FARM CREDIT FOCUS



2009 FIRST QUARTER REPORT TENTH FARM CREDIT DISTRICT MARCH 31, 2009

# FIRST QUARTER 2009

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

(dollars in thousands, except as noted)

The following discussion reviews the combined financial condition and results of operations of the Farm Credit Bank of Texas (bank), the Federal Land Credit Associations (FLCAs) and the Agricultural Credit Associations (ACAs) of the Tenth Farm Credit District (district) for the three months ended March 31, 2009. FLCAs and ACAs are collectively referred to as associations. These comments should be read in conjunction with the accompanying combined financial statements and footnotes, along with the 2008 Annual Report to stockholders. The accompanying financial statements were prepared under the oversight of the bank's audit committee.

#### RESULTS OF OPERATIONS

#### Net Income

Net income for the three months ended March 31, 2009, was \$49,876, a decrease of \$19,877, or 28.5 percent, over the same period of 2008. The decrease in net income for the three months ended March 31, 2009, consisted of a \$10,980 increase in net interest income and a \$333 decrease in provision for income taxes, offset by a \$1,486 decrease in noninterest income, a \$23,150 increase in provision for loan losses, and a \$6,554 increase in noninterest expense.

#### Net Interest Income

Net interest income for the three months ended March 31, 2009, was \$124,987, an increase of \$10,980, or 9.6 percent, over the same period of 2008. The increase in net interest income was attributable to a volume increase of \$1.78 billion in the district's average earning assets and a 24-basis-point increase in the district's interest rate spread. Interest rate spreads increased as a result of calling high-cost debt and replacing it with lower cost debt.

#### Provision for Loan Losses

The district's provision for loan losses for the three months ended March 31, 2009, was \$31,560, representing an increase of \$23,150 over the \$8,410 provision for the first quarter of 2008. The increase consists of a \$4,880 increase in the bank's provision for loan losses and an \$18,270 increase in provision for loans losses at district associations. The increase was primarily due to specific provisions for loan losses in the first quarter of 2009 related to ethanol loans which totaled \$22,844. The allowance at March 31, 2009, was considered adequate by management to absorb probable losses existing in and inherent to its loan portfolio.

#### Noninterest Income

Noninterest income for the three months ended March 31, 2009, was \$9,331, reflecting a decrease of \$1,486, or 13.7 percent, over the same period of 2008. The decrease was due mainly to a \$1,361 loss recognized due to the estimated amount of credit loss related to an other-than-temporary impairment on investment securities — which is more fully discussed in Note 2, "Investments" — and a decrease of \$915 in patronage income from another System bank, offset by a \$290 increase in gains on sale of investments and a \$500 increase in all other noninterest items, collectively.

#### Noninterest Expense

Noninterest expense for the three months ended March 31, 2009, was \$53,138, reflecting an increase of \$6,554 over the same period of 2008. The increase is primarily attributable to a \$3,544 increase in

salaries and employee benefits, a \$2,610 increase in premiums to the Farm Credit System Insurance Corporation (FCSIC or Insurance Fund), a \$244 increase in occupancy and equipment expenses, a \$100 increase in losses on other property owned and a \$56 increase in other operating expenses. The \$3,544 increase in salaries and employee benefits was primarily due to a \$3,390 increase in pension and retirement expenses and a \$1,744 increase in compensation and related payroll taxes, offset by a \$1,590 decrease in other benefits. Compensation increased due to increases in the number of employees and increases in compensation rates. The \$2,610 increase in premiums paid to the Insurance Fund was primarily due to a change in the premium base effective July 1, 2008, from loans to Systemwide debt outstanding as well as an increase in the premium rate in 2009. Other operating expenses increased due to a \$1,226 increase in Federal Farm Credit Banks Funding Corporation (Funding Corporation) assessment fees, offset by a \$591 decrease in advertising and member relations expenses, a \$223 decrease in travel expenses and a \$356 decrease in all other operating expenses, collectively.

#### Key results of operations comparisons:

	Annualized for the Three Months Ended	Annualized for the Three Months Ended
	3/31/2009	3/31/2008
Return on average assets	1.01%	1.54%
Return on average members' equity	8.50%	12.27%
Net interest income as a percentage of average earning assets	2.58%	2.56%
Charge-offs, net of recoveries, to average loans	0.12%	0.01%
Operating expenses as a percentage of net interest income and noninterest income	39.48%	37.32%
Operating expenses as a percentage of average earning assets	1.09%	1.05%

#### FINANCIAL CONDITION

#### Loan Portfolio

Gross loan volume at March 31, 2009, was \$16,497,831, a decrease of \$92,240, or 0.6 percent, from \$16,590,071 at December 31, 2008, and an increase of \$805,649, or 5.1 percent, from \$15,692,182 at March 31, 2008. Loans classified as "acceptable" or "other assets especially mentioned" as a percentage of total loans and accrued interest receivable were 95.5 percent at March 31, 2009, 97.1 percent at December 31, 2008, and 98.8 percent at March 31, 2008. Nonaccrual loans for the district were 2.55 percent of total loans at March 31, 2009, compared to 1.94 percent at December 31, 2008, and 0.78 percent at March 31, 2008. The \$78,519 allowance for loan losses at March 31, 2009, constituted 0.48 percent of total loans, and was considered by management to be adequate to absorb potential losses on existing loans.

