

HERE FOR AGRICULTURE



EVERY DAY



2010 FIRST QUARTER REPORT  
FARM CREDIT BANK OF TEXAS  
MARCH 31, 2010

# ***FIRST QUARTER 2010***

## **Table of Contents**

Management's Discussion and Analysis of Financial Condition and Results of Operations.....	2
Controls and Procedures.....	8
Financial Statements:	
Balance Sheets.....	9
Statements of Income .....	10
Statements of Changes in Shareholders' Equity.....	11
Statements of Cash Flows .....	12
Notes to Financial Statements .....	13

## **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 months ended March 31, 2010. These comments should be read in conjunction with the accompanying financial statements and footnotes, along with the 2009 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 four 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 FCBs 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 related associations collectively are referred to as the district. At March 31, 2010, the bank provided financing to 19 district associations and certain other financing institutions.

### **RESULTS OF OPERATIONS**

#### *Net Income*

Net income for the three months ended March 31, 2010, was \$35,233, an increase of \$18,592, or 111.7 percent, over the same period of 2009. The increase in net income for the three months ended March 31, 2010, consisted of a \$13,872 increase in net interest income, a \$1,323 decrease in provision for loan losses, and a \$3,656 decrease in noninterest expense, offset by a \$259 decrease in noninterest income.

#### *Net Interest Income*

Net interest income for the three months ended March 31, 2010, was \$49,708, an increase of \$13,872, or 38.7 percent, over the same period of 2009. The increase in net interest income was attributable to a 58-basis-point increase in the bank's interest rate spread, offset by a volume decrease of \$1.22 billion in the bank's average earning assets. Interest rate spreads increased primarily as a result of a 97-basis-point reduction in the effective rate on debt from the first quarter of 2009 to the first quarter of 2010, which was achieved largely due to the bank's ability to call high-cost debt and replace it with lower-cost debt during that period. The bank's earning assets decreased due to scheduled repayments and limited growth within its loan portfolio due to general economic conditions and tightened credit standards. Interest rate conditions are not expected to be the same throughout 2010, and thus these spread increases are not expected to be sustained in the future.

#### *Provision for Credit Losses*

The bank's provision for credit losses for the three months ended March 31, 2010, including provision for loan losses and provision for losses on stand-by letters of credit, totaled \$5,710, a decrease of \$1,323 over the \$7,033 provision for the first quarter of 2009. The decrease is primarily due to \$12.9 million decrease of specific provisions related to certain impaired loans, offset by a \$6.1 million increase in the general

allowance for loan losses and a \$5.5 million provision for credit losses on stand-by letters of credit. The general provision reflects expected credit deterioration in the participation loan portfolio due to general economic conditions. There is no provision for loan losses recorded for the bank's direct notes receivable from associations and other financing institutions. The reserve for losses on unfunded commitments is primarily related to expected losses on certain letters of credit to a rural electric facility outstanding on March 31, 2010.

#### *Noninterest Income*

Noninterest income for the three months ended March 31, 2010, was \$7,750, a decrease of \$259, or 3.2 percent, over the same period of 2009. The decrease was due mainly to a \$64 decrease in patronage income and a \$195 decrease in all other noninterest items, collectively.

#### *Noninterest Expense*

Noninterest expense for the three months ended March 31, 2010, was \$16,515, reflecting a decrease of \$3,656 over the same period of 2009. The decrease is primarily attributable to a \$1,738 decrease in premiums to the Farm Credit System Insurance Corporation (FCSIC or Insurance Fund), a \$1,569 decrease in salaries and employee benefits, a \$415 decrease in other operating expenses, and a \$167 increase in gains on other property owned, offset by a \$233 increase in occupancy and equipment expenses. The \$1,738 decrease in premiums paid to the Insurance Fund resulted from a decrease in the premium rate. The \$1,569 decrease in salaries and employee benefits included a \$771 decrease in compensation and related payroll taxes, a \$735 decrease in pension and retirement expenses, and a \$63 decrease in other benefits. The decrease in compensation included the effects of \$964 in accruals during the first three months of 2009 for deferred compensation for the bank's chief executive officer as outlined in the bank's 2009 Annual Report to shareholders. The decrease in pension and retirement benefits was mainly the result of reductions in required contributions to the district's multi-employer defined benefit pension plan. Contributions from the plan's various employers were increased in 2009 in response to declines in market values of the plan's investments during the last half of 2008. Other operating expenses decreased due to a \$961 decrease in assessments for the Federal Farm Credit Banks Funding Corporation (Funding Corporation) offset by a \$415 increase in professional and contract services and a \$131 increase in all other operating expenses, collectively.

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

	<b>Annualized for the Three Months Ended 3/31/2010</b>	Annualized for the Three Months Ended 3/31/2009
Return on average assets	<b>1.03%</b>	0.46%
Return on average shareholders' equity	<b>16.94%</b>	8.89%
Net interest income as a percentage of average earning assets	<b>1.51%</b>	1.00%
Charge-offs, net of recoveries, to average loans	<b>0.01%</b>	0.01%
Operating expenses as a percentage of net interest income and noninterest income	<b>29.03%</b>	46.01%
Operating expenses as a percentage of average earning assets	<b>0.51%</b>	0.56%

