses	734	4,360	766	(1,116)	377	-	3	-	-	21	5,145
Other *	2	-	-	-	1,688	-	-	-	-	-	1,690
Balance at June 30, 2013	\$ 3,678	\$ 4,993	\$ 4,812	\$ 199	\$ 3,924	\$ -	\$ 6	\$ -	\$ -	\$ 29	\$ 17,641
Individually evaluated for impairment	2,672	4,244	2,674	-	1,688	-	-	-	-	-	11,278
Collectively evaluated for impairment	289	528	2,138	199	2,236	-	6	-	-	29	5,425
Loans acquired with deteriorated credit quality	717	221	-	-	-	-	-	-	-	-	938
Balance at June 30, 2013	\$ 3,678	\$ 4,993	\$ 4,812	\$ 199	\$ 3,924	\$ -	\$ 6	\$ -	\$ -	\$ 29	\$ 17,641
Balance at March 31, 2012	\$ 3,451	\$ 759	\$ 6,177	\$ 2,252	\$ 5,386	\$ -	\$ -	\$ -	\$ -	\$ 6	\$ 18,031
Charge-offs	(1,453)	(139)	-	-	(5,918)	-	-	-	-	-	(7,510)
Recoveries	6	-	-	-	-	-	-	-	-	-	6
Provision for credit losses	2,512	188	(1,668)	92	4,981	-	-	-	-	77	6,182
Other *	523	-	-	-	(2,750)	-	-	-	-	-	(2,227)
Balance at June 30, 2012	\$ 5,039	\$ 808	\$ 4,509	\$ 2,344	\$ 1,699	\$ -	\$ -	\$ -	\$ -	\$ 83	\$ 14,482
Balance at December 31, 2011	\$ 7,112	\$ 424	\$ 4,096	\$ 2,163	\$ 1,851	\$ -	\$ -	\$ -	\$ -	\$ 13	\$ 15,659
Charge-offs	(8,528)	(2,192)	-	-	(9,043)	-	-	-	-	-	(19,763)
Recoveries	26	-	36	-	-	-	-	-	-	-	62
Provision for credit losses	5,917	2,576	377	181	11,641	-	-	-	-	70	20,762
Other *	512	-	-	-	(2,750)	-	-	-	-	-	(2,238)
Balance at June 30, 2012	\$ 5,039	\$ 808	\$ 4,509	\$ 2,344	\$ 1,699	\$ -	\$ -	\$ -	\$ -	\$ 83	\$ 14,482
Individually evaluated for impairment	2,792	-	3,614	2,000	-	-	-	-	-	77	8,483
Collectively evaluated for impairment	292	398	895	344	1,699	-	-	-	-	6	3,634
Loans acquired with deteriorated credit quality	1,955	410	-	-	-	-	-	-	-	-	2,365
Balance at June 30, 2012	\$ 5,039	\$ 808	\$ 4,509	\$ 2,344	\$ 1,699	\$ -	\$ -	\$ -	\$ -	\$ 83	\$ 14,482
<b>Recorded Investments in Loans Outstanding:</b>											
Ending balance at June 30, 2013	\$ 307,142	\$ 510,539	\$ 1,779,135	\$ 219,973	\$ 1,315,686	\$ 26	\$ 14,482	\$ 7,185,152	\$ 37,022	\$ 20,169	\$ 11,389,326
Individually evaluated for impairment	\$ 12,037	\$ 26,229	\$ 10,604	\$ -	\$ 1,713	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 50,583
Collectively evaluated for impairment	\$ 292,909	\$ 482,880	\$ 1,768,531	\$ 219,973	\$ 1,313,973	\$ 26	\$ 14,482	\$ 7,185,152	\$ 37,022	\$ 20,169	\$ 11,335,117
Loans acquired with deteriorated credit quality	\$ 2,196	\$ 1,430	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 3,626
Ending balance at June 30, 2012	\$ 349,907	\$ 392,186	\$ 1,699,793	\$ 275,394	\$ 1,127,624	\$ 31	\$ -	\$ 7,063,015	\$ 69,407	\$ 38,007	\$ 11,015,364
Individually evaluated for impairment	\$ 40,655	\$ 8,493	\$ 15,647	\$ 3,036	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 440	\$ 68,271
Collectively evaluated for impairment	\$ 302,875	\$ 380,812	\$ 1,684,146	\$ 272,358	\$ 1,127,624	\$ 31	\$ -	\$ 7,063,015	\$ 69,407	\$ 37,567	\$ 10,937,835
Loans acquired with deteriorated credit quality	\$ 6,377	\$ 2,881	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 9,258

\* Reserve for losses on standby letters of credit recorded in other liabilities

A restructuring of a debt constitutes a troubled debt restructuring (TDR) if the creditor for economic or legal reasons related to the debtor's financial difficulties grants a concession to the debtor that it would not otherwise consider. Troubled debt restructurings are undertaken in order to improve the likelihood of recovery on the loan and may include, but are not limited to, forgiveness of principal or interest, interest rate reductions that are lower than the current market rate for new debt with similar risk, or significant term or payment extensions.