Total district high-risk asset volume increased by \$107.9 million, or 30.5 percent, to \$460.8 million at March 31, 2009, from \$352.9 million at December 31, 2008.

Comparative balances of high-risk assets follow (in millions):

		Inc	crease (De	crease)			
	Marc	March 31, 2009		\$	%	Decemb	er 31, 2008
Nonaccrual loans	\$	421.1	\$	98.7	30.6 %	\$	322.4
Formally restructured loans		2.5		(3.6)	(59.0)		6.1
Loans 90 days past due and							
still accruing interest		28.6		10.7	59.8		17.9
Total impaired loans		452.2		105.8	30.5		346.4
Other property owned, net		8.6		2.1	32.3		6.5
Total high-risk assets	\$	460.8	\$	107.9	30.6 %	\$	352.9

Nonaccrual loans at March 31, 2009, include participation loans totaling \$292.2 million to 10 borrowers held by the bank and 13 district associations, with specific allowances on these loans totaling \$35.9 million.

The \$98.7 million increase in nonaccrual loans from December 31, 2008, to March 31, 2009, includes a \$31.6 million increase in nonaccrual loans to one borrower held by the bank and two district associations, a \$28.5 million increase in nonaccrual loans to two borrowers held by one district association and a \$23.3 million increase in nonaccrual loans to four borrowers held by two district associations. Impaired loans, consisting of nonaccrual loans, formally restructured loans, and loans past due 90 days or more and still accruing interest, constituted 2.7 percent of gross loans at March 31, 2009, and 2.09 percent of gross loans at December 31, 2008.

#### Liquidity and Funding Sources

As of March 31, 2009, the Farm Credit Bank of Texas and all district associations exceeded all regulatory liquidity requirements. Cash and investment securities totaled \$3,186,764, or 16.0 percent, of total assets at March 31, 2009, compared to \$3,279,977, or 16.3 percent, at December 31, 2008, reflecting a decrease of \$93,213, or 2.8 percent. At March 31, 2009, the district's cash balance was \$320,595, an increase of \$263,713 from the balance at December 31, 2008. This includes the bank's increase of \$291,140, related to the bank's repositioning of its liquidity funding from federal funds sold and other liquid investments to cash. Interest-bearing liabilities, consisting of bonds, notes, and subordinated debt, decreased by \$164,579, or 1.0 percent, in concert with the decrease in earning assets requiring funding.

#### Investments

The district's investments included an available-for-sale portfolio with a fair market value of \$2.8 billion and a held-to-maturity portfolio recorded at an amortized cost of \$47.5 million at March 31, 2009. The held-to-maturity portfolio consisted of mission-related rural housing mortgage-backed securities that had a fair value of \$49.1 million. The district's available-for-sale portfolio consisted primarily of federal agency collateralized mortgage-backed securities, agency debt, corporate debt and commercial paper, other collateralized mortgage-backed securities, and asset-backed securities. At March 31, 2009, the bank held five investments that were ineligible for liquidity purposes by FCA standards, due to credit ratings that were below AAA by both Moody's and Standard and Poor's. Those ineligible securities had an amortized cost basis of \$58,611 and a fair value of \$44,895 at March 31, 2009.

As is more fully disclosed in Note 1, "Organization and Significant Accounting Policies," and in Note 2, "Investments," the district early adopted Financial Accounting Standards Board (FASB) Staff Position No. 115-2 and 124-2, "Recognition and Presentation of Other-Than-Temporary Impairments" (FSP 115-

2), which amends existing impairment guidance in FASB Statement No. 115, "Accounting for Certain Investments in Debt and Equity Investments." Accordingly, the bank recognized other-than-temporary impairment losses on three mortgage-backed investments during the first quarter of 2009. The credit portion of the impairment losses, totaling \$1,361, was recognized as a loss in earnings in the first quarter. The balance of the impairment losses on the three investments, totaling \$3,380, is included as a charge against other comprehensive income. Also in accordance with FSP 115-2, \$1,527 in non-credit-related impairment losses taken as a charge against earnings during 2008 was added back to retained earnings and charged against accumulated other comprehensive income.

#### Capital Resources

Total members' equity increased \$66,722, or 2.9 percent, from December 31, 2008, to the March 31, 2009, total of \$2,396,439. This increase is the result of net income of \$49,876 for the three months ended March 31, 2009, a decrease in unrealized net losses on investment securities totaling \$22,982, an increase of \$1,793 in unrealized gains on cash flow derivatives, and an adjustment to retained earnings of \$1,527 resulting from the effects the noncredit portion of the previous other-than-temporary-impairment losses pursuant to FSP 115-2, offset by patronage of \$9,025 and a net decrease in capital stock of \$431.