## FINANCIAL CONDITION

*Loan Portfolio*

Gross loan volume at March 31, 2010, was \$10,846,852, a decrease of \$186,262, or 1.7 percent, compared to \$11,033,114 at December 31, 2009. The decrease in the loan portfolio is mainly attributable to decreases in the bank's direct loans to associations and other financing institutions, offset by limited growth in the bank's capital markets loan portfolio. In March 2010, the bank purchased loans with credit deterioration since origination and other property owned from a district association. The purchase of the loan assets and other property owned by the bank were completed to ensure the district association remained a viable stand-alone institution. This purchase activity avoided a non-accrual classification of a district association direct note receivable and protected the bank's charter in the state of which the district association was located and has lending authorities. The loans, which had book balances at the association totaling \$40.1 million, were purchased at fair value of \$32.8 million. The fair value was derived by discounting the total estimated cash flows of \$36.3 million by appropriate yield curves, resulting in an accretable discount of \$3.5 million. The resulting accretable discount will be accreted into interest income on a level-yield basis. In addition to these loans, the bank also purchased acquired property related to three other loans from the association at fair value of \$2.9 million. The financial impact of the purchases to the bank is negligible due to the size of the bank's balance sheet. Because the assets were purchased at fair value, the transaction should not adversely impact future earnings as the assets are liquidated or refinanced over the next two to three years. The \$33,494 increase in nonaccrual loans in the table below included \$20,143 of the above-mentioned loans purchased from a district association related to lands in transition and dairy sectors.

Loans classified under the Farm Credit Administration's Uniform Loan Classification System as "acceptable" or "other assets especially mentioned" were 95.0 percent of total loans and accrued interest at March 31, 2010, compared to 94.9 percent at December 31, 2009. The table below summarizes the balances of the bank's high-risk assets at March 31, 2010 compared to the balances at December 31, 2009:

	<b>March 31, 2010</b>	<b>Increase (Decrease)</b>		<b>December 31, 2009</b>
		<b>\$</b>	<b>%</b>	
Nonaccrual loans	<b>\$ 145,409</b>	\$ 33,494	29.93 %	\$ 111,915
Formally restructured loans	<b>635</b>	(12)	(1.85)	647
Loans 90 days past due and still accruing interest	<b>2,306</b>	2,306	-	-
Total impaired loans	<b>148,350</b>	35,788	31.79	112,562
Other property owned, net	<b>3,228</b>	2,589	405.16	639
Total high-risk assets	<b>\$ 151,578</b>	\$ 38,377	33.90 %	\$ 113,201

At March 31, 2010, \$57.0 million, or 39.2 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. Nonaccrual loans on which interest income from cash payments is recognized totaled \$4.2 million at March 31, 2010, compared to \$10.0 million at December 31, 2009. The increase in loans 90 days past due and still accruing interest resulted primarily from the loans purchased from a district association.

Impaired loans, consisting of nonaccrual loans, formally restructured loans and loans 90 days or more past due and still accruing interest, constituted 1.4 percent of gross loans at March 31, 2010, and 1.0 percent of gross loans at December 31, 2009. The bank had other property owned totaling \$3,228 at

March 31, 2010, which included \$2,917 in other property owned purchased from a district association in March 2010 and the underlying collateral on two participation loans.

The allowance for loan losses as a percentage of impaired loans was 21.8 percent as of March 31, 2010, as compared to 28.1 percent as of December 31, 2009. The relatively low percentage is attributable to the strength of the collateral (primarily first lien real estate) supporting many of the impaired loans.

At March 31, 2010, the allowance for loan losses was \$32,380, equating to 0.30 percent of total loans outstanding, and 1.17 percent of capital markets participation loans outstanding, and was considered by management to be adequate to absorb estimated losses inherent in the loan portfolio at that date. The allowance for loan losses at March 31, 2010, was attributable to participation loans.

### *Liquidity and Funding Sources*

Cash and investment securities totaled \$2,917,086, or 21.0 percent, of total assets at March 31, 2010, compared to \$2,634,400, or 19.1 percent, at December 31, 2009, an increase of \$282,686, or 10.7 percent. At March 31, 2010, the bank's cash balance was \$328,507, a \$141,918 decrease from December 31, 2009. Interest-bearing liabilities, consisting of bonds, notes and subordinated debt, increased by \$79,325, or 0.6 percent, in concert with the increase in earning assets requiring funding.

### *Investments*

The bank's investments included an available-for-sale portfolio with a fair value of \$2.6 billion at March 31, 2010. The bank's available-for-sale portfolio consisted primarily of federal agency collateralized mortgage-backed securities, corporate debt, other collateralized mortgage-backed securities and asset-backed securities. At March 31, 2010, the bank held 11 investments that were ineligible for liquidity purposes by FCA regulations, due to credit ratings that were below AAA by both Moody's Investors Service and Standard & Poor's. Those ineligible securities had an amortized cost basis of \$72,568 and a fair value of \$63,123 at March 31, 2010.

The types of corporate debt, mortgage-backed and asset-backed securities that are included in the bank's available-for-sale investment portfolio were (in thousands):

	March 31, 2010		December 31, 2009	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Corporate debt	\$ 101,582	\$ 103,680	\$ 131,815	\$ 133,733
Federal agency collateralized mortgage obligations	2,320,441	2,343,865	1,843,894	1,871,339
Other collateralized mortgage obligations	107,059	97,552	123,315	110,106
Asset-backed securities	26,036	23,057	31,658	28,307
Total available-for-sale investments	<u>\$ 2,555,118</u>	<u>\$ 2,568,154</u>	<u>\$ 2,130,682</u>	<u>\$ 2,143,485</u>

The bank's increases in federal agency collateralized mortgage obligations during the first quarter of 2010 have been in Government National Mortgage Association (GNMA) mortgage-backed securities. Pricing on agency securities remains strong due to the Federal Reserve's mortgage-backed securities purchase program, stabilization in the agency market, and increased demand for quality GNMA structures.