As of June 30, 2013, the total recorded investment of troubled debt restructured loans was \$16,483, including \$6,802 classified as nonaccrual and \$9,681 classified as accrual, with specific allowance for loan losses of \$1,609. As of June 30, 2013, there were no commitments to lend funds to borrowers whose loan terms have been modified in a troubled debt restructuring.

The following table summarizes TDR loan balances by loan type:

	Loans Modified as TDRs		TDRs in Nonaccrual Status	
	June 30, 2013	December 31, 2012	June 30, 2013	December 31, 2012
Real estate mortgage	\$ 5,413	\$ 2,657	\$ 4,488	\$ 1,743
Production and intermediate term	8,756	8,668	-	-
Agribusiness	2,314	5,352	2,314	2,933
Total	<u>\$ 16,483</u>	<u>\$ 16,677</u>	<u>\$ 6,802</u>	<u>\$ 4,676</u>

During the quarter and six months ended June 30, 2013, there were no restructured loans designated as troubled debt restructurings. During the period there were no payment defaults on loans that were restructured during the previous 12 months. A payment default is defined as a payment that is 30 days past due after the date the loan was restructured.

**NOTE 4 — COMMITMENTS AND CONTINGENT LIABILITIES**

The bank is primarily liable for its portion of Systemwide debt obligations. Additionally, the bank is jointly and severally liable for the consolidated Systemwide bonds and notes of the other System banks. Total consolidated bank and Systemwide obligations of the System at June 30, 2013, were approximately \$199.0 billion.

In the normal course of business, the bank has various outstanding commitments and contingent liabilities, including the possibility of actions against the bank in which claims for monetary damages may be asserted. Management and legal counsel are not aware of any other pending lawsuits or actions. Upon the basis of current information, management and legal counsel are of the opinion that the ultimate liability, if any, resulting from lawsuits or other pending actions will not be material in relation to the financial position, results of operations or cash flows of the bank.

**NOTE 5 — FAIR VALUE MEASUREMENTS**

Accounting guidance defines fair value as the exchange price that would be received for an asset or paid to transfer a liability in the principal or most advantageous market for the asset or liability. See Note 2, “Summary of Significant Accounting Policies,” of the 2012 Annual Report for a more complete description.

Assets and liabilities recorded at fair value on a recurring basis at June 30, 2013, for each of the fair value hierarchy levels are summarized below:

	<b>Fair Value Measurements at June 30, 2013</b>			
	<b>Total</b>	<b>Quoted Prices in Active Markets for Identical Assets (Level 1)</b>	<b>Significant Other Observable Inputs (Level 2)</b>	<b>Significant Unobservable Inputs (Level 3)</b>
<b>Assets:</b>				
Federal funds	\$ 22,489	\$ -	\$ 22,489	\$ -
Investments available for sale:				
Corporate debt	255,530	-	195,648	59,882
Agency-guaranteed debt	110,368	-	81,252	29,116
Mortgage-backed securities	2,964,582	-	2,865,775	98,807
Asset-backed securities	33,802	-	30,607	3,195
Mission-related and other available-for-sale investments	105,622	-	-	105,622
Loans valued under the fair value option	58,970	-	58,970	-
Derivative assets	1,059	-	1,059	-
Assets held in nonqualified benefit trusts	156	156	-	-
<b>Total assets</b>	<b>\$ 3,552,578</b>	<b>\$ 156</b>	<b>\$ 3,255,800</b>	<b>\$ 296,622</b>
<b>Liabilities:</b>				
Standby letters of credit	\$ 1,432	\$ -	\$ 1,432	\$ -
<b>Total liabilities</b>	<b>\$ 1,432</b>	<b>\$ -</b>	<b>\$ 1,432</b>	<b>\$ -</b>

#### *Loans With Fair Value Option*

During 2012, the bank elected the fair value option for certain callable loans purchased on the secondary market at a significant premium. The fair value option provides an irrevocable option to elect fair value as an alternative measurement for selected financial assets. It requires entities to display the fair value of those assets for which the entity has chosen to use fair value on the face of the statement of condition. Fair value is used for both the initial and subsequent measurement of the designated instrument, with the changes in fair value recognized in net income. On these instruments, the related contractual interest income and premium amortization are recorded as Interest Income in the Statements of Comprehensive Income. The remaining changes in fair value on these instruments are recorded as net gains (losses) in Noninterest Income on the Statements of Comprehensive Income. The fair value of these instruments is included in Level 2 in the fair value hierarchy for assets recorded at fair value on a recurring basis.

