



STRENGTH THROUGH DIVERSITY

2008 THIRD QUARTER REPORT
TENTH FARM CREDIT DISTRICT
SEPTEMBER 30, 2008

THIRD QUARTER 2008

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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 and nine months ended September 30, 2008. 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 2007 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 quarter ended September 30, 2008, was \$73,345, an increase of \$7,182, or 10.9 percent, from the quarter ended September 30, 2007. The \$7,182 increase in net income for the third quarter of 2008 was due to a \$10,352 increase in net interest income and \$3,632 increase in noninterest income, offset by a \$4,098 increase in provision for loan losses, a \$2,703 increase in noninterest expense, and a \$1 increase in provision for income taxes.

Net income for the nine months ended September 30, 2008, was \$218,357, an increase of \$40,840, or 23.0 percent, over the same period of 2007. The increase in net income for the nine months ended September 30, 2008, consisted of a \$28,892 increase in net interest income, a \$10,981 increase in noninterest income, a \$7,849 decrease in provision for loan losses, and a \$232 decrease in provision for income taxes, offset by a \$7,114 increase in noninterest expense.

Net Interest Income

Net interest income for the three months ended September 30, 2008, was \$120,642, an increase of \$10,352, or 9.4 percent, from the three months ended September 30, 2007. The increase in net interest income for the quarter ended September 30, 2008, was attributable to a volume increase of \$2.43 billion in the district's average earning assets and an 11-basis-point increase in the district's interest rate spread.

Net interest income for the nine months ended September 30, 2008, was \$350,889, an increase of \$28,892, or 9.0 percent, over the same period of 2007. The increase in net interest income was attributable to a volume increase of \$2.24 billion in the district's average earning assets and an eight-basis-point increase in the district's interest rate spread. The growth in interest-earning assets for the three and nine months ended September 30, 2008, was primarily due to loan growth at the district's associations and to an increase in the bank's participations portfolio, offset by reductions in the bank's investment portfolio. The bank's ability to call and replace debt with borrowings that have preferable terms has enabled the district to maintain its spread in a decreasing interest rate market.

Provision for Loan Losses

The district's provision for loan losses for the quarter ended September 30, 2008, was \$12,431, representing an increase of \$4,098 over the \$8,333 provision for the third quarter of 2007. Provision for loan losses for the nine months ended September 30, 2008, was \$27,504, reflecting a decrease of \$7,849 over the same period of 2007. The increase in provision for the third quarter of 2008 was primarily due to an increase in the bank's provision for loan losses which was primarily related to a third quarter 2008 provision related to participation loans to three borrowers, offset by a decrease in district associations' provision for loan losses which was due to provisions in the third quarter of 2007 related to participations

in a loan to one borrower. The decrease in the provision for the nine months ended September 30, 2008, was primarily due to provisions by associations related to the participation loans to one borrower mentioned above, net of a \$10.6 million increase in the bank's provision for loan losses. The allowance at each period end was considered adequate by management to absorb probable losses existing in and inherent to its loan portfolio.

Noninterest Income

Noninterest income for the quarter ended September 30, 2008, was \$8,562, reflecting an increase of \$3,632, or 73.7 percent, over the same period of 2007. The increase for the third quarter of 2008 over the same period of 2007 was due mainly to a \$2,398 increase in patronage income from another System bank and a \$1,144 increase in fees for loan-related services, offset by a \$90 decrease in all other income items, collectively.

Noninterest income for the nine months ended September 30, 2008, was \$28,154, reflecting an increase of \$10,981, or 63.9 percent, over the same period of 2007. The \$10,981 increase in noninterest income for the nine months ended September 30, 2008, compared to the same period of 2007 was primarily the result of an \$8,786 increase in patronage income from another System bank and a \$3,272 increase in fees for loan-related services, offset by a \$543 decrease in gains on sales of investments and a \$494 decrease in all other income items, collectively.