The bank recognized other-than-temporary impairment losses on four mortgage-backed investments and one asset-backed security during 2010. The credit portion of the impairment losses, recognized as a loss in earnings, totaled \$1,342 for the three months ended March 31, 2010. The non-credit-related increase in fair value totaling \$1,065 on the five investments is included as a credit to other comprehensive income.

Farm Credit Administration 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, such as Moody's Investors Service, Standard & Poor's or Fitch Ratings. If an investment no longer meets the credit rating criteria, the investment becomes ineligible. A bank must dispose of an investment that becomes ineligible within six months, unless the Farm Credit Administration approves, in writing, a plan that authorizes the bank to divest the instrument over a longer period of time. The Farm Credit Administration has approved, with conditions, plans submitted by the bank and is in the process of reviewing other plans that have been submitted. To date, the Farm Credit Administration has not required disposition of any of these securities.

The following table sets forth investments available-for-sale at fair value by credit rating:

	Eligible		Ineligible								Total
	AAA/Aaa	Split Rated	AA/Aa	AA/BBB Split Rated	A-/BB-Split Rated	B3/BBB/B Split Rated	BBB/Baa	BB/Ba	B3/CCC/CC	CCC/Caa	
<u>March 31, 2010</u>											
Corporate debt	\$ 103,680	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 103,680
Federal agency collateralized mortgage obligations	2,343,865	-	-	-	-	-	-	-	-	-	2,343,865
Other collateralized mortgage obligations	25,386	12,269	12,696	-	-	5,624	-	10,095	8,813	22,669	97,552
Asset-backed securities	15,535	4,296	-	-	-	-	1,669	1,557	-	-	23,057
<b>Total</b>	<b>\$ 2,488,466</b>	<b>\$ 16,565</b>	<b>\$ 12,696</b>	<b>\$ -</b>	<b>\$ -</b>	<b>\$ 5,624</b>	<b>\$ 1,669</b>	<b>\$ 11,652</b>	<b>\$ 8,813</b>	<b>\$ 22,669</b>	<b>\$ 2,568,154</b>
	Eligible		Ineligible								Total
	AAA/Aaa	Split Rated	AA/Aa	AA/BBB Split Rated	A-/BB-Split Rated	B3/BBB/B Split Rated	BBB/Baa	BB/Ba	B3/CCC/CC	CCC/Caa	
<u>December 31, 2009</u>											
Corporate debt	\$ 103,733	\$ -	\$ 30,000	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 133,733
Federal agency collateralized mortgage obligations	1,871,339	-	-	-	-	-	-	-	-	-	1,871,339
Other collateralized mortgage obligations	32,753	25,698	-	5,792	2,400	8,203	-	10,909	-	24,351	110,106
Asset-backed securities	19,655	4,958	-	-	-	-	2,014	1,680	-	-	28,307
<b>Total</b>	<b>\$ 2,027,480</b>	<b>\$ 30,656</b>	<b>\$ 30,000</b>	<b>\$ 5,792</b>	<b>\$ 2,400</b>	<b>\$ 8,203</b>	<b>\$ 2,014</b>	<b>\$ 12,589</b>	<b>\$ -</b>	<b>\$ 24,351</b>	<b>\$ 2,143,485</b>

### Capital Resources

As of March 31, 2010, the bank exceeded the minimum permanent capital, core surplus, total surplus and net collateral ratio requirements under Farm Credit Administration regulations. At March 31, 2010, the bank's permanent capital ratio was 15.61 percent, core surplus was 6.56 percent, total surplus was 11.91 percent and the net collateral ratio was 106.13 percent. Total shareholders' equity at March 31, 2010, totaled \$853,675, an increase of \$32,383 from December 31, 2009. This increase is the result of net income of \$35,233 for the three months ended March 31, 2010, a decrease in unrealized net losses on

investment securities totaling \$235, and a \$72 amortization related to retirement benefits, offset by a \$1,823 unrealized loss on cash flow derivatives and patronage paid of \$1,334.

The change in unrealized losses on investment securities was due primarily to changes in the market value of fixed-rate mortgage-backed securities, whose values have changed as interest rates have fluctuated during the period, and to changes in the market value of mortgage-backed and asset-backed securities. 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."

***Key financial condition comparisons:***

	<b>March 31, 2010</b>	<b>December 31, 2009</b>
Permanent capital ratio	<b>15.61 %</b>	15.98%
Net collateral ratio	<b>106.13 %</b>	105.83%
Allowance and reserve for credit losses to total loans	<b>0.35 %</b>	0.29%

The undersigned certify that we have reviewed the March 31, 2010, 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