#### Key financial condition comparisons:

	March 31, 2009	December 31, 2008
Members' equity to assets	12.02%	11.55%
Total liabilities to members' equity	7.32:1	7.66:1
Allowance for loan losses to total loans	0.48%	0.31%

#### **OTHER**

Effective January 1, 2009, one FLCA restructured to form an ACA with operating FLCA and Production Credit Association subsidiaries.

The undersigned certify that we have reviewed the March 31, 2009, quarterly report of the Farm Credit Bank of Texas and district associations, 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 Ralph W. Cortese Chairman of the Board

Thomas W. Hill

Senior Vice President, Chief Financial Officer, Chief Operations Officer

Thomas W. Will

May 5, 2009

#### **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 senior vice president, chief financial officer, chief operations 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. This evaluation relies upon the evaluations made by the individual associations and the related certifications they provide to the bank.

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

Map

Thomas W. Hill Senior Vice President, Chief Financial Officer, Chief Operations Officer

Thomas W. Will

May 5, 2009

# **Combined Balance Sheets**

(dollars in thousands)	March 31, 2009 Unaudited)	December 31, 2008			
Assets					
Cash	\$ 320,595	\$	56,882		
Federal funds sold and securities	•				
purchased under resale agreements	23,275		176,698		
Investment securities	2,842,894		3,046,397		
Loans	16,497,831		16,590,071		
Less allowance for loan losses	 78,519		51,653		
Net loans	16,419,312	16,538,418			
Accrued interest receivable	187,786		202,807		
Other property owned, net	8,606		6,495		
Premises and equipment, net	50,924		49,499		
Other assets	88,225		89,116		
Total assets	\$ 19,941,617	\$	20,166,312		
Liabilities and members' equity					
Liabilities					
Bonds and notes, net	\$ 17,137,626	\$	17,302,205		
Subordinated debt	50,000		50,000		
Accrued interest payable	98,337		103,288		
Patronage distributions payable	13,809		55,024		
Other liabilities	 245,406		326,078		
Total liabilities	 17,545,178		17,836,595		
Commitments and contingent liabilities (Note 4)					
Members' equity					
Preferred stock, net	202,754		202,754		
Capital stock and participation certificates	63,428		63,859		
Allocated retained earnings	212,134		211,450		
Unallocated retained earnings	2,026,115		1,984,421		
Accumulated other comprehensive loss	 (107,992)		(132,767)		
Total members' equity	 2,396,439		2,329,717		
Total liabilities and members' equity	\$ 19,941,617	\$	20,166,312		

# **Combined Statements of Income**

(unaudited)

	Quarter Ended March 31,									
(dollars in thousands)	2009	2008								
Interest income Investment securities Loans	\$ 26,194 223,139									
<b>Total interest income</b>	249,333	3 288,174								
Interest expense Bonds, notes and subordinated debt Notes payable and other	114,757 9,589	•								
Total interest expense	124,346	174,167								
Net interest income Provision for loan losses	124,987 31,560	·								
Net interest income after provision for loan losses	93,427	7 105,597								
Noninterest income Loan-related fees Gain on sale of investment securities Miscellaneous income, net	4,499 290 5,903	-								
Impairment losses on investments Total other-than-temporary-impairment losses Less: portion of loss recognized	(4,74)									
in other comprehensive income  Net impairment loss recognized in earnings	3,380									
Total noninterest income	9,331	10,817								
Noninterest expense Salaries and employee benefits Occupancy and equipment Insurance Fund premiums Losses on other property owned, net Other operating expenses  Total noninterest expense	28,326 3,224 8,217 103 13,268	2,980 5,607 3 3 13,212								
Income before provision for income taxes	49,620	69,830								
(Benefit from) provision for income taxes	(250	<u>5)</u> 77								
Net income	\$ 49,876	\$ 69,753								

# **Combined Statements of Changes in Members' Equity**

(unaudited)