Noninterest Expense

Noninterest expense for the three and nine months ended September 30, 2008, was \$43,290 and \$132,827, respectively, reflecting an increase of \$2,703 and \$7,114, respectively, over the same periods of 2007. The increase for the third quarter of 2008 as compared to the same period of 2007 is primarily attributable to a \$945 increase in premiums to the Farm Credit System Insurance Corporation (FCSIC or Insurance Fund), a \$628 increase in other operating expenses, a \$556 increase in salaries and employee benefits, a \$363 increase in occupancy and equipment expenses, and a \$211 increase in losses on other property owned. The \$945 increase in premiums paid to the FCSIC was primarily due to a change in the premium base effective July 1, 2008, from loans to Systemwide debt issued. The \$628 increase in other operating expenses was due to a \$385 increase in advertising and member relations, a \$265 increase in travel expenses, a \$171 increase in communications expenses, and a \$71 increase in all other operating expenses, collectively, offset by a \$264 decrease in professional and contract services. The \$556 increase in salaries and employee benefits was primarily due to a \$2,767 increase in compensation and related payroll taxes and a \$168 increase in other benefits, offset by a \$2,295 million increase in salaries and benefits capitalized in accordance with Statement of Financial Accounting Standards (SFAS) No. 91, "Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases," and an \$84 decrease in pension and retirement expenses. Compensation increased due to increases in the number of employees and increases in compensation rates. The \$363 increase in occupancy and equipment expenses was due primarily to an increase in information systems expenses.

The \$7,114 increase in noninterest expense for the nine months ended September 30, 2008, compared to the same period of 2007 was due mainly to a \$2,167 increase in premiums to the FCSIC, a \$1,586 increase in salaries and employee benefits, a \$3,058 increase in other operating expenses, a \$200 increase in occupancy and equipment expenses, and a \$103 increase in losses on other property owned. The \$2,167 increase in premiums paid to the FCSIC was primarily due to a change in the premium base effective July 1, 2008, from loans to Systemwide debt issued and to an increase in the loans on which premiums were based during the first six months of 2008. The \$1,586 increase in salaries and employee benefits was the result of an \$8,081 million increase in salaries and related payroll taxes and a \$439

increase in other benefits, offset by a \$6,690 million increase in salaries and benefits capitalized in accordance with FAS 91, and a \$244 decrease in pension and retirement expenses.

Compensation increased due to increases in the number of employees and increases in compensation rates, primarily at the district's associations. The \$3,058 increase in other operating expenses was due to a \$1,862 million increase in professional and contract services expenses at the district's associations, including a \$608 increase in legal fees, a \$634 increase in travel-related expenses, and a \$516 increase in advertising and member relations, and a \$46 increase in all other operating expenses, collectively. The \$200 increase in occupancy and equipment expenses was due primarily to an increase in information systems expenses.

Key results of operations comparisons:

	Annualized for the Nine Months Ended 9/30/2008	Annualized for the Nine Months Ended 9/30/2007
Return on average assets	1.55%	1.43%
Return on average members' equity	12.46%	10.79%
Net interest income as a percentage of average earning assets	2.53%	2.64%
Charge-offs, net of recoveries, to average loans	0.01%	0.28%
Operating expenses as a percentage of net interest income and noninterest income	34.96%	37.00%
Operating expenses as a percentage of average earning assets	0.95%	1.03%

FINANCIAL CONDITION

Loan Portfolio

Gross loan volume at September 30, 2008, was \$16,542,392, an increase of \$1,427,855, or 9.4 percent, from \$15,114,537 at December 31, 2007, and an increase of \$2,097,119, or 14.5 percent, from \$14,445,273 at September 30, 2007. The primary factors contributing to the growth in the district's loan volume included an increased focus on market share and loan growth opportunities within the territory, growth in loan participations, and increased marketing and customer service efforts by the associations.

Overall credit quality in the district remained strong during the quarter. Loans classified as "acceptable" or "other assets especially mentioned" as a percentage of total loans and accrued interest receivable were 97.5 percent at September 30, 2008, 98.8 percent at December 31, 2007, and 99.0 percent at September 30, 2007. Nonaccrual loans for the district were 0.96 percent of total loans at September 30, 2008, compared to 0.66 percent at December 31, 2007, and 0.54 percent at September 30, 2007. The \$50,666 allowance for loan losses at September 30, 2008, constituted 0.31 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 \$51.6 million, or 41.2 percent, to \$176.7 million at September 30, 2008, from \$125.1 million at December 31, 2007.