Ralph W. Cortese  
Chairman of the Board



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

May 10, 2010



## **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.

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



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

May 10, 2010

## Balance Sheets

(dollars in thousands)	March 31, 2010 (Unaudited)	December 31, 2009
<b>Assets</b>		
Cash	\$ 328,507	\$ 470,425
Federal funds sold and overnight investments	20,425	20,490
Investment securities	2,568,154	2,143,485
Loans	10,846,852	11,033,114
Less allowance for loan losses	32,380	31,602
Net loans	10,814,472	11,001,512
Accrued interest receivable	48,583	48,709
Other property owned, net	3,228	639
Premises and equipment, net	14,744	12,348
Other assets	62,396	78,894
<b>Total assets</b>	<b>\$ 13,860,509</b>	<b>\$ 13,776,502</b>
<b>Liabilities and shareholders' equity</b>		
<b>Liabilities</b>		
Bonds and notes, net	\$ 12,848,804	\$ 12,769,479
Subordinated debt	50,000	50,000
Accrued interest payable	66,414	68,106
Other liabilities	41,616	67,625
<b>Total liabilities</b>	<b>13,006,834</b>	<b>12,955,210</b>
<b>Commitments and contingent liabilities (Note 4)</b>		
<b>Shareholders' equity</b>		
Preferred stock, net	200,000	200,000
Capital stock	237,361	237,361
Allocated retained earnings	8,031	8,029
Unallocated retained earnings	398,928	365,031
Accumulated other comprehensive income	9,355	10,871
<b>Total shareholders' equity</b>	<b>853,675</b>	<b>821,292</b>
<b>Total liabilities and shareholders' equity</b>	<b>\$ 13,860,509</b>	<b>\$ 13,776,502</b>

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

**Statements of Income**

(unaudited)

(dollars in thousands)	<b>Quarter Ended March 31,</b>	
	<b>2010</b>	<b>2009</b>
<b>Interest Income</b>		
Investment securities	\$ 16,678	\$ 26,108
Loans	108,702	124,485
<b>Total interest income</b>	<b>125,380</b>	<b>150,593</b>
<b>Interest Expense</b>		
Bonds, notes and subordinated debt	75,672	114,757
<b>Net interest income</b>	<b>49,708</b>	<b>35,836</b>
Provision for credit losses	5,710	7,033
<b>Net interest income after provision for credit losses</b>	<b>43,998</b>	<b>28,803</b>
<b>Noninterest Income</b>		
Patronage income	4,733	4,797
Fees for services to associations	2,146	2,128
Loan-related fees	2,030	2,005
Miscellaneous income, net	183	440
Impairment losses on investments		
Total other-than-temporary impairment losses	(277)	(3,215)
Less: portion of (gain) loss recognized in other comprehensive income	(1,065)	1,854
Net impairment loss recognized in earnings	(1,342)	(1,361)
<b>Total noninterest income</b>	<b>7,750</b>	<b>8,009</b>
<b>Noninterest Expense</b>		
Salaries and employee benefits	9,537	11,106
Occupancy and equipment	1,602	1,369
Insurance Fund premiums	966	2,704
Gains on other property owned, net	(167)	-
Other operating expenses	4,577	4,992
<b>Total noninterest expense</b>	<b>16,515</b>	<b>20,171</b>
<b>Net Income</b>	<b>\$ 35,233</b>	<b>\$ 16,641</b>

*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 Income (Loss)	Total Shareholders' Equity
Balance at December 31, 2008	\$ 200,000	\$ 227,212	\$ 6,114	\$ 336,999	\$ (25,783)	\$ 744,542
Noncredit portion of previous other-than-temporary impairment losses	-	-	-	1,527	(1,527)	-
Balance at January 1, 2008	200,000	227,212	6,114	338,526	(27,310)	744,542
Comprehensive income						
Net income	-	-	-	16,641	-	16,641
Change in pension and postretirement benefit plans	-	-	-	-	62	62
Net change in unrealized net gains on investment securities	-	-	-	-	23,576	23,576
Noncredit portion of current other-than-temporary impairment losses	-	-	-	-	(1,854)	(1,854)
Net change in unrealized net gains on cash flow derivatives	-	-	-	-	1,793	1,793
Total comprehensive income	-	-	-	16,641	23,577	40,218
Patronage distributions						
Cash	-	-	-	(1,552)	-	(1,552)
Shareholders' equity	-	-	31	(31)	-	-
Balance at March 31, 2009	\$ 200,000	\$ 227,212	\$ 6,145	\$ 353,584	\$ (3,733)	\$ 783,208
Balance at December 31, 2009	\$ 200,000	\$ 237,361	\$ 8,029	\$ 365,031	\$ 10,871	\$ 821,292
Comprehensive income						
Net income	-	-	-	35,233	-	35,233
Change in pension and postretirement benefit plans	-	-	-	-	72	72
Net change in unrealized net gains on investment securities	-	-	-	-	(830)	(830)
Noncredit portion of current other-than-temporary impairment losses	-	-	-	-	1,065	1,065
Net change in unrealized net losses on cash flow derivatives	-	-	-	-	(1,823)	(1,823)
Total comprehensive income	-	-	-	35,233	(1,516)	33,717
Patronage distributions						
Cash	-	-	-	(1,334)	-	(1,334)
Shareholders' equity	-	-	2	(2)	-	-
Balance at March 31, 2010	\$ 200,000	\$ 237,361	\$ 8,031	\$ 398,928	\$ 9,355	\$ 853,675

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

# Statements of Cash Flows

(unaudited)