(dollars in thousands)  Balance at December 31, 2007		Preferred Stock	Capital Stock			Allocated Retained Earnings		Unallocated Retained Earnings		Other nprehensive ome (Loss)	Total Members' Equity	
		202,754	\$	62,489	\$	133,423	\$	1,886,488	\$	(34,493) \$	2,250,661	
Adjustment for accounting changes:												
Change in measurement date - SFAS No. 158		-		-		-		(2,713)		-	(2,713)	
Balance at January 1, 2008		202,754		62,489		133,423		1,883,775		(34,493)	2,247,948	
Comprehensive income												
Net income		-		-		-		69,753		-	69,753	
Change in pension and postretirement benefit plans		-		-		-		-		497	497	
Net change in unrealized net gains on investment securities		-		-		-		-		5,909	5,909	
Net change in unrealized net losses on												
cash flow derivatives		-		-		-		-		(10,267)	(10,267)	
Total comprehensive income		-		-		-		69,753		(3,861)	65,892	
Capital stock/participation												
certificates issued		-		3,368		-		-		-	3,368	
Capital stock/participation												
certificates and allocated				(2.057)		(10)					(2.0(0)	
retained earnings retired		-		(3,057)		(12)		-		-	(3,069)	
Patronage distributions  Cash								(7,057)			(7.057)	
Members' equity		-		-		1,360		(1,360)		-	(7,057)	
Balance at March 31, 2008	\$	202,754	\$	62,800	\$	134,771	\$		\$	(38,354) \$	3 2,307,082	
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Balance at December 31, 2008 Noncredit portion of previous	\$	202,754	\$	63,859	\$	211,450	\$	1,984,421	\$	(132,767) \$	2,329,717	
other-than-temporary-impairment losses		_		_		_		1,527		(1,527)	-	
Balance at January 1, 2009		202,754		63,859		211,450		1,985,948		(134,294)	2,329,717	
Comprehensive income		,		,		,		, ,		, , ,	, ,	
Net income		-		-		-		49,876		-	49,876	
Net change in unrealized net losses on investment securities		-		-		-		_		26,362	26,362	
Noncredit portion of current												
other-than-temporary-impairment losses		-		-		-		-		(1,853)	(1,853)	
Net change in unrealized net gains on												
cash flow derivatives		-		-		-		-		1,793	1,793	
Total comprehensive income		-		-		-		49,876		26,302	76,178	
Capital stock/participation												
certificates issued		-		4,685		-		-		-	4,685	
Capital stock/participation												
certificates and allocated												
retained earnings retired		-		(5,116)		-		-		-	(5,116)	
Patronage distributions								(0.005)			(0.005)	
Cash Members' equity		-		-		-		(9,025) (684)		-	(9,025)	
wieinders ediniv		-		-		684		(084)		_	_	

### **Combined Statements of Cash Flows**

(unaudited)

	Three Months Ended March 31,								
(dollars in thousands)		2009		2008					
Operating activities									
Net income	\$	49,876	\$	69,753					
Reconciliation of net income to net cash provided by operating activities									
Provision for loan losses		31,560		8,410					
Provision for losses on other property owned		75		97					
Depreciation and amortization on premises and equipment		1,521		1,390					
Accretion of net discount on loans		(187)		(165)					
Amortization and accretion on debt instruments		(304)		488					
Amortization of net (discount) premium on investment securities		16		(337)					
Gain on sale of investment securities		(290)		-					
Losses on impairment of investments available-for-sale		1,361		-					
(Gains) losses from sales of other property owned, net		(13)		84					
Gains from sales of premises and equipment		(929)		(1,071)					
Decrease in accrued interest receivable		15,021		5,870					
Increase in other assets		(18,135)		(5,547)					
Decrease in accrued interest payable		(4,951)		(11,306)					
Decrease in other liabilities		(55,305)		(10,093)					
Net cash provided by operating activities		19,316		57,573					
Investing activities									
Net decrease in federal funds sold and									
securities purchased under resale agreements		153,423		11,780					
Investment securities									
Purchases		(609,578)		(824,024)					
Proceeds from maturities, calls and prepayments		833,656		835,997					
Allocated equity patronage from System bank		(11,780)		(6,468)					
Decrease (increase) in loans, net		85,258		(577,476)					
(Expenditure) proceeds from (purchase) sale of loans		(100,000)		400,000					
Proceeds from sales of other property owned, net		302		-					
Proceeds from sales of premises and equipment		739		696					
Expenditures for premises and equipment		(2,756)		(1,630)					
Net cash provided by (used in) investing activities		349,264		(161,125)					
Financing activities									
Bonds and notes issued		19,876,877		11,696,625					
Bonds and notes retired		(19,910,346)		(11,580,391)					
(Decrease) increase in advanced conditional payments		(20,727)		18,010					
Capital stock and participation certificates issued		4,685		3,368					
Capital stock and participation certificates retired		(5,116)		(3,069)					
Cash patronage distributions paid		(50,240)		(54,828)					
Net cash (used for) provided by financing activities		(104,867)		79,715					
Net increase (decrease) in cash		263,713		(23,837)					
Cash at beginning of year		56,882		55,703					
Cash at end of quarter	\$	320,595	\$	31,866					
Supplemental schedule of noncash investing and financing activities									
Financed sales of other property owned	\$	13	\$	664					
Loan assets transferred to other property owned		2,488		352					
Net decrease in unrealized losses on investment securities		20,301		5,909					
Cash dividends or patronage distributions payable		13,809		16,128					
Investment purchases not settled		-		75,400					
Supplemental schedule of noncash changes in fair value related to									
hedging activities									
(Decrease) increase in bonds and notes	\$	(30,797)	\$	7,915					
	-								
Supplemental information Cash paid for:									
Interest	\$	129,297	\$	185,473					
Income taxes	Ψ	3	Ψ	377					
				511					

#### **Notes to Combined Financial Statements**

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

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

The accompanying combined financial statements (financial statements) include the accounts of the Farm Credit Bank of Texas (bank) and the accounts of the Agricultural Credit Associations (ACAs) and Federal Land Credit Associations (FLCAs) of the Tenth Farm Credit District (district) of the Farm Credit System (System). The ACAs and FLCAs are collectively referred to as associations. The financial statements also reflect the investments in and allocated earnings of the service organizations in which the bank has a partial ownership interest. All significant transactions and balances between the bank and the associations have been eliminated in combination.