The following table represents a reconciliation of all assets and liabilities measured at fair value on a recurring basis using significant unobservable inputs (Level 3) for the period from March 31, 2013, to June 30, 2013:

	Corporate Debt	Agency- Guaranteed Debt	Mortgage- Backed Securities	Agricultural Mortgage- Backed Securities	Asset- Backed Securities	Total
Available-for-sale investment securities:						
Balance at March 31, 2013	\$ 59,939	\$ 19,975	\$ 61,237	\$ 111,755	\$ 3,457	\$ 256,363
Net gains included in other comprehensive income	(57)	(475)	(1,695)	(1,729)	1	(3,955)
Net gains included in earnings	-	-	-	-	-	-
Purchases, issuances and settlements	-	9,616	63,306	(4,404)	(263)	68,255
Transfers into Level 3	-	-	15,821	-	-	15,821
Transfers out of Level 3	-	-	(39,862)	-	-	(39,862)
Balance at June 30, 2013	<u>\$ 59,882</u>	<u>\$ 29,116</u>	<u>\$ 98,807</u>	<u>\$ 105,622</u>	<u>\$ 3,195</u>	<u>\$ 296,622</u>
The amount of losses for the period included in earnings attributable to the change in unrealized gains or losses relating to assets or liabilities still held at June 30, 2013						
	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>

The following table represents a reconciliation of all assets and liabilities measured at fair value on a recurring basis using significant unobservable inputs (Level 3) for the period from January 1, 2013, to June 30, 2013:

	Corporate Debt	Agency- Guaranteed Debt	Mortgage- Backed Securities	Agricultural Mortgage- Backed Securities	Asset- Backed Securities	Total
Available-for-sale investment securities:						
Balance at January 1, 2013	\$ 59,958	\$ 15,117	\$ 26,938	\$ 115,479	\$ 3,096	\$ 220,588
Net gains (losses) included in other comprehensive income	(76)	(500)	(969)	(1,875)	574	(2,846)
Net gains (losses) included in earnings	-	-	(143)	-	-	(143)
Purchases, issuances and settlements	-	29,616	97,022	(7,982)	(475)	118,181
Transfers into Level 3	-	-	15,821	-	-	15,821
Transfers out of Level 3	-	(15,117)	(39,862)	-	-	(54,979)
Balance at June 30, 2013	<u>\$ 59,882</u>	<u>\$ 29,116</u>	<u>\$ 98,807</u>	<u>\$ 105,622</u>	<u>\$ 3,195</u>	<u>\$ 296,622</u>
The amount of losses for the period included in earnings attributable to the change in unrealized gains or losses relating to assets or liabilities still held at June 30, 2013						
	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>

There were no transfers of assets or liabilities into or out of Level 1 from other levels during the six months ended June 30, 2013. Agricultural mortgage-backed securities are included in Level 3 due to limited activity or less transparency around inputs to their valuation. At June 30, 2013, Level 3 investments included three agency MBS, three agency-guaranteed debt instruments and three corporate debt instruments due to the fact that their valuations were based on Level 3 criteria (broker quotes) and certain non-agency MBS and non-agency ABS backed by home equity. In the first six months of 2013, an agency-guaranteed debt instrument which had previously been included in Level 3 was valued using independent third-party valuation services using Level 2 criteria and was, accordingly, transferred from Level 3 to Level 2. During the six months ended June 30, 2013, one agency MBS, which had previously been valued using independent third-party valuation services using Level 2 criteria was valued at June 30, 2013, using Level 3 criteria (broker quotes), and was, accordingly, transferred from Level 2 to Level 3.

Assets and liabilities measured at fair value on a nonrecurring basis at June 30, 2013, for each of the fair value hierarchy levels are summarized below:

	Fair Value Measurements at June 30, 2013				Total Gains (Losses)
	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	
<b>Assets:</b>					
Loans	\$ 32,312	\$ -	\$ -	\$ 32,312	\$ (6,730)
Other property owned	20,040	-	-	20,040	(818)
Total assets	<u>\$ 52,352</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 52,352</u>	<u>\$ (7,548)</u>

Assets and liabilities measured at fair value on a recurring basis at December 31, 2012, for each of the fair value hierarchy levels are summarized below:

	Fair Value Measurements at December 31, 2012			
	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<b>Assets:</b>				
Federal funds	\$ 24,137	\$ -	\$ 24,137	\$ -
Investments available for sale:				
Corporate debt	208,622	-	148,664	59,958
Agency-guaranteed debt	65,766	-	50,649	15,117
Mortgage-backed securities	2,939,481	-	2,912,543	26,938
Asset-backed securities	17,131	-	14,035	3,096
Mission-related and other available-for-sale investments	115,479	-	-	115,479
Loans valued under the fair value option	60,310	-	60,310	-
Derivative assets	756	-	756	-
Assets held in nonqualified benefit trusts	215	215	-	-
Total assets	<u>\$ 3,431,897</u>	<u>\$ 215</u>	<u>\$ 3,211,094</u>	<u>\$ 220,588</u>
<b>Liabilities:</b>				
Standby letters of credit	\$ 1,469	\$ -	\$ 1,469	\$ -
Total liabilities	<u>\$ 1,469</u>	<u>\$ -</u>	<u>\$ 1,469</u>	<u>\$ -</u>