(dollars in thousands)	Three Months Ended March 31,	
	2010	2009
<b>Operating activities</b>		
Net income	\$ 35,233	\$ 16,641
Reconciliation of net income to net cash provided by operating activities		
Provision for loan losses	5,710	7,033
Depreciation and amortization on premises and equipment	365	350
Accretion of net discount on loans	(54)	(73)
Amortization and accretion on debt instruments	(1,302)	(304)
Amortization of net premium on investment securities	1,018	16
Gains from sales of other property owned, net	(167)	-
Losses on impairment of investments available-for-sale	1,342	1,361
Allocated equity patronage from System bank	(12,476)	(11,762)
Decrease in accrued interest receivable	126	5,291
Decrease in other assets	20,896	7,391
Decrease in accrued interest payable	(1,692)	(1,079)
Decrease in other liabilities	(7,700)	(12,441)
Net cash provided by operating activities	41,299	12,424
<b>Investing activities</b>		
Net decrease in federal funds sold	65	153,423
Investment securities		
Purchases	(703,684)	(609,578)
Proceeds from maturities, calls and prepayments	276,890	833,042
Redemption of investment in Farmer Mac preferred stock	7,000	-
Decrease in loans, net	202,898	48,544
Expenditures from purchase of loans	(32,822)	(100,000)
Proceeds from sales of other property owned, net	328	-
Expenditures for premises and equipment	(2,761)	(1,699)
Net cash (used in) provided by investing activities	(252,086)	323,732
<b>Financing activities</b>		
Bonds and notes issued	4,270,216	19,876,877
Bonds and notes retired	(4,190,364)	(19,910,346)
Cash patronage distributions paid	(10,983)	(11,547)
Net cash provided by (used in) financing activities	68,869	(45,016)
Net (decrease) increase in cash	(141,918)	291,140
Cash at beginning of year	470,425	13,093
Cash at end of quarter	\$ 328,507	\$ 304,233
<b>Supplemental schedule of noncash investing and financing activities</b>		
Loans transferred to other property owned	\$ 2,917	\$ -
Net decrease in unrealized losses on investment securities	235	20,194
<b>Supplemental schedule of noncash changes in fair value related to hedging activities</b>		
Increase (decrease) in bonds and notes	\$ 775	\$ (30,797)
<b>Supplemental information</b>		
Interest paid	\$ 77,364	\$ 115,836

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, 2009, are contained in the 2009 Annual Report to shareholders (Annual Report). These unaudited first quarter 2010 financial statements should be read in conjunction with the Annual Report.

Effective January 1, 2010, the bank adopted Financial Accounting Standards Board (FASB) guidance on “Fair Value Measurements and Disclosures,” which is to improve disclosures about fair value measurements by increasing transparency in financial reporting. The guidance will provide for a greater level of disaggregated information and more robust disclosures of valuation techniques and inputs to fair value measurements. The adoption of this guidance had no impact on the bank’s financial condition and results of operations but resulted in additional disclosures.

In June 2009, the FASB issued guidance on “Accounting for Transfers of Financial Assets,” which amends previous guidance by improving the relevance, representational faithfulness, and comparability of the information that a reporting entity provides in its financial statements about a transfer of financial assets; the effects of a transfer on its financial position, financial performance, and cash flows; and a transferor’s continuing involvement, if any, in transferred financial assets.

This guidance is effective as of the beginning of each reporting entity’s first annual reporting period that begins after November 15, 2009, for interim periods within that first annual reporting period and for interim and annual reporting periods thereafter. Earlier application is prohibited. This Statement must be applied to transfers occurring on or after the effective date. Additionally, on and after the effective date, the concept of a qualifying special purpose entity is no longer relevant for accounting purposes. Therefore, formerly qualifying special-purpose entities (as defined under previous accounting standards) should be evaluated for consolidation by reporting entities on and after the effective date in accordance with the applicable consolidation guidance. If the evaluation on the effective date results in consolidation, the reporting entity should apply the transition guidance provided in the pronouncement that requires consolidation. The bank reviewed their loan participation agreements to ensure that participations would meet the requirements for sale treatment and not be required to be consolidated. The impact of adoption on January 1, 2010, was immaterial to the bank’s financial condition and results of operations.

In June 2009, the FASB also issued guidance to improve financial reporting for those enterprises involved with variable interest entities, which amends previous guidance by requiring an enterprise to perform an analysis to determine whether the enterprise’s variable interest or interests give it a controlling financial interest in a variable interest entity. Additionally, an enterprise is required to assess whether it has an implicit financial responsibility to ensure that a variable interest entity operates as designed when determining whether it has the power to direct the activities of the variable interest entity that most significantly impact the entity’s economic performance.

This guidance is effective as of the beginning of each reporting entity’s first annual reporting period that begins after November 15, 2009, for interim periods within that first annual reporting period and for interim and annual reporting periods thereafter. Earlier application is prohibited. The bank reviewed

transactions that are included in the scope of this guidance and determined that the impact of adoption on January 1, 2010, was immaterial to the bank's financial condition and results of operations.

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 March 31, 2010, the bank provided financing to 19 district associations and certain other financing institutions.

## 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, 2010, and December 31, 2009, is as follows:

	March 31, 2010				
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value	Weighted Average Yield
Corporate debt	\$ 101,582	\$ 2,098	\$ -	\$ 103,680	1.90 %
Federal agency collateralized mortgage obligations	2,320,441	32,404	(8,980)	2,343,865	2.68
Other collateralized mortgage obligations	107,058	70	(9,576)	97,552	6.98
Asset-backed securities	26,035	3	(2,981)	23,057	3.44
Total available-for-sale investments	<u>\$ 2,555,116</u>	<u>\$ 34,575</u>	<u>\$ (21,537)</u>	<u>\$ 2,568,154</u>	<u>2.86 %</u>

  

	December 31, 2009				
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value	Weighted Average Yield
Corporate debt	\$ 131,815	\$ 1,918	\$ -	\$ 133,733	1.56 %
Federal agency collateralized mortgage obligations	1,843,894	32,866	(5,421)	1,871,339	3.16
Other collateralized mortgage obligations	123,315	12	(13,221)	110,106	6.87
Asset-backed securities	31,658	-	(3,351)	28,307	3.50
Total available-for-sale investments	<u>\$ 2,130,682</u>	<u>\$ 34,796</u>	<u>\$ (21,993)</u>	<u>\$ 2,143,485</u>	<u>3.30 %</u>