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

	September 30, 2008	Increase (Decrease)		December 31, 2007
		<u>\$</u>	<u>%</u>	
Nonaccrual loans	\$ 158.3	\$ 58.2	58.1 %	\$ 100.1
Formally restructured loans	6.3	-	-	6.3
Loans 90 days past due and still accruing interest	11.3	(5.6)	(33.1)	16.9
Total impaired loans	175.9	52.6	42.7	123.3
Other property owned, net	0.8	(1.0)	(55.6)	1.8
Total high-risk assets	<u>\$ 176.7</u>	<u>\$ 51.6</u>	<u>41.2 %</u>	<u>\$ 125.1</u>

Nonaccrual loans at September 30, 2008, include participation loans totaling \$94.3 million to six borrowers held by the bank and nine district associations, with specific allowances on these loans totaling \$18.3 million.

The \$58.2 million increase in nonaccrual loans from December 31, 2007, to September 30, 2008, includes a \$20.1 million increase in nonaccrual loans to one borrower held by four district associations, and two loans totaling \$13.6 million held by the bank and \$6.1 million in loans to one borrower held by the bank and one association. The \$5.6 million decrease in accruing loans past due 90 days or more consisted of a \$9.9 million decrease in bank participation loans, offset by a \$4.0 million increase from association loans. Impaired loans, consisting of nonaccrual loans, formally restructured loans, and loans past due 90 days or more and still accruing interest, constituted 1.1 percent of gross loans at September 30, 2008, and 0.8 percent of gross loans at December 31, 2007.

Liquidity and Funding Sources

In September 2008, the bank issued \$50.0 million in subordinated debt in a private placement to one investor. The debt is a 10-year instrument with a coupon rate of 8.406 percent. The FCA confirmed its determination that the subordinated debt will receive preferential regulatory ratio treatment, being includible in permanent capital and total surplus and being excludible from total liabilities for purposes of net collateral ratio calculation. These preferential treatments will be ratably removed 20 percent per year during years six to 10 of the debt's term.

As of September 30, 2008, the Farm Credit Bank of Texas and all district associations exceeded all regulatory liquidity requirements. Cash and investment securities totaled \$2,805,138, or 14.3 percent, of total assets at September 30, 2008, compared to \$2,592,204, or 14.4 percent, at December 31, 2007, reflecting an increase of \$212,934, or 8.2 percent. Interest-bearing liabilities, consisting of bonds, notes, and subordinated debt, increased by \$1,502,902, or 9.8 percent, in order to fund the increases in loan volume.

In August 2008, Moody's Investor Service upgraded the bank's issuer rating to Aa2 from the Aa3 rating it had issued in July 2008. In addition, its A2 preferred stock rating was affirmed and it received an A1 subordinated debt rating. In June 2008, Fitch Ratings, Ltd., issued an AA-long-term issuer default rating with a Stable Rating Outlook and assigned an A rating to the bank's preferred stock.

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 \$52.2 million at September 30, 2008. The held-to-maturity portfolio consisted of mission-related rural housing mortgage-backed securities that had a fair value of \$51.7 million. One association held an \$18.5 million available-for-sale portfolio consisting of investments in SBA-guaranteed loans with a \$167 unrealized gain at September 30, 2008. The bank's

available-for-sale portfolio includes \$93.6 million in asset-backed securities, including \$21.0 million in securitizations of Sallie Mae loans and \$72.6 million of sub-prime mortgage, asset-backed securities. Due to the economic conditions currently affecting that market, the bank reviews internally the investments in question, and consults with outside analysts. Of the sub-prime asset-backed securities, \$70.5 million were rated Aaa and AAA by Moody's and Standard and Poor's, respectively. One \$2.1 million securitization of sub-prime mortgages was downgraded to Baa3 and BB by Moody's and Standard and Poor's, respectively. In May 2008, the FCA approved the bank's plan of divestiture for this downgraded investment, which indicated the bank's desire to continue to hold the investment. Subsequent changes in market or credit conditions could change these evaluations. The bank continues to monitor these investments. Asset-backed securities represent 4.8 percent of the bank's investment portfolio.