The significant accounting policies followed and the financial condition and results of operations of the combined bank and associations as of and for the year ended December 31, 2008, are contained in the 2008 Annual Report to stockholders (Annual Report). These unaudited first quarter 2009 financial statements should be read in conjunction with the Annual Report.

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

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

The adoption of this standard did not have an impact on the district's financial statements; however, the derivative instruments disclosures have been expanded in accordance with SFAS 161.

Effective January 1, 2009, the bank and related associations adopted FASB Staff Position (FSP) No. 157-2, "Effective Date of FASB Statement No. 157." This FSP delayed the effective date of SFAS No. 157, "Fair Value Measurements" (SFAS 157) for nonfinancial assets and nonfinancial liabilities. The impact of adoption resulted in additional fair value disclosures but does not have an impact on our financial condition or results of operations.

In April 2009, the FASB issued FSP No. 157-4, "Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly" (FSP 157-4). FSP 157-4 emphasizes that even if there has been a significant decrease in the volume and level of activity for the asset or liability, and regardless of the valuation technique and inputs used, the objective for the fair value measurement is unchanged from what it would be if markets were operating at normal activity levels or transactions were orderly; that is, to determine the current exit price. It sets forth additional factors that should be considered to determine whether there has been a significant decrease in volume and level of activity when compared with normal market activity. The reporting entity shall evaluate the significance and relevance of the factors to determine whether, based on the weight of evidence, there has been a significant decrease in activity and volume. FSP 157-4 indicates that

if an entity determines that either the volume or level of activity for an asset or liability has significantly decreased (from normal conditions for that asset or liability) or price quotations or observable inputs are not associated with orderly transactions, increased analysis and management judgment will be required to estimate fair value. It is further noted that a fair value measurement should include a risk adjustment to reflect the amount market participants would demand because of the risk (uncertainty) in the cash flows.

FSP 157-4 also requires a reporting entity to make additional disclosures in interim and annual periods. It is effective for interim periods ending after June 15, 2009, with early application permitted for periods ending after March 15, 2009. Revisions resulting from a change in valuation techniques or their application are accounted for as a change in accounting estimate. The bank and related associations early adopted the FSP.

In April 2009, the FASB issued FSP No. 115-2 and 124-2, "Recognition and Presentation of Other-Than-Temporary Impairments," (FSP 115-2) which amends the other-than-temporary impairment guidance for debt securities to make the guidance more operational and to improve the presentation and disclosure of other-than-temporary impairments on debt securities in the financial statements. It does not change existing recognition and measurement guidance related to other-than-temporary impairments of equity securities.

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

This FSP is effective for interim and annual periods ending after June 15, 2009, with early application permitted for periods ending after March 15, 2009. For securities held at the beginning of the interim period of adoption for which an other-than-temporary impairment was previously recognized, if an entity does not intend to sell and it is more likely than not that it will be required to sell before recovery of its amortized cost basis, the entity shall recognize the cumulative effect of initially applying this FSP adjustment to the opening balance of retained earnings with a corresponding adjustment to accumulated other comprehensive income. The bank and related associations early adopted the FSP and recognized an adjustment to beginning retained earnings in the amount of \$1,527, and a corresponding adjustment to accumulated other comprehensive income of \$1,527. If a reporting entity early adopts this FSP, it is

required to adopt FSP 157-4, and the same applies if FSP 157-4 is adopted; then FSP 115-2 must also be adopted.

In addition, in April 2009, the FASB issued FSP No. 107-1 and Accounting Principles Board (APB) No. 28-1, "Interim Disclosures about Fair Value of Financial Instruments." This FSP requires disclosures about fair value of financial instruments for interim reporting periods of publicly traded companies as well as in annual financial statements. The FSP is effective for interim periods ending after June 15, 2009, with early application permitted for periods ending after March 15, 2009. The bank and related associations are currently evaluating the disclosures that will be impacted by the adoption of the FSP.

The accompanying financial statements contain all adjustments necessary for a fair presentation of the interim financial condition and results of operations of the district, 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.