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, 2010:

	Due after one year through five years	Due after five years through 10 years	Due after 10 years	Total
Corporate debt	\$ 103,680	\$ -	\$ -	\$ 103,680
Federal agency collateralized mortgage obligations	89,322	266,581	1,987,962	2,343,865
Other collateralized mortgage obligations	-	9,550	88,002	97,552
Asset-backed securities	2,882	5,795	14,380	23,057
Total fair value	<b>\$ 195,884</b>	<b>\$ 281,926</b>	<b>\$ 2,090,344</b>	<b>\$ 2,568,154</b>
Total amortized cost	<b>\$ 191,079</b>	<b>\$ 277,749</b>	<b>\$ 2,086,290</b>	<b>\$ 2,555,118</b>
Weighted average yield	<b>3.49 %</b>	<b>2.96 %</b>	<b>2.79 %</b>	<b>2.86 %</b>

### Investments Available for Sale

The following table shows 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 March 31, 2010. 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
Federal agency collateralized mortgage obligations	\$ 947,298	\$ (8,875)	\$ 30,892	\$ (108)	\$ 978,190	\$ (8,983)
Other collateralized mortgage obligations	-	-	85,370	(9,573)	85,370	(9,573)
Asset-backed securities	-	-	14,380	(2,981)	14,380	(2,981)
Total	<b>\$ 947,298</b>	<b>\$ (8,875)</b>	<b>\$ 130,642</b>	<b>\$ (12,662)</b>	<b>\$ 1,077,940</b>	<b>\$ (21,537)</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).

The bank recognized other-than-temporary impairment losses on four mortgage-backed investments and one asset-backed security during the first three months of 2010. The credit portion of the impairment losses, totaling \$1,342, was recognized as a loss in earnings in the first quarter. The non-credit-related impairment losses on the five investments, totaling \$6,303, are included as a charge against other comprehensive income.

As the bank has no intent of selling 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 quarter of 2010. 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. 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. Default rate assumptions are generally estimated using historical loss and performance information to estimate future defaults. The default rates used at March 31, 2010, ranged from 10.7 percent to 17.1 percent for non-agency mortgage-backed securities and was 12.7 percent for the asset-backed security. Prepayment rate assumptions are based on historical prepayment rates and ranged from 6.1 percent to 12.2 percent for non-agency mortgage-backed securities and was 10.2 percent for the asset-backed security at March 31, 2010. At March 31, 2010, the loss severity assumptions ranged from 45.0 percent to 58.1 percent for non-agency mortgage-backed securities and was 62.1 percent for the asset-backed security. 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 is a rollforward of the amount related to credit losses recognized during the three months ended March 31, 2010:

Credit losses for which a portion of an other-than-temporary impairment was recognized in OCI at January 1, 2010	\$ 6,005
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	<u>1,342</u>
Credit losses for which a portion of an other-than-temporary impairment was recognized in OCI at March 31, 2010	<u><u>\$ 7,347</u></u>

The following is a rollforward of the amount related to credit losses recognized during the three months ended March 31, 2009:

Credit losses for which a portion of an other-than-temporary impairment was recognized in OCI at January 1, 2009	\$ 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	<u>469</u>
Credit losses for which a portion of an other-than-temporary impairment was recognized in OCI at March 31, 2009	<u><u>\$ 2,073</u></u>

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

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

	<b>March 31, 2010</b>	<b>December 31, 2009</b>
Direct notes receivable from district associations and OFIs	<b>\$ 8,024,104</b>	\$ 8,304,420
Participations purchased	<b>2,777,613</b>	2,715,889
Other loans	<b>45,135</b>	12,805
Balance at end of period	<b><u>\$ 10,846,852</u></b>	<b><u>\$ 11,033,114</u></b>

The following table presents information concerning nonaccrual loans, accruing restructured loans and accruing loans 90 days or more past due, collectively referred to as “impaired loans.”

	<b>March 31, 2010</b>	<b>Increase (Decrease)</b>		<b>December 31, 2009</b>
		<b>\$</b>	<b>%</b>	
Nonaccrual loans	<b>\$ 145,409</b>	\$ 33,494	29.93 %	\$ 111,915
Formally restructured loans	<b>635</b>	(12)	(1.85)	647
Loans 90 days past due and still accruing interest	<b>2,306</b>	2,306	-	-
Total impaired loans	<b><u>\$ 148,350</u></b>	<b><u>\$ 35,788</u></b>	<b>31.79 %</b>	<b><u>\$ 112,562</u></b>

The average recorded investment in impaired loans for the three months ended March 31, 2010 and 2009, were \$115.0 million and \$112.6 million, respectively. The bank recognized interest income of \$131 on impaired loans during the three months ended March 31, 2010.

During March of 2010, the bank purchased loans with evidence of credit deterioration since origination from a district association. The loans, with book balances totaling \$40,069 at the association, were purchased at a fair value of \$32,822, which was the discounted present value of estimated cash flows of \$36,341. The accretable yield of \$3,519, the difference between the estimated cash flows on the loans and the fair value, will be recognized on a level-yield basis over the life of the loan. The total contractually required payments (currently due and scheduled for the future) totaled \$62,365. Under the purchase agreement, the association will continue to service the loans over their remaining lives.

At March 31, 2010, impaired loans of \$58.4 million had a related specific allowance of \$26.1 million, while the remaining \$90.0 million of impaired loans had no related specific allowance as a result of adequate collateralization.