In addition, the bank's liquidity investment portfolio includes \$101.3 million of money market holdings in The Reserve U.S. Government Fund (Government Fund). This fund is composed of short-term senior debt securities issued by Federal National Mortgage Association (Fannie Mae), Federal Home Loan Mortgage Association (Freddie Mac), Federal Home Loan Bank and Farm Credit System. Effective September 18, 2008, the Securities and Exchange Commission (SEC) issued an order, at the request of The Reserve, to suspend all rights of redemption on its Government Fund and other funds. The Reserve was experiencing heavy redemption requests on all of its funds due to the negative publicity associated with its Primary Fund's net asset value (NAV) falling below \$1 per share. The Reserve's Primary Fund was holding commercial paper issued by Lehman Brothers Holdings, Inc. when it filed bankruptcy on September 15, 2008. The bank has no holdings in the Primary Fund. The SEC's goal is to ensure an orderly disposition of the securities in the Government Fund to maintain the integrity of the fund's NAV of \$1.00 per share. The Government Fund is continuing to be priced daily and is reporting NAV of \$1.00 which means the bank's investment is valued at par. The Reserve is working with the SEC to finalize an ultimate liquidation plan for the Government Fund. Distributions from the Government Fund are expected to begin in the fourth quarter of 2008. The fund is currently rated AAA/watch negative and is an eligible liquidity investment by regulation.

Capital Resources

Total members' equity increased \$165,654, or 7.4 percent, from December 31, 2007, to the September 30, 2008, total of \$2,416,315. This increase is the result of net income of \$218,357 for the nine months ended September 30, 2008, an adjustment to accumulated other comprehensive income of \$1,152, and a net increase in capital stock of \$1,602, offset by dividends paid on preferred stock totaling \$7,561, an increase in unrealized net losses on investment securities totaling \$17,011, an \$882 unrealized loss on cash flow derivatives, an adjustment to retained earnings of \$2,713 resulting from the effects of an accounting change regarding the measurement date of postretirement benefits plans pursuant to FASB Statement No. 158, revolvment of allocated retained earnings of \$2,526, and patronage declared of \$24,764.

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. The bank performs other-than-temporary-impairment assessments of our investment securities based on evaluations of both current and future market and credit conditions at each quarter-end. The district considers all of the unrealized losses on its investment securities to be temporary in nature, and has both the ability and the intent to recover all of its investment in the securities.

Key financial condition comparisons:

	<u>September 30, 2008</u>	<u>December 31, 2007</u>
Members' equity to assets	12.29%	12.51%
Total liabilities to members' equity	7.14:1	7:1
Allowance for loan losses to total loans	0.31%	0.16%

OTHER

On September 30, 2008, the bank, in concert with the four other System banks, purchased senior cumulative perpetual preferred stock of the Federal Agricultural Mortgage Corporation (Farmer Mac). The bank's investment is \$7.0 million of the \$60.0 million total invested by System banks. The investment will enable Farmer Mac to strengthen its capital position and comply with its minimum regulatory capital requirements. The investment is not considered part of the bank's liquidity investment portfolio and is included in other assets at cost.

Effective October 1, 2008, two of the district's associations, Capital Farm Credit, ACA and First Ag Credit, FCS, merged to form Capital Farm Credit, ACA.

The undersigned certify that we have reviewed the September 30, 2008, 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
Chief Financial Officer

November 4, 2008

Combined Balance Sheets

(dollars in thousands)	September 30, 2008 (Unaudited)	December 31, 2007
Assets		
Cash	\$ 29,235	\$ 55,703
Federal funds sold and securities purchased under resale agreements	187,398	125,502
Investment securities	2,588,505	2,410,999
Loans	16,542,392	15,114,537
Less allowance for loan losses	50,666	24,495
Net loans	16,491,726	15,090,042
Accrued interest receivable	252,309	228,212
Other property owned, net	753	1,817
Premises and equipment, net	46,334	42,599
Other assets	63,264	41,623
Total assets	\$ 19,659,524	\$ 17,996,497
Liabilities and members' equity		
Liabilities		
Bonds and notes, net	\$ 16,826,917	\$ 15,324,015
Subordinated debt	50,000	-
Accrued interest payable	124,821	122,459
Patronage distributions payable	15,315	63,899
Other liabilities	226,156	235,463
Total liabilities	17,243,209	15,745,836
Commitments and contingent liabilities (Note 3)		
Members' equity		
Preferred stock	202,754	202,754
Capital stock and participation certificates	64,091	62,489
Allocated retained earnings	135,933	133,423
Unallocated retained earnings	2,064,771	1,886,488
Accumulated other comprehensive loss	(51,234)	(34,493)
Total members' equity	2,416,315	2,250,661
Total liabilities and members' equity	\$ 19,659,524	\$ 17,996,497