#### **NOTE 2 — INVESTMENTS**

#### **Available for Sale**

A summary of the amortized cost and fair value of investment securities available for sale, excluding mission-related and other investments, at March 31, 2009 is as follows:

		ortized Cost	Uı	Gross nrealized Gains	-	Gross nrealized Losses	F	air Value	Weighted Average Yield	_
Agency debt	\$	500,000	\$	256	\$	_	\$	500,256	1.17	%
Corporate debt	Ψ.	282,504	Ψ	1,456	Ψ	(1,408)	4	282,552	1.47	,,
Federal agency collateralized						, , ,				
mortgage obligations		1,736,479		36,084		(1,134)		1,771,429	4.42	
Other collateralized										
mortgage obligations		204,100		-		(29,890)		174,210	5.77	
Asset-backed securities		72,953		224		(6,198)		66,979	4.05	
Total available-for-sale-investments	\$	2,796,036	\$	38,020	\$	(38,630)	\$	2,795,426	3.62	%

The following table is a summary of the contractual maturity, fair value, amortized cost and weighted average yield of available-for-sale investments at March 31, 2009:

		Due in one year or less	ye	e after one ar through five years	yea	e after five ars through 10 years	Due after 10 years	Total
Agency debt	\$	500,256	\$	-	\$	-	\$ -	\$ 500,256
Corporate debt		178,753		103,799		-	-	282,552
Other collateralized mortgage obligations		702,439		1,241,089		2,111	-	1,945,639
Asset-backed securities		39,426		10,924		-	16,629	66,979
Total fair value	\$	1,420,874	\$	1,355,812	\$	2,111	\$ 16,629	\$ 2,795,426
Total amortized cost Weighted average yield	\$	1,424,713 3.01%	\$	1,349,791 4.24%	\$	5,112 3.11%	\$ 16,420 3.11%	\$ 2,796,036 3.59%

#### Mission-Related and Other Held-to-Maturity Investments

The bank's held-to-maturity investments consisted of mission-related investment securities with contractual maturities greater than 10 years. A summary of the amortized cost and fair value of mission-related and other held-to-maturity investment securities at March 31, 2009 is as follows:

			(	Gross	Gross					
			Uni	realized	Unrealized	l		Weigh	ted	
	Amoi	rtized Cost	(	Gains	Losses	Fa	ir Value	Average	Yield	_
Mission-related securi	ties									
due after 10 years	\$	47,468	\$	1,641	\$ -	\$	49,109		5.11	%

#### **Investments Available for Sale**

The following table shows eligible investments that were not other-than-temporarily impaired 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 March 31, 2009. The continuous loss position is based on the date the impairment was first identified:

	Less T	han	n Greater Than								
	 12 Months				12 N	Iont	ths	Total			
	Fair Unrealized			Fair Un			Unrealized		Fair	Unrealized	
	Value	Losses		Value		Losses			Value	Losses	
Collateralized mortgage obligations	\$ 78,174	\$	(688)	\$	203,285	\$	(26,956)	\$	281,459	\$	(27,644)
Corporate debt	-		-		78,592		(1,408)		78,592		(1,408)
Asset-backed securities	-		-		49,268		(6,198)		49,268		(6,198)
Total	\$ 78,174	\$	(688)	\$	331,145	\$	(34,562)	\$	409,319	\$	(35,250)

The bank evaluates investment securities for other-than-temporary impairment on a quarterly basis. Factors considered in determining whether an impairment is other than temporary include: 1) the length

of time and the extent to which the fair value is less than cost, 2) the financial condition and near-term prospects of the issuer, 3) the estimated cash flow projections compared to contractual cash flows and 4) significant rating agency changes on the issuer.

The bank recognized other-than-temporary impairment losses on three mortgage-backed investments during the first quarter of 2009. The credit portion of the impairment losses, totaling \$1,361, was recognized as a loss in earnings in the first quarter. The balance of the impairment losses on the three investments, totaling \$3,380, is included as a charge against other comprehensive income. Also, in accordance with FSP 115-2, \$1,527 in non-credit-related impairment losses taken as a charge against earnings during 2008 was added back to retained earnings and charged against accumulated other comprehensive income.

As the bank has no intent of selling the securities deemed other-than-temporarily impaired (OTTI) 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 quarter 2009. To measure the amount related to credit loss in the determination of OTTI, 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. Applicable securities are identified through prior analysis based on the deterioration of price and credit ratings. 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. These cash flow projections are then evaluated against the specific security's structure and credit enhancement to determine if the bond will absorb losses.