The following table represents a reconciliation of all assets and liabilities measured at fair value on a recurring basis using significant unobservable inputs (Level 3) for the period from March 31, 2012, to June 30, 2012:

	Corporate Debt	Mortgage- Backed Securities	Agricultural Mortgage- Backed Securities	Asset- Backed Securities	Total
Available-for-sale investment securities:					
Balance at March 31, 2012	\$ 14,730	\$ 74,483	\$ 137,525	\$ 3,199	\$ 229,937
Net gains (losses) included in other comprehensive income	120	(628)	(471)	157	(822)
Net losses included in earnings	-	-	-	-	-
Purchases, issuances and settlements	-	131,673	(9,881)	11,855	133,647
Transfers out of Level 3	-	(32,637)	-	-	(32,637)
Balance at June 30, 2012	<u>\$ 14,850</u>	<u>\$ 172,891</u>	<u>\$ 127,173</u>	<u>\$ 15,211</u>	<u>\$ 330,125</u>

The amount of losses for the period included in earnings attributable to the change in unrealized gains or losses relating to assets or liabilities still held at June 30, 2012

\$ -	\$ -	\$ -	\$ -	\$ -
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The following table represents a reconciliation of all assets and liabilities measured at fair value on a recurring basis using significant unobservable inputs (Level 3) for the period from January 1, 2012, to June 30, 2012:

	Corporate Debt	Mortgage- Backed Securities	Agricultural Mortgage- Backed Securities	Asset- Backed Securities	Total
Available-for-sale investment securities:					
Balance at January 1, 2012	\$ 82,464	\$ 40,872	\$ 110,921	\$ 3,450	\$ 237,707
Net gains included in other comprehensive income	67	2,677	(640)	238	2,342
Net losses included in earnings	-	-	-	(1)	(1)
Purchases, issuances and settlements	-	161,979	16,892	11,524	190,395
Transfers out of Level 3	(67,681)	(32,637)	-	-	(100,318)
Balance at June 30, 2012	<u>\$ 14,850</u>	<u>\$ 172,891</u>	<u>\$ 127,173</u>	<u>\$ 15,211</u>	<u>\$ 330,125</u>

The amount of losses for the period included in earnings attributable to the change in unrealized gains or losses relating to assets or liabilities still held at June 30, 2012

\$ -	\$ -	\$ -	\$ 1	\$ 1
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There were no transfers of assets or liabilities into or out of Level 1 from other levels during the six months ended June 30, 2012. Agricultural mortgage-backed securities are included in Level 3 due to limited activity or less transparency around inputs to their valuation. The net purchases and settlements in agricultural mortgage-backed securities include the bank's purchase of additional AMBS from a district association during the quarter ended June 30, 2012. At June 30, 2012, Level 3 investments included five agency MBS, one corporate debt instrument and one asset-backed security due to the fact that their valuations were based on Level 3 criteria (broker quotes), certain non-agency MBS and non-agency ABS backed by home equity, and certain loans held under the fair value option by a district association. In the first six months of 2012, corporate debt instruments and an agency MBS which had previously been included in Level 3 were valued using independent third-party valuation services using Level 2 criteria and were, accordingly, transferred from Level 3 to Level 2.

Assets and liabilities measured at fair value on a nonrecurring basis at December 31, 2012, for each of the fair value hierarchy levels are summarized below:

	Fair Value Measurement at December 31, 2012				
	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total Gains (Losses)
<b>Assets:</b>					
Loans	\$ 51,769	\$ -	\$ -	\$ 51,769	\$ (20,745)
Other property owned	34,155	-	-	34,155	(5,567)
Total assets	\$ 85,924	\$ -	\$ -	\$ 85,924	\$ (26,312)

Financial assets and financial liabilities measured at carrying amounts and not measured at fair value on the Balance Sheet for each of the fair value hierarchy values are summarized as follows:

	June 30, 2013					December 31, 2012	
	Total Carrying Amount	Fair Value Measurements Using			Total Fair Value	Total Carrying Amount	Total Fair Value
Quoted Prices in Active Markets for Identical Assets (Level 1)		Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)				
<b>Assets:</b>							
Cash	\$ 374,588	\$ 374,588	\$ -	\$ -	\$ 374,588	\$ 502,242	\$ 502,242
Net loans	11,249,089	-	-	11,205,480	11,205,480	11,209,493	11,366,931
Total assets	\$ 11,623,677	\$ 374,588	\$ -	\$ 11,205,480	\$ 11,580,068	\$ 11,711,735	\$ 11,869,173
<b>Liabilities:</b>							
Systemwide debt securities	\$ 13,930,075	\$ -	\$ -	\$ 13,912,882	\$ 13,912,882	\$ 13,910,860	\$ 14,124,485
Subordinated debt	50,000	-	-	55,069	55,069	50,000	56,945
	\$ 13,980,075	\$ -	\$ -	\$ 13,967,951	\$ 13,967,951	\$ 13,960,860	\$ 14,181,430

## Valuation Techniques

As more fully discussed in Note 2, "Summary of Significant Accounting Policies," of the Annual Report, accounting guidance establishes a fair value hierarchy, which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The following represent a brief summary of the valuation techniques used for the bank's assets and liabilities:

### Investments Available for Sale

Where quoted prices are available in an active market, available-for-sale securities would be classified as Level 1. If quoted prices are not available in an active market, the fair value of securities is estimated using pricing models, quoted prices for similar securities received from pricing services or discounted cash flows. Generally, these securities would be classified as Level 2. To estimate the fair value of investments, the bank obtains prices from third-party pricing services. This would include certain mortgage-backed and asset-backed securities. Where there is limited activity or less transparency around inputs to the valuation, the securities are classified as Level 3. Investments classified as Level 3 primarily consist of the certain non-agency mortgage-backed securities and asset-backed securities valued using independent third-party valuation services. Also included in the bank's Level 3 assets are the Farmer Mac AMBS.

### *Derivative Assets and Liabilities*

The bank's derivative positions are valued using internally developed models that use as their basis readily observable market parameters and are classified within Level 2 of the valuation hierarchy. Such derivatives include fair value interest rate swaps, interest rate caps and cash flow interest rate swaps. The models used to determine the fair value of derivative assets and liabilities use an income approach based on observable inputs, primarily the LIBOR swap curve and volatility assumptions about future interest rate movements.

### *Assets Held in Nonqualified Benefit Trusts*

Assets held in trust funds related to deferred compensation and supplemental retirement plans are classified within Level 1. The trust funds include investments that are actively traded and have quoted net asset values that are observable in the marketplace.

### *Standby Letters of Credit*

The fair value of letters of credit approximates the fees currently charged for similar agreements or the estimated cost to terminate or otherwise settle similar obligations.

### *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. As the discount rates are based on the bank's loan rates as well as on 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. Expected future cash flows and discount rates reflecting appropriate credit risk are determined separately for each individual pool.

For loans which are valued at fair value under the fair value pricing option, if quoted prices are not available in an active market, the fair value is estimated using pricing models, quoted prices for similar instruments received from pricing services or discounted cash flows. Generally, these loans would be classified as Level 2. To estimate the fair value of these instruments, the bank obtains prices from third-party pricing services.

For certain loans evaluated for impairment, the fair value is based upon the underlying collateral since the loans were collateral-dependent loans for which real estate is the collateral. These loans are generally classified as Level 3. The fair value measurement process uses independent appraisals and other market-based information, but in many cases it also requires significant input based on management's knowledge of and judgment about current market conditions, specific issues relating to the collateral and other matters. As a result, these fair value measurements fall within Level 3 of the hierarchy. When the value of the real estate, less estimated costs to sell, is less than the principal balance of the loan, a specific reserve is established.

### *Subordinated Debt*

The fair value of these obligations is determined by discounting expected future cash flows based on the Treasury yield curve.

### *Other Property Owned*

Other property owned is generally classified as Level 3. The fair value is based upon the collateral less estimated costs to sell. Costs to sell represent transaction costs and are not included as a component of the asset's fair value.

***Sensitivity to Changes in Significant Unobservable Inputs***

For recurring fair value measurements categorized within Level 3 of the fair value hierarchy, the significant unobservable inputs used in the fair value measurement of the mortgage-backed securities are prepayment rates, probability of default and loss severity in the event of default. Significant increases (decreases) in any of those inputs in isolation would result in a significantly lower (higher) fair value measurement.

Generally, a change in the assumption used for the probability of default is accompanied by a directionally similar change in the assumption used for the loss severity and a directionally opposite change in the assumption used for prepayment rates.

Quoted market prices may not be available for the instruments presented below. Accordingly, fair values are based on internal models that consider 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.