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

Combined Statements of Income

(unaudited)

(dollars in thousands)	Quarter Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
Interest Income				
Investment securities	\$ 27,330	\$ 32,635	\$ 82,478	\$ 100,256
Loans	250,763	271,672	755,381	780,309
Total interest income	278,093	304,307	837,859	880,565
Interest Expense				
Bonds, notes, and subordinated debt	132,592	168,102	408,659	490,716
Notes payable and other	24,859	25,915	78,311	67,852
Total interest expense	157,451	194,017	486,970	558,568
Net interest income	120,642	110,290	350,889	321,997
Provision for loan losses	12,431	8,333	27,504	35,353
Net interest income after provision for loan losses	108,211	101,957	323,385	286,644
Noninterest Income				
Loan-related fees	4,591	3,447	13,362	10,090
Gain from sale of investment securities	-	-	-	543
Miscellaneous income, net	3,971	1,483	14,792	6,540
Total noninterest income	8,562	4,930	28,154	17,173
Noninterest Expense				
Salaries and employee benefits	21,114	20,558	66,424	64,838
Occupancy and equipment	3,244	2,881	9,155	8,955
Insurance Fund premiums	6,124	5,179	17,597	15,430
Losses on other property owned, net	319	108	313	210
Other operating expenses	12,489	11,861	39,338	36,280
Total noninterest expense	43,290	40,587	132,827	125,713
Income before provision for income taxes	73,483	66,300	218,712	178,104
Provision for income taxes	138	137	355	587
Net Income	\$ 73,345	\$ 66,163	\$ 218,357	\$ 177,517

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

Combined Statements of Changes in Members' Equity

(unaudited)

(dollars in thousands)	Preferred Stock	Capital Stock	Allocated Retained Earnings	Unallocated Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total Members' Equity
Balance at December 31, 2006	\$ 203,565	\$ 59,068	\$ 83,705	\$ 1,792,723	\$ (26,401)	\$ 2,112,660
Comprehensive income						
Net income	-	-	-	177,517	-	177,517
Net change in unrealized losses on investment securities	-	-	-	-	12,125	12,125
Total comprehensive income	-	-	-	177,517	12,125	189,642
Capital stock/participation certificates issued	-	9,641	-	-	-	9,641
Capital stock/participation certificates and allocated retained earnings retired	(395)	(6,955)	(936)	-	-	(8,286)
Preferred stock dividends paid	-	-	-	(7,561)	-	(7,561)
Patronage distributions						
Cash	-	-	-	(14,246)	-	(14,246)
Members' equity	-	-	6,307	(6,307)	-	-
Balance at September 30, 2007	\$ 203,170	\$ 61,754	\$ 89,076	\$ 1,942,126	\$ (14,276)	\$ 2,281,850
Balance at December 31, 2007	\$ 202,754	\$ 62,489	\$ 133,423	\$ 1,886,488	\$ (34,493)	\$ 2,250,661
Comprehensive income						
Net income	-	-	-	218,357	-	218,357
Amortization of costs included in net periodic pension costs	-	-	-	-	1,152	1,152
Net change in unrealized losses on investment securities	-	-	-	-	(17,011)	(17,011)
Net change in unrealized gains on cash flow derivatives	-	-	-	-	(882)	(882)
Total comprehensive income	-	-	-	218,357	(16,741)	201,616
Effects of accounting change regarding measurement date of postretirement benefits plans pursuant to FASB Statement No. 158	-	-	-	(2,713)	-	(2,713)
Capital stock/participation certificates issued	-	11,004	-	-	-	11,004
Capital stock/participation certificates allocated retained earnings retired	-	(9,402)	(2,526)	-	-	(11,928)
Preferred stock dividends paid	-	-	-	(7,561)	-	(7,561)
Patronage distributions						
Cash	-	-	-	(24,764)	-	(24,764)
Members' equity	-	-	5,036	(5,036)	-	-
Balance at September 30, 2008	\$ 202,754	\$ 64,091	\$ 135,933	\$ 2,064,771	\$ (51,234)	\$ 2,416,315