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

Beginning balance – credit losses for which a portion of an	
other-than-temporary impairment was recognized in OCI	\$ 712
Additions for the amount related to credit loss for which other-	
than-temporary impairment was not previously recognized	892
Increases to amount related to credit loss for which other-than-	
temporary impairment previously recognized when it did not	
intend to sell and it is not more likely than not that it will be required to sell	 469
Ending balance – credit losses for which a portion of an other-than-temporary	
impairment was recognized in OCI	\$ 2,073

#### NOTE 3 — ALLOWANCE FOR LOAN LOSSES

An analysis of the allowance for loan losses follows:

	T	hree Months	Ended N	larch 31,		
		2009	2008			
Balance at beginning of period	\$	51,653	\$	24,495		
Provision for loan losses		31,560		8,410		
Loans charged off		(5,432)		(419)		
Recoveries		617		110		
Change in reserve for						
unfunded commitments		121				
Balance at end of period	\$	78,519	\$	32,596		

At March 31, 2009, impaired loans of \$185.9 million had a related specific allowance of \$52.8 million, while the remaining \$266.3 million of impaired loans had no related specific allowance. Provision for loan losses and loans charged off for the first three months of 2009 included \$24.5 million and \$4.8 million, respectively, related to ethanol-related participation loans.

The average recorded investment in impaired loans for the three months ended March 31, 2009, was \$385.0 million. The district recognized interest income of \$2.7 million on impaired loans during the three months ended March 31, 2009, as compared to \$684 for 2008.

#### 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 March 31, 2009, were approximately \$179.2 billion.

#### NOTE 5 — FAIR VALUE MEASUREMENTS

SFAS 157 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 1 of the 2008 Annual Report for a more complete description.

Assets and liabilities measured at fair value on a recurring basis are summarized below:

	Fair Value Measurements at March 31, 2009							
			-	ed Prices Active	S	ignificant Other	Sig	gnificant
			Identi	kets for cal Assets		bservable Inputs	Uno	bservable Inputs
		Total	(L	evel 1)		(Level 2)	<u>(I</u>	Level 3)
Assets:								
Federal funds	\$	23,275	\$	-	\$	23,275	\$	-
Investments available for sale		2,795,426		-		2,774,145		21,281
Derivative assets		643		-		643		-
Assets held in nonqualified benefit trusts		845		845		-		_
Total	\$	2,820,189	\$	845	\$	2,798,063	\$	21,281
Liabilities:								
Derivative liabilities	\$	1,280	\$	-	\$	1,280	\$	-
Standby letters of credit		1,901		-		1,901		-
	\$	3,181	\$	-	\$	3,181	\$	-

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, 2009, to March 31, 2009.

#### Fair Value Measurements Using Significant Unobservable Inputs (Level 3):

Available-for-sale investment securities:

Balance at January 1, 2009	\$ 99,992
Net losses included in other comprehensive income	(1,853)
Net losses included in earnings	(1,361)
Purchases, issuances and settlements	(99,992)
Transfers to Level 3	 24,495
Balance at March 31, 2009	\$ 21,281

The net losses included in other comprehensive income in the previous table are all on securities held at March 31, 2009.

Assets and liabilities measured at fair value on a nonrecurring basis at March 31, 2009 for each of the fair value hierarchy levels are summarized below:

	Fair Value Measurements at March 31, 2009								
		Total		Quoted Prices in Active Markets for Identical Assets (Level 1)		Significant Other Observable Inputs (Level 2)		Significant Unobservable Inputs (Level 3)	
Assets:	·								
Loans	\$	133,119	\$	-	\$	-	\$	133,119	
Other property owned		8,606		-		-		8,606	
Total assets	\$	141,725	\$	-	\$	-	\$	141,725	

#### **Valuation Techniques**

As more fully discussed in Note 1, "Organization and Summary of Significant Accounting Policies," of the Annual Report, SFAS 157 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 and its related associations' assets and liabilities:

#### **Investment Securities**

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. 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. Securities classified within Level 3 at March 31, 2009, include certain mortgage-backed securities.

#### Assets Held in Nonqualified Benefits 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.

#### Derivatives

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 basic interest rate swaps.

#### Loans

For certain loans evaluated for impairment under SFAS 114, 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.

#### 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.

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

Effective January 1, 2009, the bank and related associations adopted SFAS 161, "Disclosures about Derivative Instruments and Hedging Activities," which amends and expands the disclosure requirements for derivative instruments and for hedging activities previously required by SFAS 133.

The district 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 that are lower than those available to the bank if floating rate borrowings were made directly. Under interest rate swap arrangements, the bank agrees with other parties to exchange, at specified intervals, payment streams calculated on a specified notional principal amount, with at least one stream based on a specified floating rate index.

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 while the related interest-bearing liabilities tend to be short- or medium-term fixed rate obligations. Given this asset-liability mismatch, interest rate swaps in which a bank pays the floating rate and receives the fixed rate (receive fixed swaps) are used to reduce the impact of market fluctuations on a bank's net interest income. Because the size of swap positions needed to reduce the impact of market fluctuations varies over time, a 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 primary types of derivative instruments used and the amount of activity during the period is summarized in the following table:

	Rec	ceived-Fixed Swaps		Pay-Fixed xed Swaps		Total
Balance at January 1, 2009	\$	350,000	\$	450,000	\$	800,000
Maturities		(150,000)		(250,000)		(250,000)
Terminations	Φ.	(150,000)	Φ	-	Φ	(150,000)
Balance at March 31, 2009	\$	200,000	\$	200,000	\$	400,000

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 March 31, 2009 and December 31, 2008, the bank's exposure to counterparties, net of collateral, was \$2.2 million and \$32.1 million, respectively. At March 31, 2009 and December 31, 2008, the bank had posted no securities as collateral. At December 31, 2008, the bank held cash collateral of \$1.1 million with respect to its obligations under these arrangements.