***Quantitative Information About Recurring and Nonrecurring Level 3 Fair Value Measurement***

	<b>Valuation Technique(s)</b>	<b>Unobservable Input</b>
Mortgage-backed securities	Discounted cash flow	Prepayment rate Probability of default Loss severity
Asset-backed securities	Discounted cash flow	Prepayment rate Probability of default Loss severity
Mission-related investments	Discounted cash flow	Prepayment rates

**Information About Recurring and Nonrecurring Level 2 Fair Value Measurements**

	<b>Valuation Technique(s)</b>	<b>Input</b>
Federal funds sold	Carrying value	Par/principal
Investment securities available for sale	Quoted prices	Price for similar security
	Discounted cash flow	Constant prepayment rate Appropriate interest rate yield curve
Loans held under the fair value option	Quoted prices	Price for similar asset
	Discounted cash flow	Constant prepayment rate Appropriate interest rate yield curve
Interest rate swaps	Discounted cash flow	Appropriate interest rate yield curve
Interest rate caps	Discounted cash flow	Appropriate interest rate yield curve Annualized volatility

**Information About Other Financial Instrument Fair Value Measurements**

	<b>Valuation Technique(s)</b>	<b>Input</b>
Cash	Carrying value	Actual balances
Loans	Discounted cash flow	Prepayment forecasts
		Appropriate interest rate yield curve
Systemwide debt securities and subordinated debt	Discounted cash flow	Benchmark yield curve
		Derived yield spread
		Own credit risk

**NOTE 6 — DERIVATIVE FINANCIAL INSTRUMENTS AND HEDGING ACTIVITIES**

The bank maintains an overall interest rate risk management strategy that incorporates the use of derivative products 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 movements in interest rates do not adversely affect the net interest margin. 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 floating-rate assets and liabilities 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 the 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 derivative transactions, particularly interest rate swaps, to lower funding costs, diversify sources of funding, alter interest rate exposures arising from mismatches between assets and liabilities, or better manage liquidity. Interest rate swaps allow the bank to raise long-term borrowings at fixed rates and swap them into floating rates to better match the repricing characteristics of earning assets.

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.

A substantial amount of the bank's assets are interest-earning assets (principally loans and investments) that tend to be medium-term floating-rate instruments. In order to match the asset structure, interest rate swaps in which the bank pays the floating rate and receives the fixed rate (receive fixed swaps) are used to reduce the impact of market fluctuations on the bank's net interest income. Because the size of swap positions needed to reduce the impact of market fluctuations varies over time, the bank also enters into swaps in which it receives the floating rate and pays the fixed rate (pay fixed swaps) when necessary to reduce its net position.

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. The notional amounts and primary types of derivative instruments used and the amount of activity during the period are summarized in the following table:

	<b>Receive-Fixed Swaps</b>	<b>Pay-Fixed Swaps</b>	<b>Interest Rate Caps</b>	<b>Total</b>
Balance at January 1, 2013	\$ 100	\$ -	\$ 695	\$ 795
Maturities/Amortizations	(100)	-	-	(100)
Balance at June 30, 2013	<b>\$ -</b>	<b>\$ -</b>	<b>\$ 695</b>	<b>\$ 695</b>

By using derivative products, 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 a derivative. Generally, when the fair value of a derivative contract is positive, this indicates that the counterparty owes the bank, thus creating a repayment (credit) 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 or better credit rating from a major rating agency, and also monitors the credit standing and levels of exposure to individual counterparties. 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. However, derivative contracts must be reflected in the financial statements on a gross basis regardless of the netting agreement. Another way the bank minimizes the risk of credit losses from derivatives is that substantially all derivative contracts are supported by bilateral collateral agreements with counterparties requiring the posting of collateral in the event certain dollar thresholds of exposure of one party to the other one are reached, which thresholds may vary depending on the counterparty's credit rating. At June 30, 2013, and December 31, 2012, the bank's exposure to counterparties, net of collateral, was \$1,059 and \$756, respectively. At June 30, 2013, and December 31, 2012, the bank had posted no securities as collateral, nor has any counterparty been required to post collateral.

The bank's derivative activities are monitored by its Asset-Liability Management Committee (ALCO) as part of the 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 within parameters established by the bank's board of directors through the bank's analysis of data derived from financial simulation models and other internal and industry sources. The resulting hedging strategies are then incorporated into the bank's overall interest rate risk-management strategies. The bank held no derivatives that were not designated as hedges at June 30, 2013, or December 31, 2012.

*Fair Value Hedges*

The bank's derivative instruments that are designated and qualify as a fair value hedge all meet the standards for accounting treatment that presume full effectiveness. Accordingly, no gain or loss is recognized in earnings. The bank held one fair value interest rate swap at December 31, 2012, which matured in May 2013.

*Cash Flow Hedges*

The bank's derivative instruments that are designated and qualify as a cash flow hedge all meet the standards for accounting treatment that presume full effectiveness. Thus, the effective portion of the gain or loss on the derivative is reported as a component of other comprehensive income. The bank's cash flow hedges at June 30, 2013, and December 31, 2012, consisted of interest rate caps.