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

Combined Statements of Cash Flows

(unaudited)

(dollars in thousands)	Nine Months Ended September 30,	
	2008	2007
Operating activities		
Net income	\$ 218,357	\$ 177,517
Reconciliation of net income to net cash provided by operating activities		
Provision for loan losses	27,504	35,353
(Negative provision) provision for losses on other property owned	(289)	147
Depreciation and amortization on premises and equipment	4,247	4,015
Accretion of net discount on loans	(766)	(1,538)
Amortization and accretion on debt instruments	(1,720)	(1,774)
Amortization of net discount (premium) on investment securities	339	(2,201)
Gain on sale of investment securities	-	(543)
Losses from sales of other property owned, net	153	13
Gains from sales of premises and equipment	(3,207)	(1,285)
Increase in accrued interest receivable	(24,097)	(80,327)
Increase in other assets	(4,376)	(4,061)
Increase in accrued interest payable	2,362	34,121
Decrease in other liabilities	(9,755)	(11,320)
Net cash provided by operating activities	208,752	148,117
Investing activities		
Net increase in federal funds sold and securities purchased under resale agreements	(61,896)	(75,351)
Investment securities		
Purchases	(2,329,932)	(3,222,546)
Proceeds from maturities, calls and prepayments	2,135,077	3,376,056
Proceeds from sales	-	83,163
Investment in Farmer Mac preferred stock	(7,000)	-
Patronage stock from System banks	(6,468)	(1,998)
Increase in loans, net	(1,427,222)	(1,566,429)
Proceeds from sale of loans	800,000	600,000
Proceeds from sales of premises and equipment	2,373	3,492
Expenditures for premises and equipment	(7,148)	(7,272)
Net cash used in investing activities	(902,216)	(810,885)
Financing activities		
Bonds and notes issued	36,819,746	20,564,392
Subordinated debt issued, net of costs	49,433	-
Bonds and notes retired	(36,118,013)	(19,858,213)
Decrease in advanced conditional payments	(2,337)	(1,201)
Capital stock and participation certificates issued	11,004	9,641
Capital stock and participation certificates retired	(11,928)	(8,286)
Cash dividends on preferred stock	(7,561)	(7,561)
Cash patronage distributions paid	(73,348)	(69,762)
Net cash provided by financing activities	666,996	629,010
Net decrease in cash	(26,468)	(33,758)
Cash at beginning of year	55,703	60,170
Cash at end of quarter	\$ 29,235	\$ 26,412
Supplemental schedule of noncash investing and financing activities		
Financed sales of other property owned	\$ 7,758	\$ 2,307
Loan assets transferred to other property owned	6,558	1,929
Net (increase) decrease in unrealized losses on investment securities	(17,010)	12,125
Cash dividends or patronage distributions payable	15,315	4,556
Supplemental schedule of noncash changes in fair value related to hedging activities		
Increase in bonds and notes	\$ 2,889	\$ 10,168
Supplemental information		
Cash paid for:		
Interest	\$ 484,608	\$ 524,447
Income taxes	705	315

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

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, 2007, are contained in the 2007 Annual Report to stockholders (Annual Report). These unaudited third quarter 2008 financial statements should be read in conjunction with the Annual Report.

In December 2007, the Financial Accounting Standards Board (FASB) issued Statements of Financial Accounting Standards (SFAS) No. 141R, "Business Combinations" (SFAS No. 141R). SFAS No. 141R requires business combinations to be accounted for under the acquisition method of accounting (previously called the purchase method). The acquisition method requires (a) identifying the acquirer, (b) determining the acquisition date, (c) recognizing and measuring the identifiable assets acquired, the liabilities assumed and any noncontrolling interest in the acquiree, at their acquisition date fair values, and (d) recognizing and measuring goodwill or a gain from a bargain purchase. SFAS No. 141R should be applied prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. Early application is prohibited. The bank and its related associations are still evaluating the provisions of the standard, but believe that its adoption will significantly impact its accounting for acquisitions that occur in 2009 and beyond.