An analysis of the reserves for credit losses follows:

	<b>Three Months Ended March 31, 2010</b>	<b>Year Ended December 31, 2009</b>
<b>Allowance for loan losses:</b>		
Balance at beginning of period	\$ 31,602	\$ 12,549
Provision for credit losses	5,710	33,648
Loans charged off	(397)	(14,364)
Recoveries	97	518
Change in reserve for losses on unfunded commitments and standby letters of credit	(4,632)	(749)
Balance at end of period	<u>\$ 32,380</u>	<u>\$ 31,602</u>
 Reserve for losses on unfunded commitments and standby letters of credit	 <u>\$ 5,502</u>	 <u>\$ 870</u>

#### **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, 2010, were approximately \$174.6 billion.

#### **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 2009 Annual Report for a more complete description.

Assets and liabilities measured at fair value on a recurring basis at March 31, 2010, for each of the fair value hierarchy levels are summarized below:

Fair Value Measurements at March 31, 2010				
	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	\$ 20,425	\$ -	\$ 20,425	\$ -
Investments available for sale	2,568,154	-	2,568,154	-
Derivative assets	3,903	-	3,903	-
Assets held in nonqualified benefit trusts	324	324	-	-
Total	<u>\$ 2,592,806</u>	<u>\$ 324</u>	<u>\$ 2,592,482</u>	<u>\$ -</u>
<b>Liabilities:</b>				
Standby letters of credit	\$ 3,006	\$ -	\$ 3,006	\$ -
Total	<u>\$ 3,006</u>	<u>\$ -</u>	<u>\$ 3,006</u>	<u>\$ -</u>

The amount of gains or losses for the period included in earnings attributable to the change in unrealized gains or losses relating to assets or liabilities still held at March 31, 2010

\$ 1,342

There were no transfers of assets or liabilities into or out of levels 1 or 2 from other levels during the quarter ended March 31, 2010.

Assets and liabilities measured at fair value on a nonrecurring basis at March 31, 2010, for each of the fair value hierarchy levels are summarized below:

Fair Value Measurement at March 31, 2010					
	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	\$ 33,519	\$ -	\$ -	\$ 33,519	\$ (397)
Other property owned	3,228			3,228	167
Total assets	<u>\$ 36,747</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 36,747</u>	<u>\$ (230)</u>

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

Fair Value Measurements at December 31, 2009				
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
	Total			
<b>Assets:</b>				
Federal funds	\$ 20,490	\$ -	\$ 20,490	\$ -
Investments available for sale	2,143,485	-	2,143,485	-
Derivative assets	2,526	-	2,526	-
Assets held in nonqualified benefit trusts	235	235	-	-
Total	<u>\$ 2,166,736</u>	<u>\$ 235</u>	<u>\$ 2,166,501</u>	<u>\$ -</u>
<b>Liabilities:</b>				
Derivative liabilities	\$ 30	\$ -	\$ 30	\$ -
Standby letters of credit	3,006	-	3,006	-
	<u>\$ 3,036</u>	<u>\$ -</u>	<u>\$ 3,036</u>	<u>\$ -</u>

There were no transfers of assets or liabilities into or out of level 1 from other levels during 2009. There were no liabilities transferred into or out of level 2 from other levels during 2009. During 2009, mortgage-backed securities with a fair value of \$36,816 were transferred from level 2 to level 3 due to significant unobservable inputs in the valuation model. Subsequently in 2009, these securities were returned to level 2 at a fair value of \$26,931 when level 2 pricing models were used in their valuation.

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 December 31, 2009:

Available-for-sale investment securities:

Balance at January 1, 2009	\$ 99,992
Net losses included in other comprehensive income	(376)
Net losses included in earnings	(5,293)
Purchases, issuances and settlements	(104,208)
Transfers to Level 3	9,885
Balance at December 31, 2009	<u>\$ -</u>

The amount of gains or losses for the period included in earnings attributable to the change in unrealized gains or losses relating to assets or liabilities still held at December 31, 2009

\$ 5,293

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

	Fair Value Measurement at December 31, 2009				
	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	\$ 53,084	\$ -	\$ -	\$ 53,084	\$ (14,365)
Other property owned	710			710	14
Total assets	\$ 53,794	\$ -	\$ -	\$ 53,794	\$ (14,351)

### 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:

#### *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. 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.

#### *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 and cash flow derivatives. 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.

### Loans

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.

### 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.

## NOTE 6 — FAIR VALUE OF FINANCIAL INSTRUMENTS

The following table presents the carrying amounts and estimated values of the bank's financial instruments at March 31, 2010, and December 31, 2009.

The estimated fair values of the bank's financial instruments follows:

	March 31, 2010		December 31, 2009	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
<b>Financial assets</b>				
Cash, federal funds sold and investment securities	\$ 2,917,086	\$ 2,917,086	\$ 2,634,400	\$ 2,634,400
Loans	10,846,852	11,060,273	11,033,114	11,176,487
Allowance for loan losses	(32,380)	—	(31,602)	—
Loans, net	10,814,472	11,060,273	11,001,512	11,176,487
Derivative assets	3,903	3,903	2,526	2,526
<b>Financial liabilities</b>				
Bonds and notes	12,848,804	12,967,437	12,769,479	12,862,844
Subordinated debt	50,000	51,076	50,000	50,696
Derivative liabilities	-	-	30	30

A description of the methods and assumptions used to estimate the fair value of each class of the bank's financial instruments for which it is practicable to estimate that value follows:

### Cash and Federal Funds Sold:

The carrying value is a reasonable estimate of fair value.