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 March 31, 2009, or December 31, 2008.

#### 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 in SFAS 133 that presumes full effectiveness. Accordingly, no gain or loss is recognized in earnings.

#### 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 in SFAS 133 that presumes full effectiveness. Thus, the effective portion of the gain or loss on the derivative is reported as a component of other comprehensive income.

	As	sset Derivativo	es	<b>Liability Derivatives</b>		
Derivatives designated as hedging instruments under SFAS 133	Balance Sheet Location	Fair Value 3/31/2009	Fair Value 12/31/2008	Balance Sheet Location	Fair Value 3/31/2009	Fair Value 12/31/2008
Received fixed Pay fixed	Other assets	\$ 643	\$ 31,439	Other liabilities	\$ 1,280	\$ 3,074
		nt of Gain o				

**Derivative** 

instruments under SFAS 133	(Effective Portion)
Pay fixed	\$ (1.794)

#### NOTE 7 — EMPLOYEE BENEFIT PLANS

**Derivatives designated as hedging** 

Employees of the bank and district associations participate in either the defined benefit retirement plan or a defined contribution plan (DC Plan) and are eligible to participate in the district's 401(k) plan. Employer contributions to the DC Plan and 401(k) Plan are expensed as incurred. The multi-employer structure of the district's defined benefit pension plan results in the recording of this plan only upon combination. The following table summarizes the components of net periodic benefit costs for the district's defined benefit pension plans and for other postretirement benefit costs for the three months ended March 31:

Pension Benefits			Other Bene		
2009	2008	_	2009	2008	
\$ 1,379	\$1,397	\$	310	\$ 266	
3,920	3,861		624	587	
(2,650)	(3,536)			-	
98	204		(433)	(420)	
3,030	513		35	5	
\$ 5,777	\$2,439	\$	536	\$ 438	
	\$ 1,379 3,920 (2,650) 98 3,030	2009     2008       \$ 1,379     \$ 1,397       3,920     3,861       (2,650)     (3,536)       98     204       3,030     513	2009       2008         \$ 1,379       \$ 1,397       \$ 3,920       3,861         (2,650)       (3,536)       98       204         3,030       513	2009     2008     2009       \$ 1,379     \$ 1,397     \$ 310       3,920     3,861     624       (2,650)     (3,536)     (433)       98     204     (433)       3,030     513     35	

As of March 31, 2009, contributions of \$32.4 million have been made for pension benefits. The district presently anticipates no additional contributions to fund its pension plan in 2009.

#### NOTE 8 — INCOME TAXES

The bank and its affiliated associations did not have any uncertain tax positions for which it is reasonably possible that the total amounts of unrecognized tax benefits will significantly increase or decrease within the next 12 months.

#### NOTE 9 — BANK-ONLY FINANCIAL DATA

Condensed financial information for the bank follows. All significant transactions and balances between the bank and associations are eliminated in combination.

Balance sheet data	Ma	March 31, 2009		ember 31, 2008
Cash	\$	304,233	\$	13,093
Federal funds sold and securities				
purchased under resale agreements		23,275		176,698
Investment securities		2,825,183		3,028,468
Loans		11,450,286		11,403,113
Less allowance for loan losses		19,392		12,549
Net loans		11,430,894		11,390,564
Accrued interest receivable		58,341		63,632
Premises and equipment, net		8,121		6,772
Other assets		54,839		81,274
Total assets	\$	14,704,886	\$	14,760,501
	·			
Bonds and notes	\$	13,737,626	\$	13,802,205
Subordinated debt		50,000		50,000
Accrued interest payable		95,768		96,847
Other liabilities		38,284		66,907
Total liabilities		13,921,678		14,015,959
Preferred stock		200,000		200,000
Capital stock		227,212		227,212
Retained earnings		359,729		343,113
Accumulated other comprehensive loss		(3,733)		(25,783)
Total shareholders' equity		783,208		744,542
Total liabilities and shareholders' equity	\$	14,704,886	\$	14,760,501

	Three Months Ended March 31,						
Statement of income data		2009	2008				
Interest income	\$	150,593	\$	173,022			
Interest expense		114,757		144,942			
Net interest income		35,836		28,080			
Provision for loan losses		7,033	3 2,1:				
Net interest income after provision			·				
for loan losses		28,803		25,927			
Noninterest income		8,009		9,658			
Noninterest expense		20,171		14,566			
Net income	\$	16,641	\$	21,019			

Farm Crean Bank of Texas and District Associations
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