In March 2008, the FASB issued SFAS No. 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 No. 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.

This statement is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008, with early application encouraged. This statement encourages, but does not require, comparative disclosures for earlier periods at initial adoption. The bank is currently evaluating the impact of adoption on its financial statement disclosures.

Effective January 1, 2008, the bank and its related associations adopted SFAS No. 157, "Fair Value Measurements" (SFAS No. 157). This statement defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements. It describes three levels of inputs that may be used to measure fair value:

Level 1 - Quoted prices in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date. Level 1 assets and liabilities include debt and equity securities and derivative contracts that are traded in an active exchange market, as well as certain U.S. Treasury,

other U.S. government and agency mortgage-backed debt securities that are highly liquid and are actively traded in over-the-counter markets.

Level 2 - Observable inputs other than quoted prices included within Level 1 that are observable for the asset or liability either directly or indirectly. Level 2 inputs include the following: (a) quoted prices for similar assets or liabilities in active markets; (b) quoted prices for identical or similar assets or liabilities in markets that are not active so that they are traded less frequently than exchange-traded instruments, the prices are not current, or principal market information is not released publicly; (c) inputs other than quoted prices that are observable such as interest rates and yield curves, prepayment speeds, credit risks, and default rates, and (d) inputs derived principally from or corroborated by observable market data by correlation or other means. This category generally includes certain U.S. government and agency mortgage-backed debt securities, corporate debt securities, and derivative contracts.

Level 3 - Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities. These unobservable inputs reflect the reporting entity's own assumptions about assumptions that market participants would use in pricing the asset or liability. Level 3 assets and liabilities include financial instruments whose value is determined using pricing models, discounted cash flow methodologies, or similar techniques, as well as instruments for which the determination of fair value requires significant management judgment or estimation. This category generally includes certain private equity investments, retained residual interests in securitizations, asset-backed securities, and highly structured or long-term derivative contracts.

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 — ALLOWANCE FOR LOAN LOSSES

An analysis of the allowance for loan losses follows:

	Nine Months Ended September 30,	
	2008	2007
Balance at beginning of period	\$ 24,495	\$ 13,969
Provision for loan losses	27,504	35,353
Loans charged off	(2,025)	(29,054)
Recoveries	692	662
Balance at end of period	<u>\$ 50,666</u>	<u>\$ 20,930</u>

At September 30, 2008, impaired loans of \$101.7 million had a related specific allowance of \$27.4 million, while the remaining \$74.2 million of impaired loans had no related specific allowance. Provision for loan losses and loans charged off for the first nine months of 2007 included \$24.7 million and \$15.2 million, respectively, related to participation loans to one borrower held by 12 district associations.

The average recorded investment in impaired loans for the nine months ended September 30, 2008, was \$139.5 million. The district recognized interest income of \$1.8 million on impaired loans during the nine months ended September 30, 2008, as compared to \$2.2 million for 2007.

NOTE 3 — 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 September 30, 2008, were approximately \$173.6 billion.

In early February 2008, the bank was named as a counter-defendant in a lawsuit involving a lending matter between an association in the district and a borrower group. In April 2008, the bank was dismissed without prejudice from the lawsuit.

Other actions are pending against the bank and associations in which claims for monetary damage are asserted. Upon the basis of current information, management and legal counsel are of the opinion that the ultimate liability, if any, resulting therefrom will not be material in relation to the combined financial positions or results of operations of the bank and associations.

NOTE 4 — FAIR VALUE MEASUREMENTS

SFAS No. 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, “Organization and Significant Accounting Policies” for additional information.

There was no financial statement impact resulting from the adoption of SFAS No. 157 by the bank and its related associations.

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

Fair Value Measurements at September 30, 2008				
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
	Total			
Available-for-sale investment securities	\$ 2,723,748	\$ -	\$ 2,489,548	\$ 234,200
Derivatives, net	8,863	-	8,863	-
Total	<u>\$ 2,732,611</u>	<u>\$ -</u>	<u>\$ 2,498,411</u>	<u>\$ 234,200</u>

The following table represents a reconciliation of all assets and liabilities measured at fair value on a recurring basis using significant unobservable inputs (Level 3) for the period from January 1, 2008, to September 30, 2008.