<b>Derivatives designated as hedging instruments</b>	<b>Balance Sheet Location</b>	<b>Fair Value 6/30/2013</b>	<b>Fair Value 12/31/2012</b>	<b>Balance Sheet Location</b>	<b>Fair Value 6/30/2013</b>	<b>Fair Value 12/31/2012</b>
Receive fixed	Other assets	\$ -	\$ 91	Other liabilities	\$ -	\$ -
Interest rate caps	Other assets	1,059	665	Other liabilities	-	-

<b>Derivatives designated as hedging instruments</b>	<b>Amount of Gain (Loss) Recognized in OCL on Derivatives (Effective Portion)</b>		<b>Location of Gain Reclassification from AOCL into Income</b>	<b>Amount of Loss Reclassified from AOCL into Income (Effective Portion)</b>	
	<b>June 30,</b>			<b>June 30,</b>	
	<b>2013</b>	<b>2012</b>		<b>2013</b>	<b>2012</b>
Interest rate caps	\$ 393	\$ (892)	Interest expense	\$ 627	\$ 169
Cash flow derivatives	-	-			

**NOTE 7 — EMPLOYEE BENEFIT PLANS**

In addition to pension benefits, the bank provides certain health care benefits to qualifying retired employees (other postretirement benefits). These benefits are not characterized as multiemployer and, consequently, the liability for these benefits is included in other liabilities. Bank employees hired after January 1, 2004, will be eligible for retiree medical benefits for themselves and their spouses at their expense but will be responsible for 100 percent of the related premiums. The following table summarizes the components of net periodic benefit costs for the bank's other postretirement benefit costs for the six months ended June 30:

	Other Postretirement Benefits	
	2013	2012
Service cost	\$ 137	\$ 114
Interest cost	211	209
Amortization of prior service costs	(96)	(118)
Amortization of net loss	9	-
Net periodic benefit cost	\$ 261	\$ 205

The structure of the district's defined benefit pension plan is characterized as multiemployer, since the assets, liabilities and cost of the plan are not segregated or separately accounted for by participating employers (bank and associations).

The bank's supplemental defined benefit pension plan was terminated effective January 16, 2011. By terminating the plan, no further vesting or benefit occurred subsequent to January 16, 2011, and remaining unpaid vested benefits were distributed in a cash lump-sum payment in January 2012 to the participating bank employees after a one-year deferral period. There was no expense recognized on the supplemental defined benefit pension plan after 2011.

**NOTE 8 — ACCUMULATED OTHER COMPREHENSIVE LOSS**

Accumulated other comprehensive loss includes the accumulated balance of certain gains, losses or costs for which values are included in assets or liabilities on the balance sheets, but which have not yet been recognized in earnings. For the bank, these elements include unrealized gains or losses on the bank's available-for-sale investment portfolio, amortization of retirement benefit elements, and changes in the value of cash flow derivative instruments.

The following table summarizes the changes in the balance of the components of accumulated other comprehensive (loss) income for the six months ended June 30, 2013:

	<b>Total</b>	<b>Unrealized Gain on Securities</b>	<b>Retirement Benefit Plans</b>	<b>Cash Flow Derivative Instruments</b>
Balance, January 1, 2013	\$ 27,833	\$ 34,104	\$ (56)	\$ (6,215)
Change in unrealized gains on available-for-sale securities				
Net change in unrealized gains on investment securities	(39,457)	(39,457)		
Decrease in noncredit portion of other-than-temporary impairment (OTTI) losses	970	970		
Reclassification adjustment for OTTI credit losses included in net income	143	143		
Net increase in unrealized losses on securities	<u>(38,344)</u>	<u>(38,344)</u>		
Change in postretirement benefit plans				
Amounts amortized into net periodic expense:				
Amortization of prior service credits	(96)		(96)	
Amortization of net losses	9		9	
Net change in postretirement benefit plans	<u>(87)</u>		<u>(87)</u>	
Change in cash flow derivative instruments				
Gains on interest rate caps	393			393
Reclassification of amount recognized in interest expense	627			627
Net change in cash flow derivative instruments	<u>1,020</u>			<u>1,020</u>
<b>Total other comprehensive (loss) income</b>	<b>(37,411)</b>	<b>(38,344)</b>	<b>(87)</b>	<b>1,020</b>
<b>Balance, June 30, 2013</b>	<b>\$ (9,578)</b>	<b>\$ (4,240)</b>	<b>\$ (143)</b>	<b>\$ (5,195)</b>

The following table summarizes the changes in the balance of the components of accumulated other comprehensive loss for the six months ended June 30, 2012:

	<b>Total</b>	<b>Unrealized Gain on Securities</b>	<b>Retirement Benefit Plans</b>	<b>Cash Flow Derivative Instruments</b>
Balance, January 1, 2012	\$ 25,146	\$ 29,577	\$ 1,251	\$ (5,682)
Change in unrealized gains on available-for-sale securities				
Net change in unrealized gains on investment securities	(3,366)	(3,366)		
Decrease in noncredit portion of other-than-temporary impairment (OTTI) losses	1,665	1,665		
Reclassification adjustment for OTTI credit losses included in net income	1	1		
Net increase in unrealized losses on securities	<u>(1,700)</u>	<u>(1,700)</u>		
Change in postretirement benefit plans				
Amounts amortized into net periodic expense:				
Amortization of prior service credits	(118)		(118)	
Net change in postretirement benefit plans	<u>(118)</u>		<u>(118)</u>	
Change in cash flow derivative instruments				
Losses on interest rate caps	(892)			(892)
Reclassification of loss recognized in interest expense	169			169
Net change in cash flow derivative instruments	<u>(723)</u>			<u>(723)</u>
Total other comprehensive loss	(2,541)	(1,700)	(118)	(723)
Balance, June 30, 2012	<u>\$ 22,605</u>	<u>\$ 27,877</u>	<u>\$ 1,133</u>	<u>\$ (6,405)</u>

**NOTE 9 — SUBSEQUENT EVENTS**

On July 23, 2013, the bank issued \$300.0 million of Class B noncumulative subordinated perpetual preferred stock, Series 2 (Class B-2 preferred stock), representing three million shares at \$100 per share par value for net proceeds of \$296.3 million. Dividends on the preferred stock, if declared by the board of directors at its sole discretion, are noncumulative and are payable quarterly in arrears on the fifteenth day of March, June, September and December in each year, commencing September 15, 2013, at an annual fixed rate of 6.75 percent of par value of \$100 per share up to, but excluding September 15, 2023, from and after which date will pay at an annual rate of the 3-Month USD LIBOR plus 4.01 percent. The Class B-2 preferred stock is not mandatorily redeemable at any time, but may be redeemed in whole or in part at the option of the bank on any dividend payment date on or after September 15, 2023. The Class B-2 preferred stock ranks junior, both as to dividends and upon liquidation to the bank's Class A preferred stock, *pari passu* with respect to the existing Class B-1 preferred stock, and senior to all of the bank's outstanding capital stock. For regulatory purposes, the Class B-2 preferred stock is included in permanent capital, total surplus and core surplus within certain limitations.

In July 2013, the bank purchased \$32,358 in loan participations from a district association in Capitalized Participation Pool (CPP) transactions. As a condition of the transactions, the bank redeemed stock in the amount of 2.0 percent of the par value of the loans purchased, and the association bought bank stock equal to 8.0 percent of the purchased loans' par value.

The bank has evaluated subsequent events through August 9, 2013, which is the date the financial statements were issued. There are no other significant subsequent events requiring disclosure as of August 9, 2013.

**NOTE 10 — COMBINED ASSOCIATION FINANCIAL DATA**

Condensed financial information for the associations follows. All significant transactions and balances between the associations are eliminated in combination. The multiemployer structure of certain of the district's retirement and benefit plans results in the recording of these plans only in the district's combined financial statements.

<b>Balance sheet data</b>	<b>June 30, 2013</b>	<b>December 31, 2012</b>
Cash	\$ 4,137	10,600
Investment securities	61,969	69,075
Loans	12,963,547	12,695,132
Less allowance for loan losses	73,928	89,584
Net loans	12,889,619	12,605,548
Accrued interest receivable	121,116	111,173
Other property owned, net	56,329	67,472
Other assets	323,716	321,533
Total assets	<u>\$ 13,456,886</u>	<u>\$ 13,185,401</u>
Notes payable	\$ 10,814,956	\$ 10,570,291
Other liabilities	168,817	276,076
Total liabilities	<u>10,983,773</u>	<u>10,846,367</u>
Capital stock and participation certificates	81,542	81,140
Retained earnings	2,398,797	2,264,408
Accumulated other comprehensive loss	(7,226)	(6,514)
Total members' equity	<u>2,473,113</u>	<u>2,339,034</u>
Total liabilities and members' equity	<u>\$ 13,456,886</u>	<u>\$ 13,185,401</u>

<b>Statement of income data</b>	<b>Six Months Ended June 30,</b>	
	<b>2013</b>	<b>2012</b>
Interest income	\$ 306,515	\$ 309,524
Interest expense	99,234	113,392
Net interest income	207,281	196,132
Provision for loan losses	3,181	252
Net interest income after provision		
for loan losses	204,100	195,880
Noninterest income	27,568	43,939
Other expense	85,000	80,067
Provision for income taxes	900	359
Net income	<u>145,768</u>	<u>159,393</u>
Other comprehensive loss:		
Change in postretirement benefit plans	(712)	(609)
Total other comprehensive loss	(712)	(609)
Comprehensive Income	<u>\$ 145,056</u>	<u>\$ 158,784</u>