### Investment securities:

If an active market exists, the fair value is based on currently quoted market prices. For those securities for which an active market does not exist, the fair value is determined as described in Note 5, "Fair Value Measurements."

### Loans:

Because no active market exists for the bank's loans, fair value is estimated by discounting the expected future cash flows using the bank's current interest rates at which similar loans would be made to borrowers with similar credit risk. 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.

Fair value of loans in a nonaccrual status that are current as to principal and interest is estimated as described above, with appropriately higher discount rates to reflect the uncertainty of continued cash flows. For noncurrent nonaccrual loans, it is assumed that collection will result only from the disposition of the underlying collateral. Fair value of these loans is estimated to equal the aggregate net realizable value of the underlying collateral, discounted at an interest rate that appropriately reflects the uncertainty of the expected future cash flows over the average disposal period.

*Bonds and Notes:*

Systemwide bonds and notes are not regularly traded; thus, quoted market prices are not available. Fair value of these instruments is estimated by discounting expected future cash flows based on the quoted market price of new issues of Systemwide bonds with similar-maturity terms.

*Subordinated Debt:*

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

*Derivative Assets and Liabilities:*

The fair value of derivative financial instruments is the estimated amount that a bank would receive or pay to replace the instruments at the reporting date, considering the current interest rate environment and the current creditworthiness of the counterparties. Where such quoted market prices do not exist, these values are generally provided by sources outside the respective bank or by internal market valuation models.

*Commitments to Extend Credit:*

Fees on commitments to extend credit are not normally assessed; hence, there is no fair value to be assigned to these commitments until they are funded.

## **NOTE 7 — 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 a 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, 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 notional amounts and primary types of derivative instruments used and the amount of activity during the period is summarized in the following table:

	Receive-Fixed Swaps	Interest Rate Caps	Total
Balance at January 1, 2010	\$ 125,000	\$ 130,000	\$ 255,000
Additions	-	225,000	225,000
Balance at March 31, 2010	<b>\$ 125,000</b>	<b>\$ 355,000</b>	<b>\$ 480,000</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 March 31, 2010, and December 31, 2009, the bank's exposure to counterparties, net of collateral, was \$3.9 million and \$2.5 million, respectively. At March 31, 2010, and December 31, 2009, the bank had posted no securities as 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 March 31, 2010, or December 31, 2009.

#### *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.

#### *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.

Derivatives designated as hedging instruments	Balance Sheet Location	Fair Value 3/31/2010	Fair Value 12/31/2009	Balance Sheet Location	Fair Value 3/31/2010	Fair Value 12/31/2009
Receive fixed	Other assets	\$ 1,667	\$ 921	Other liabilities	\$ -	\$ 30
Interest rate caps	Other assets	2,236	1,605	Other liabilities	-	-

Derivatives designated as hedging instruments	Change in OCI on Derivative (Effective Portion)
Interest rate caps	\$ (1,823)

#### **NOTE 8 — EMPLOYEE BENEFIT PLANS**

The following table summarizes the components of net periodic benefit costs for the bank's supplemental defined benefit pension plan and for the bank's other postretirement benefit costs for the three months ended March 31:

	Supplemental Defined Pension Benefits		Other Postretirement Benefits	
	2010	2009	2010	2009
Service cost	\$ 38	\$ 22	\$ 47	\$ 48
Interest cost	60	79	107	110
Amortization of prior service costs	89	89	(75)	(75)
Amortization of net loss	58	49	-	-
Net periodic benefit cost	<u>\$ 245</u>	<u>\$ 239</u>	<u>\$ 79</u>	<u>\$ 83</u>

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

**NOTE 9 — SUBSEQUENT EVENTS**

The bank has evaluated subsequent events through May 10, 2010, which is the date the financial statements were issued. Effective May 1, 2010, Steven H. Fowlkes, Senior Vice President and Chief Credit Officer, will end his tenure with the bank and assume the duties of Chief Executive Officer of Lone Star Land Bank, ACA, a district association. There are no other significant subsequent events requiring disclosure as of May 10, 2010.

## 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 multi-employer 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>March 31, 2010</b>	<b>December 31, 2009</b>
Cash	\$ 12,253	\$ 30,542
Investment securities	258,879	35,827
Loans	12,843,882	13,316,686
Less allowance for loan losses	123,171	113,129
Net loans	12,720,711	13,203,557
Accrued interest receivable	144,582	156,805
Other property owned, net	57,700	52,685
Other assets	320,645	325,840
Total assets	\$ 13,514,770	\$ 13,805,256
Bonds and notes	\$ 11,328,067	\$ 11,613,442
Other liabilities	142,275	181,479
Total liabilities	11,470,342	11,794,921
Capital stock and participation certificates	63,600	63,983
Retained earnings	1,973,072	1,937,914
Accumulated other comprehensive income	7,756	8,438
Total members' equity	2,044,428	2,010,335
Total liabilities and members' equity	\$ 13,514,770	\$ 13,805,256

<b>Statement of income data</b>	<b>Three Months Ended March 31,</b>	
	<b>2010</b>	<b>2009</b>
Interest income	\$ 180,532	\$ 194,137
Interest expense	87,537	102,926
Net interest income	92,995	91,211
Provision for loan losses	17,173	24,527
Net interest income after provision for loan losses	75,822	66,684
Noninterest income	7,700	15,897
Other expense	46,617	46,737
Benefit from income taxes	(595)	(256)
Net income	\$ 37,500	\$ 36,100

*This page intentionally left blank.*