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

Available-for-sale investment securities:

Balance at December 31, 2007	\$ 273,231
Net losses included in other comprehensive income	(701)
Purchases, issuances and settlements	(21,639)
Transfers from Level 3	(16,691)
Balance at September 30, 2008	<u>\$ 234,200</u>

The net losses included in other comprehensive income in the previous table are all on securities held at September 30, 2008.

Valuation Techniques

As more fully discussed in Note 1, “Organization and Summary of Significant Accounting Policies,” SFAS No. 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 are 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 September 30, 2008, include certain asset-backed securities and commercial paper.

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.

NOTE 5 — EMPLOYEE BENEFIT PLANS

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 nine months ended September 30:

	Pension Benefits		Other Benefits	
	<u>2008</u>	<u>2007</u>	<u>2008</u>	<u>2007</u>
Service cost	\$ 4,193	\$ 3,907	\$ 798	\$ 926
Interest cost	11,582	10,161	1,762	1,703
Expected return on plan assets	(10,607)	(9,186)	-	-
Amortization of prior service costs	611	858	(1,261)	(1,383)
Amortization of net loss	1,538	2,378	14	54
Net periodic benefit cost	<u>\$ 7,317</u>	<u>\$ 8,118</u>	<u>\$ 1,313</u>	<u>\$ 1,300</u>

The district recorded a \$2,713 charge against retained earnings pursuant to a change in the measurement date of postretirement benefits from September 30 to December 31, in accordance with SFAS No. 158.

As of September 30, 2008, \$14.8 million of contributions has been made for pension benefits. The district presently anticipates no additional contributions to fund its pension plan in 2008.

NOTE 6 — 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 7 — SUBORDINATED DEBT

In September 2008, the bank issued \$50 million of 8.406 percent unsecured subordinated notes due in 2018, generating proceeds of \$49.4 million. The proceeds were used to increase regulatory permanent capital and total surplus pursuant to Farm Credit Administration regulations and for general corporate purposes. This debt is unsecured and subordinate to all other categories of creditors, including general creditors, and senior to all classes of shareholders. Interest is payable semi-annually on March 15 and September 15. Interest will be deferred if, as of the fifth business day prior to an interest payment date of the debt, any applicable minimum regulatory capital ratios are not satisfied. A deferral period may not last

for more than five consecutive years or beyond the maturity date of the subordinated debt. During such a period, we may not declare or pay any dividends or patronage refunds, among certain other restrictions, until interest payments are resumed and all deferred interest has been paid. The subordinated debt is not considered Systemwide debt and is not guaranteed by the Farm Credit System or any banks in the System. Payments on the subordinated notes are not insured by the Farm Credit Insurance Fund.

NOTE 8 — 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	September 30, 2008	December 31, 2007
Cash	\$ 15,220	\$ 16,600
Federal funds sold and securities purchased under resale agreements	187,398	125,502
Investment securities	2,569,964	2,410,999
Loans	11,420,702	10,865,991
Less allowance for loan losses	12,035	1,065
Net loans	11,408,667	10,864,926
Accrued interest receivable	63,326	66,789
Premises and equipment, net	5,342	2,719
Other assets	55,326	33,243
Total assets	\$ 14,305,243	\$ 13,520,778
 Bonds and notes	\$ 13,326,917	\$ 12,624,015
Subordinated debt	50,000	-
Accrued interest payable	116,388	110,188
Other liabilities	52,423	57,974
Total liabilities	13,545,728	12,792,177
Preferred stock	200,000	200,000
Capital stock	198,865	198,864
Retained earnings	383,297	334,394
Accumulated other comprehensive loss	(22,647)	(4,657)
Total shareholders' equity	759,515	728,601
Total liabilities and shareholders' equity	\$ 14,305,243	\$ 13,520,778
Statement of income data	Nine Months Ended September 30, 2008	2007
Interest income	\$ 496,536	\$ 565,519
Interest expense	408,695	490,720
Net interest income	87,841	74,799
Provision for loan losses	10,745	118
Net interest income after provision for loan losses	77,096	74,681
Noninterest income	24,754	15,157
Noninterest expense	39,485	35,246
Net income	\$ 62,365	\$ 54,592